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THE TRANSPARENCY ISSUES ASSOCIATED WITH CHINA'S SOVEREIGN WEALTH FUND

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ABSTRACT: *Sovereign wealth funds (SWF), though a relatively recent financial vehicle has had a profound impact in the world's political and financial arenas. SWF's have the potential to provide a much needed source of capital for a nation or enterprise which could foster and spur economic growth as well as international trade. In the long-run, such international collaborations and investments could pave the way for a more peaceful globalization of the world. However, such governmental intrusions could also lead to unwanted foreign governmental control and possible loss of trade secrets and other sensitive national security interests. Perhaps an even greater issue is the possible political implications that could arise when it comes to SWFs. For example, certain SWFs could choose to invest capital with political allies thereby indirectly punishing their political foes. However, at the central issue with any SWF, is the issue of transparency. SWFs have been notorious for being shrouded in secrecy, from the way a fund is managed to how they choose to invest. With China, this issue is highlighted even more given the political climate coupled with its history and customs regarding foreigners. This paper will take an in-depth look into China's largest SWF, the China Investment Corporation and compare it to SWFs of other nations and analyze as to what possible solutions China can take to make its SWF more transparent in the eyes of the international community and whether given China's historical past, current political climate and unique culture and traditions can allow such changes and reforms to be possible. After all, what works for the western world may not necessarily work for China. Finally, this paper will examine certain reforms China's SWF can make and what collateral benefits such changes could potentially bring.*

KEYWORDS: Sovereign wealth fund, transparency, Santiago principles, China Investment Corporation, economic reform

INTRODUCTION

There is no denying the fact that as time marches forward, mankind is living in an increasingly smaller world – smaller in the sense that large distances do not seem to be as significant a barrier anymore. With the onset of various technological advances, we are becoming more accessible to one another and more interdependent than ever. We truly have transformed from a world of local communities to one global society. This notion applies not only to people but to countries as well.

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One move by one country can have vast and consequential results for another country. In the realm of foreign direct investment, this is no new concept. Private companies and enterprises have been investing, acquiring and merging with their counterparts in other nations for quite some time now. However, the relatively recent emergence of sovereign wealth funds only highlights the globalization of society that much more. Sovereign wealth funds allow a foreign government to directly invest in another country and as such, to literally lay claim to another nation's enterprise. For those sitting on the sidelines or directly involved in such transactions, this could be viewed as a welcome infusion of badly needed capital. However, for others, this is nothing more than a foreign invasion of sorts—a type of foreign financial invasion. Many nations have established such funds and as experience and history tells us, there are various pros and cons associated with sovereign wealth funds.

In short, a sovereign wealth fund is an investment fund owned by the state that invests in both real and financial assets. These assets can range from stocks and bonds to real estate and business enterprises as well as precious metals or other alternative investments such as hedge funds or private equity funds. Usually, sovereign wealth funds are created when governments have an excess budget surplus while possessing little to no debt. Most of the time, sovereign wealth funds are funded through commodity export revenues or from foreign-exchange reserves held by a central bank.

As stated earlier, sovereign wealth funds have been met with both positive and negative outlooks. Those that champion the emergence and rise of sovereign wealth funds hail it as a source of much needed capital. Given the relatively large pool of capital that these funds have under management, financially-troubled or cash-strapped enterprises can view sovereign wealth funds as potential suitors to help turnaround a business on the brink of collapse. Proponents of sovereign wealth funds see these funds as passive investors in for the long haul. Finally, sovereign wealth funds have the potential to foster international trade and improve political and economic relations between nations and allies.

However, many of these pros can be turned into cons in the eyes of those who look at sovereign wealth funds with a wary and skeptical eye. First of all, the idea of foreign government control over another nation's financial interests or to have a country even have a say or stake in another nation's economic welfare is enough to make most nations flinch. Moreover, given the lack of transparency behind sovereign wealth funds, in terms of what types of oversight are put in place, how and why investment decisions are made and the reasons why certain nations receive funding as opposed to others, it becomes entirely reasonable to see why sovereign wealth funds are feared by some.

China is no different in that it too, has a sovereign wealth fund. China's sovereign wealth fund, China Investment Corp. (CIC) ranks fourth in the world in terms of the amount of capital it has under management. Presently, CIC has approximately $575.2 billion under management. What makes this figure even more impressive is the fact that this fund only saw its inception in 2007 with an initial $200 billion. In essence, it only took six years for CIC to nearly triple the size of its fund. However, given the party-dominated structure of China's government, it is sometimes privy to more scrutiny, perhaps sometimes unfairly. This paper aims to explore the emergence of

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sovereign wealth funds, its inception in China and the types of changes and reforms China could pursue in the future to mitigate any potential criticisms with regards to the operation of its sovereign wealth fund. More importantly, this paper will specifically explore some of the legal implications and ambiguities that are unique to China's sovereign wealth fund and any steps that can be taken to dispel any claims of lack of transparency or governmental collusion with its fund operatives.

RESEARCH METHODOLOGIES

In my mind, the Chinese sovereign wealth fund is the perfect microcosm of the Chinese economic situation given China's history of having a planned economy. Perhaps the reforms, adjustments and improvements China makes in terms of its sovereign wealth fund can one day be implemented on a larger scale towards its economic model in its efforts to move toward a complete market-based economy.One of the main methodologies I employ in my research is through case studies and analysis. During the course of my research, I studied and analyzed the sovereign wealth funds of other nations, especially ones that have substantial amounts of capital under management. As such, I looked quite closely at the sovereign wealth funds of nations like Norway, United Arab Emirates and Kuwait. I looked at how these nations managed their respective funds and how they handled any of the similar criticisms that China's sovereign wealth fund encountered. Furthermore, I analyzed whether or not the solutions and actions used by their various funds are compatible and transferable to China's situation, given China's economic and political climate as well as China's unique customs and business culture. After all, what may work in an Arab or Western country might not necessarily work for China.

My research will also include an informative overview of China's sovereign wealth fund, China Investment Corporation (CIC), its history, inception and where it is headed in the future. In addition, I will also talk about CIC's wholly-owned subsidiary, Central Hujin and its role in regards to CIC. I will talk about the potential conflicts of interest that exist by having Central Hujin as a subsidiary of CIC and how it will contribute to criticisms regarding CIC's transparency. Furthermore, I will postulate that having Central Hujin as a subsidiary is actually a detriment to CIC's economic potential and efficiency.

Sovereign Wealth Fund Defined

In order to properly understand the issues and concerns relating to sovereign wealth funds, it is essential to first understand what exactly a sovereign wealth fund is. To put it simply, there actually is no definition of sovereign wealth fund that is universally agreed upon among nations. The term "sovereign wealth fund" is a rather recent term and as mentioned in the introduction of this paper, the term was first coined by Andrew Rozanov in 2005 in an article entitled, "Who holds the wealth of nations?" which was published in the Central Banking Journal. But despite its relative recent coinage, sovereign wealth funds have actually been existence for more than a century. In fact, the earliest sovereign wealth funds began in the U.S. state of Texas in the latter half of the 19th century to fund public education. The Permanent School Fund (PSF) was created in 1854 to benefit primary and secondary schools while the Permanent University Fund (PUF) which was created in 1876 was used to benefit universities. Furthermore, the first sovereign wealth fund that was established for a sovereign state is the Kuwait Investment Authority which was created in 1953 from oil revenues. In short, a sovereign wealth fund is a state-owned investment fund that invests in real and financial assets such as stocks, bonds, real estate, business enterprises, precious metals or other alternative investments such as hedge funds or private equity funds. Sovereign wealth funds are usually created when governments have a substantial budget surplus and little or no debt. Most sovereign wealth funds are funded by revenues from commodity exports or from foreign-exchange reserves held by a central bank. According to the U.S. Treasury Department, SWFs are "a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities (the Central Bank and reserve-related functions of the Finance Ministry).[2] However, there are others who have given a more specific definition, such as Mr. Stephen Jen, who works as a currency analyst at Morgan Stanley. According to Mr. Jen, sovereign wealth funds hold five key attributes:

1) They are sovereign government entities that possess;
2) High foreign currency exposures;
3) Possess no explicit liabilities such as a national state pension fund;
4) Contain high-risk tolerances; and
5) Have long investment horizons.[3]

Three Primary Types of Sovereign Wealth Funds

Other international agencies and bodies such as the International Monetary Fund (IMF) actually further divide sovereign wealth funds into several other categories based on their intended goals though in practice, most sovereign wealth funds possess elements from all these categories. According to the IMF, the three primary types of SWFs are (1) Stabilization funds, (2) Savings funds and (3) Reserve investment corporations. A more detailed look into these three primary types of sovereign wealth funds is described as follows.

1) Stabilization funds – For resource and commodity intensive economies, volatile international market prices are a primary concern. In fact, certain commodities face price fluctuations of an average of 20%-25% per year. In order to offset and mitigate this volatility, many countries established funds that would in effect, sterilize capital inflows while stabilizing fiscal revenues. Due to the fact that stabilization funds serve a more immediate function than long-term savings funds, these types of funds tend to be more conservative in nature. As such, these funds would focus more on fixed income rather than higher risk equity investments.[4] Russia's Stabilization Fund of the Russian Federation and Kazakhstan's National Oil Fund are prime examples of stabilization funds due to these funds intended nature, purpose and the way they operate.

2) Savings funds – These types of funds are meant to share wealth across generations as the name of the fund would seem to imply. For countries rich in natural resources, savings funds convert nonrenewable natural resources into a diversified portfolio of international financial assets to provide for future generations or other long-term objectives. According to the IMF, while newer

[2] "Report to Congress on International Economic and Exchange Rate Policies," Department of the Treasury, December 2007, at [http://www.treas.gov/offices/international-affairs/economic-exchange-rates/].
[3] Stephen Jen, "Currencies: The Definition of a Sovereign Wealth Fund," *Morgan Stanley Research*, October 25, 2007.
[4] Rachel Ziemba, "Responses to Sovereign Wealth Funds: Are 'Draconian' Measures on the Way?," *RGE Monitor*, November 2007.

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oil funds predominantly focus on stabilization objectives, the recent increase in oil prices has allowed SWFs to emphasize savings objectives. Because savings funds have longer investment horizons than pure stabilization funds, they invest in a broader range of assets, including bonds and equities, as well as other forms of alternative investments, such as real estate, private equity, hedge funds, and commodities. Examples include the Abu Dhabi Investment Authority, Kuwait Investment Authority, Singapore's Government Investment Corporation, and the China Investment Corporation.

3) Reserve investment corporations — Reserve investment corporations are funds established to reduce the opportunity cost of holding excess foreign reserves or to pursue investment policies with higher returns. Reserve investment corporations adapt more aggressive investment strategies, including taking direct equity stakes. These funds typically seek higher returns than other SWFs and use leverage (i.e., debt) in their investments. Historically, these vehicles tend to be more secretive than other SWFs that are primarily portfolio investors.17 Examples of such funds are Singapore's Temasek, Qatar's Investment Authority, and Abu Dhabi's Mubadala.[5]

The Emergence of Sovereign Wealth Funds

In 1953, Kuwait established the first sovereign wealth fund as a means and method to help stabilize the economy from fluctuating oil prices. Then in 1956, the Gilbert Islands, now known as Kiribati established the Revenue Equalization Reserve Fund to manage profits from phosphate mining. Following the actions taken by Kuwait and Kiribati, the next major SWFs were created in the 1970s during the onset of the oil shock. The most recent wave began in the 1990s with the Norway Government Pension Fund-Global in 1990 and this trend continues even today with no signs of slowing down. In the last five years alone, funds have been established by China, Iran, Russia, Qatar, and the United Arab Emirates. As noted previously, the recent growth of SWFs is due to the rapid growth in emerging market reserves driven by (1) the impact of rising oil prices for Middle Eastern economies and (2) large trade surpluses, net foreign direct investment flows, and high savings rates among Asian economies. Reserve accumulation has been especially sharp in the case of China, where there has been extensive intervention in the foreign exchange markets to limit the yuan's appreciation against the dollar.[6] Furthermore, analysts estimate that foreign assets held by sovereign nations currently exceed the $5 trillion mark and are increasing at a significantly more rapid rate in emerging market countries with high savings rates than in the industrialized countries.[7]

Among Asian economies, the expansion of reserves has been even more dramatic. By 2006, Asia held 54% of the then $4.2 trillion of worldwide reserves, more than the global total 10 years earlier.[8] Asian reserve accumulation is largely the result of persistent and sustained current account

[5] "Global Financial Stability Report: September 2007," *International Monetary Fund*, September 2007.
[6] CRS Report RL32165, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. Morrison and Marc Labonte.
[7] CRS Report RL34336, *Sovereign Wealth Funds: Background and Policy Issues for Congress* by Martin A. Weiss.
[8] Steffen Kern, "Sovereign Wealth Funds-State Investments on the Rise," *Deutsche Bank Research*, September 10, 2007.

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surpluses with the United States and other Western countries.[9] Following the 1998 Asian financial crisis, many Asian economies began accumulating large amounts of reserves to provide adequate insurance against any future currency fluctuations or macroeconomic insecurity.[10] Two additional factors motivate Asian reserve accumulation. First, several countries have pursued an export-led growth strategy targeted at the United States involving significant market intervention (especially by China) to maintain a stable undervalued

exchange rate.[11] Second, many Asian emerging market economies have financial markets that are not developed enough to absorb the traditionally high levels of private savings seen in Asia.[12]
It is difficult to accurately measure the amount of assets under management by SWFs because many funds do not disclose much information about their operations and assets. The funds believed to be the largest do not disclose their size, investment strategies, or current holdings. Estimates for the size of the largest fund, the United Arab Emirates' ADIA, for example, range widely between $500 and $900 billion. Reportedly, ADIA has achieved a 20% rate of return for many years and rarely considers deals less than $100 million.[13]

Official and private sector analysts estimate that there is between $1.9 and $2.9 trillion under management by SWFs. For a list of the largest SWF's in the world, please see Table 1 under the List of Figures and Tables section. This is significantly smaller than other investment classes. However, analysts expect that if oil prices remain, and there is no immediate correction of current global imbalances, SWFs will grow rapidly over the next few years. Morgan Stanley estimates that if foreign reserves continue to increase at a current pace, they could grow to $12 trillion by 2015.[14] Several factors could weaken these growth projections, including a cyclical economic downturn, a reduction in oil prices, or a weakening of competitiveness in Asian exporting economies. On the contrary, given the rapid increase in emerging market foreign exchange reserves, if countries decide to increase transfers from official reserves to SWFs, projected figures could be substantially higher. SWFs financed by oil and gas exports are estimated to account for around two thirds of SWFs by amount invested. Asian funds financed by current account surpluses make up the rest.[15]

PRIMARY ISSUES CONCERNING SOVEREIGN WEALTH FUNDS

Transparency and Governance-Related Concerns

[9] Joshua Aizenman, "Large Hoarding of International Reserves and the Emerging Global Economic Architecture," *National Bureau of Economic Research Working Paper 13277*, July 2007.

[10] CRS Report 98-434 E, *The Asian (Global?) Financial Crisis, the IMF, and Japan: Economic Issues*, by Dick K. Nanto.

[11] "New paradigm changes currency rules," *Oxford Analytica*, January 17, 2008.

[12] Euro riding high as an international reserve currency, *Deustche Bank Research*, May 4, 2007.

[13] Henny Sender, Live at Apollo (Management): Plan to Cash In, Limit Scrutiny, *Wall Street Journal*, July 17, 2007.

[14] Stephen Jen, "Currencies: How Big Can Sovereign Wealth Funds Be by 2015," *Morgan Stanley Global Research*, May 3, 2007.

[15] Stephen Jen, "How Big Could Sovereign Wealth Funds Be by 2015," *Morgan Stanley Perspectives*, May 3, 2007.

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Given the recent and projected growth of SWFs, many analysts stress the need for increased transparency of SWF activity. There are no supra-national regulations or disclosure requirements for the size of SWFs, their investment strategies, or their current holdings. Unlike privately owned, nationally regulated funds, SWFs are not required to provide information to stock-holders and stake-holders. "In terms of disclosure on fund performance, investment strategy, or even basic philosophy, many [SWFs] rank below the most secretive hedge fund," according to Gary Kleiman, a senior partner at Kleiman International Consultants, an emerging financial markets consulting group.[16] Of the existing national funds, only Norway's fund is universally considered to be transparent and publically accountable. Minimal SWF transparency masks SWF investment activity and can obscure governance and risk-management problems within the funds. This can have distressing consequences for policy makers. First, without insight into SWF activity, it is difficult to assess systemic risks or to determine whether SWFs are in fact pursuing strategic, non-commercial investment strategies. Second, limited disclosure makes it difficult to assess the management and governance of the funds and therefore difficult to identify mismanagement or corruption by fund managers. To further compound the problem, many of these SWFs are established in countries that currently lack the foundation and resources for good SWF governance and oversight. This is especially problematic since sizable failures due to poor management, particularly if concentrated within certain sectors, could affect national or global markets. Some analysts have tried to empirically measure the lack of SWF transparency. The Peterson Institute of International Economics (IIE) has tabulated a SWF scorecard that looks at transparency and accountability.[17] For its transparency and accountability figure, IIE scored a number of questions which are shown below:

- "Do regular reports on the investments by the SWF include the size of the fund? Information on the returns it earns?
- Do reports provide information on the types of investments? Information on the geographic location of investments? Information on the specific investments, for example, which instruments, countries, and companies? Information on the currency composition of investments?
- Is the SWF subjected to a regular audit? Is the audit published? Is the audit independent?"[18]

As a result, the IIE found that the largest funds (i.e., those owned by the United Arab Emirates, Qatar, Kuwait, and China) scored very low on the transparency and accountability rankings. This is thus, particularly troubling given the amount of capital that these funds hold and the potential that mismanagement or corruption can have on the rest of the global financial system. Indeed, too much money concentrated within the largest funds while shrouded within the veil of secrecy can result in financial impropriety at best and worldwide economic disaster at worst.

Non-Commercial Investment Motives

Although the ultimate goal of SWFs is long-term value creation, government control could mean that a SWF may be motivated by non-commercial considerations in its investment decisions. Felix

[16] Tony Tassell and Joanna Chung, "The $2,500 Question," *Financial Times*, May 25, 2007.
[17] Edwin M. Truman, "Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications," Testimony before the Committee on Banking, Housing, and Urban Affairs United States Senate, November 14, 2007. Testimony is available at [http://iie.com/ publications/papers/truman1107.pdf].
[18] The Peterson Institute of International Economics (IIE) SWF scorecard.

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Rohatyn, a prominent investment banker and former U.S. official, has noted that for many funds, political and commercial objectives are closely intertwined. According to Mr. Rohatyn, "they are making investments that they probably think are O.K. but not spectacular."[19] However, for these funds, "there has to be a political objective over and above the rate of return."[20]
Many U.S. policy makers are concerned that countries will use SWFs to support what one analyst has called "state capitalism," using government-controlled assets to secure strategic stakes around the world in areas such as telecommunications, energy resources, and financial services, among other sectors.[21] Recent deals in the energy and finance sector suggest that securing access to natural resources and developing domestic financial markets appear to be the two primary SWF strategic objectives.[22]

A report by Citigroup notes that "some sovereign wealth funds invest purely to achieve financial returns and portfolio diversification while others have a broader economic or social agenda."[23] Such an agenda could be benign; many countries have expressed their interest in using investments in foreign financial institutions to acquire knowledge and technology to help build their own domestic financial institutions. On the other hand, many are concerned that countries may use their SWFs to gain access to other countries' natural resource industries or other politically sensitive sectors. Such concern is not limited to Western countries. In January 2006, one of Singapore's SWFs, Temasek, purchased from the family of then-Prime Minister Thaksin Shinawatra a controlling stake in the Thai telecom company Shin Corporation, which included taking control of space satellites used by the Thai military. This purchase sparked a political crisis in Thailand, which eventually led to the ousting of Thaksin's government.

A HISTORY AND OVERVIEW OF THE CHINA INVESTMENT CORPORATION (CIC)

History of CIC

China's ruling executive body, the State Council, established the China Investment Corporation (CIC) in September 2007 to invest $200 billion of China's then $1.4 trillion in foreign exchange reserves. As with other sovereign wealth funds worldwide, the CIC's existence allows China to invest its reserves in a wide range of assets, including stocks, bonds, and hedge funds. After a rocky start in which it incurred losses of 2.1% on its global investments in 2008 – caused in part by aftereffects of the global financial crisis of 2007 – the CIC's rate of return in 2009 rose to 11.7%. The State Council is reportedly considering a CIC request for an additional $200 billion out of China's $2.5 trillion in foreign exchange reserves.[24]

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[19] Andrew Ross Sorkin, "What Money Can Buy: Influence," *The New York Times*, January 22, 2008, at [http://www.nytimes.com/2008/01/22/business/22sorkin.html?dlbk].
[20] Ibid.
[21] Gerald Lyons, "State Capitalism: The Rise of Sovereign Wealth Funds," *Standard Chartered*, October 15, 2007. Document is available from the author.
[22] Richard Portes, "Sovereign Wealth Funds," *VOXEU*, October 17, 2007, at [http://www.voxeu.org/index.php?q=node/636].
[23] *The Global Competitiveness Report 2007-2008*, World Economic Forum, at [http://www.gcr.weforum.org/].
[24] CRS Report RL34337, *China's Sovereign Wealth Fund* by Michael F. Martin.

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The United States Congress and financial analysts raised concerns about the CIC after its creation, partly because it was a comparatively large sovereign wealth fund, partly because it was government-owned, and partly because it reported directly to the State Council. Some observers were apprehensive that the Chinese government would use the CIC to acquire control over strategically important natural resources, obtain access to sensitive technology, and/or disrupt international financial markets. The CIC attempted to counter these concerns by announcing that its investment strategy would conform to international standards, and sought only to maximize its "risk-adjusted financial return." The CIC also promised to avoid politically and strategically sensitive investments.[25]

The CIC has been the focus of discussions among China's leadership about its economic objectives and its organizational structure. Soon after its creation, the CIC became the sole owner of Central Huijin Investment Limited (Central Huijin), an investment fund established by China's central bank, the People's Bank of China (PBOC), as a vehicle for injecting capital into major Chinese banks. Over the last three years, Central Huijin has provided billions of dollars to the Bank of China (BOC), the China Construction Bank (CCB), the Industrial and Commercial Bank of China (ICBC), and other financial institutions. Some analysts maintain that there is an inherent conflict between the CIC's goal to maximize its return on investments and Central Huijin's mission to provide capital to domestic financial institutions, and have been advocating for their separation. While there have been reports of a possible separation, Central Huijin remains a subsidiary of the CIC.[26]

Concerns about the CIC's investment activities reemerged in 2009 when it greatly expanded its overseas holdings, and began acquiring stakes in energy companies, natural resource companies and alternative energy companies. According to its filings with the Security and Exchange Commission (SEC), the CIC had holdings in 82 U.S. entities as of December 31, 2009. Commentators once again questioned the true goals of the CIC's investment strategy. The CIC maintains that its main mission is to maximize its long-term, risk-adjusted rate of return.[27]

Organizational Structure and Investment Objective

The China Investment Corporation is a wholly state-owned company, under the direct supervision of the State Council, China's ruling executive body. The daily operations of the CIC are managed by its Executive Committee, which is overseen by a board of directors (appointed by the State Council) and monitored by a board of supervisors (also appointed by the State Council). The CIC's Chairman and Chief Executive Officer is Ding Xuedong while its Vice Chairman, President & Chief Investment Officer is Li Keping. The CIC has set up its Board of Directors and Board of Supervisors in accordance with China's Company Law. Furthermore, The State Council exercises shareholder's rights on behalf of the State.[28]

[25] *Ibid.*
[26] *Ibid.*
[27] *Ibid.*
[28] See China Investment Corporation's webpage, www.china.inv.cn

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Moreover, according to CIC's corporate homepage, "CIC's Board of Directors is authorized to oversee the company's operations, evaluate its overall performance and make decisions on important matters in accord with the company's Charter. Based on investment objectives and development strategies set by the shareholder, the Board reviews and approves the company's investment strategies and operational guidelines. It also decides on ways to implement such strategies, identifies major issues to report to the shareholder, appoints and removes senior executives, determines or authorizes the establishment of management bodies as necessary.The Board of Directors is supported by the Remuneration Committee and Executive Committee. The Remuneration Committee assists the Board of Directors in examining and approving CIC's human resource strategies and remuneration mechanism; researches and establishes senior management's remuneration allocation system, reviewing their personal annual salary liquidation scheme; and supervises the implementation of senior management's remuneration policy.The Executive Committee translates the Board of Directors' guidance into detailed strategies and oversees CIC's day-to-day operations. It has the authority to make required operating decisions, including those for basic rules, institutional adjustment, operating mechanisms, performance evaluation and remuneration."[29]

The CIC utilizes both its internal staff of about 250 people, as well as contracted asset management companies and an unknown number of subsidiary investment companies, to make investments. Since its creation, there have been several unconfirmed reports that the CIC has hired specific asset management companies (including U.S. firms) to manage a portion of its investment portfolio, but the CIC and the alleged companies have generally refused to comment on the details. The CIC's 2009 annual report indicates that 51% of its holdings are externally managed and 41% are internally managed.[30] Among the CIC's known subsidiaries are Beijing Wonderful Investment, Ltd., Chengdong Investment Corporation, Country Forest Limited, Fullbloom Investment Corporation, Land Breeze II, Stable Investment Corporation, and Central Huijin. While the CIC technically owns Central Huijin, Central Huijin has its own board of directors, board of supervisors, and executive officers. The CIC's CEO is the chairman of Central Huijin's board of directors, and the CIC executive vice president is Central Huijin's chairman.

According to its 2009 annual report, the CIC's investment objective is "to achieve an appropriate long-term and risk-adjusted return for its shareholder [the State Council]."[31] In its efforts to achieve this goal, the CIC says it abides by four key investment principles. First, it selects investments based on commercial criteria. Second, it is a passive, financial investor, and does not seek control of companies. Third, the CIC complies with the laws and regulations of the countries in which it makes investments. Fourth, investments are selected based on research utilizing standard evaluation techniques. In addition, the CIC is a founding member of the International Forum of Sovereign Wealth Funds (IFSWF) and has agreed to abide by the IFSWF's Santiago Principles,

[29] *Ibid.*
[30] China Investment Corporation, *Annual Report 2009*, Beijing, China, July 2010, page 34.
[31] China Investment Corporation, *Annual Report 2009*, Beijing, China, July 2010, page 28.

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which set voluntary guidelines of behavior for SWFs.[32] To see the Santiago Principles in its entirety, please reference footnote 32.[33]
Since its creation in September 2007, the CIC has grown from its initial capital endowment of $200 billion to a total worth of $332 billion at the end of 2009. In 2009, the CIC's return on its total registered capital was 12.9% and its return on its global portfolio was 11.7%. In 2008, the return on capital was 6.8% and its global investments lost 2.1%. By comparison, Norway's Government Pension Fund's return on capital in 2009 was 25.6% and in 2008 was -23.3%.[34] Based on its 2009 performance, the CIC has reportedly asked for an additional $200 billion in capital.[35]

CIC Investments Over the Years

CIC's investment activities can be divided into three distinct periods. First, just prior to and immediately after its establishment, the CIC focused its investments on financial institutions. The second period was one of comparative investment inactivity in response to the global financial crisis. Third, the CIC reactivated its investment activity starting in 2009, with a notable shift to investments in energy and natural resource companies. The apparent change has raised concerns about the commercial basis of CIC's investment strategy.

According to a report submitted to the Securities and Exchange Commission (SEC) in February 2010, the CIC had holdings in 82 different U.S. entities as of December 31, 2009, with a total worth of $9.627 billion.[36] CIC also held shares in several major corporations, including Apple, Bank of America, Burlington Northern Santa Fe, Chesapeake Energy, Citigroup, Coca Cola, Eli Lilly, Hartford Financial Services, Ingersoll-Rand, Johnson & Johnson, Merck, Metlife, Motorola, News Corp, Pfizer, Sprint Nextel, Terex, and Wells Fargo.

There have also been a number of unsubstantiated reports of the CIC interest in investing in other companies. In the spring and summer of 2009, there were repeated claims that the CIC was considering providing Australian mining giant Fortescue a loan of $1 billion.[37] The CIC was also reportedly mulling an investment in the French nuclear power company Areva during the summer of 2009.[38] In October 2009, there were claims that CIC was among a list of possible investors in Russian aluminum producer United Co Rusal.[39] During a January 2010 forum in Hong Kong, CIC Chairman Lou indicated that the CIC had been discussing possible investments in the mining

[32] The Santiago Principles comprise of 23 principles that outline the operation and management of sovereign wealth Funds and was adopted in October 2008 in Santiago, Chile.

[33] The complete list is provided by http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf.

[34] As reported in its 2009 annual report, available online at http://www.nbim.no/en/press-and-publications/Reports/2009/annual-report-2009/

[35] "CIC Planning More Resource Investments," *China Daily*, January 28, 2010.

[36] Security and Exchange Commission Form 13F, submitted on February 5, 2010, SEC File Number 028-13664.\

[37] "CIC, Fortescue Metals in Talks for $1b Bond Issue," *China Daily*, August 12, 2009.

[38] "CIC May Buy into France's Areva: Report," *China Knowledge*, September 4, 2009.

[39] "Rusal Wants CIC, Temasek as IPO Investors," *China Daily*, October 28, 2009.

industries of Brazil and Mexico.[40] More recently, the CIC was reportedly negotiating with Harvard University to purchase some of its real estate funds, but the talks were unsuccessful.[41]

The shift in the CIC's portfolio is also discernible by comparing its reported global portfolio holdings as of the end of 2008 and 2009. Between the end of 2008 and the end of 2009, the CIC shifted most of its holdings from cash funds into equities and fixed income securities. According to the CIC, this shift was facilitated by several factors. First, the CIC acquired the personnel and capabilities to more efficiently allocate its investments. Second, as global markets began to recover from the financial crisis, new investment opportunities emerged. Third, the perceived "protectionist" attitudes of Europe and the United States to sovereign wealth fund investments diminished, making it easier for the CIC to act on the emerging opportunities.[42]

CIC's Future Investments

Since the day China announced the formation of the CIC, senior representatives of the new corporation and various government agencies have been actively publicizing that China's SWF would operate with a high degree of transparency utilizing an investment strategy based on commercial principles. China has also shown some sensitivity to existing apprehensions about the possible overseas investments the CIC might make, and CIC representatives have publicly announced that the new SWF will not invest in certain sensitive sectors and markets. However, the Chinese government has also made it known that it is concerned about undue criticism or scrutiny of the CIC, and in particular, is worried that other nations (including the United States) may try to use the creation of China's SWF as an opportunity to implement protectionist measures targeted at the Chinese economy.

Prior to the creation of the CIC, Chinese officials were already making statements indicating that its investment strategy would be to maximize the rate of return on its investments. On the day the CIC was created, CIC deputy general manager Yang Qingwei stated, "The company's principal purpose is to make profits."[43] During his first overseas trip as CIC's chairman, Chairman Lou stated, "We will adopt a long-term and prudent investment principle and a safe, professional portfolio strategy that adapts to market changes, which will put emphasis on a rational match of returns and risks."[44]

The CIC's need for relatively high rates of return on their investments is partially being driven by the manner in which the company has received access to China's foreign exchange reserves. According to one of the CIC's top managers, the company is responsible for servicing the interest on the 1.55 trillion-yuan of bonds issued by the PBoC. At the time, according to former CIC Chairman Lou, the interest cost on the outstanding bonds amounts to 300 million yuan ($40

[40] "CIC Planning More Resources Investments," *China Daily*, January 28, 2010.

[41] Lingling Wei and Dinny McMahon, "CIC Seeks Harvard's U.S. Real-Estate Portfolio ," *Wall Street Journal*, August 4, 2010; Zoe Hughes, "Harvard, CIC Reportedly End Real Estate Fund Sale Talks," *PERE News*, September 10, 2010.

[42] "CIC's Head Thanks Western Protectionism for Preventing Investment Losses," *China Stakes*, April 20, 2009.

[43] "China's Trillion-dollar Kitty is Ready," *Asian Times*, October 2, 2007.

[44] "CIC to be Stable Force in Global Financial Market," *Xinhua*, December 11, 2007.

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million) per day.[45] With a minimum return of $40 million per day, the CIC will need to earn at least $14.6 billion per year in profits — or at least 7.3% on its total capital of $200 billion. Furthermore, as former Chairman Lou points out, the CIC's ability to obtain access to more of China's foreign exchange reserves will depend on its profitability. "If I am making losses every day, how can I face asking the government for more money?" asked Lou.[46]

Case Studies of The UAE, Kuwait and Norway

The Abu Dhabi Investment Authority (ADIA) is by and large the largest SWF in the world with between $500-875 billion under management. The primary source of this fund which was started by The United Arab Emirates in 1976 is oil. Due to the sheer size of its fund, ADIA has been a major factor and influence in international finance. In 2008, ADIA was the co-chair for the International Working Group of 26 SWF's that ultimately created the "Generally Accepted Principles and Practices of SWF" also commonly known as the "Santiago Principles". These principles, as mentioned earlier in this paper were created in part to address the incessant criticism regarding the lack of transparency among SWF's as well as a goodwill gesture to the international financial community that SWF's were ready, willing and able to put together a set of internal regulatory and governance guidelines to abide by.

Kuwait's SWF, The Kuwait Investment Authority (KIA) was founded in 1960 and is the one of the world's first and oldest SWF. The KIA manages the Kuwait General Reserve Fund, the Kuwait Future Generations Fund in addition to any other assets committed by the Kuwait Ministry of Finance. Similar to ADIA, the KIA's main source of funds is derived from oil and has around $213 billion in assets which ranks it amongst one of the largest SWF's in the world. The KIA recently made headlines for receiving an additional $700 million quota on top of the $300 million it was awarded in March of 2012 by the Chinese regulator. In fact, this quota was at the time, the highest amount granted by China to a foreign investment entity. Yet despite all this, ADIA, along with the SWF's owned by Kuwait and China, have consistently scored amongst the lowest in terms of transparency and accountability as demonstrated by the SWF scorecard tabulated by The Peterson Institute of International Economics (mentioned earlier in the paper).

In contrast, Norway's SWF, the Government Pension Fund has been widely heralded as the poster child and model of transparency. The Government Pension Fund was started in 1990 and much like the SWF's owned by The United Arab Emirates and Kuwait, it too can claim its main source of funds from oil.[47] The fund boasts approximately $329 billion in assets. However, unlike the ADIA, KIA and CIC, Norway's SWF is seen as a model of transparency due in large part because it files quarterly financial reports, readily publishes information on its corporate governance structure and provides disclosure of every asset held by the fund in a given year. Furthermore, it also helps the Norwegian Ministry of Finance publish an annual report to the Norwegian

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[45] "China's Sovereign Wealth Fund Seeks to be a Stabilizing Presence in Global Markets," *Xinhua*, November 30, 2007.

[46] "China Wealth Fund Aims for Stability, Openness," *China Daily*, October 16, 2007.

[47] Larry Cate Backer, *The Norwegian Sovereign Wealth Funds and Public Global Governance Through Private Global Investment*, 41 GEORGETOWN JOURNAL L. REV. 2 (2009).

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Parliament detailing such information like investment strategy as well as information pertaining to investment returns.[48]

Moreover, Norway's Ministry of Finance established Ethical Guidelines for its SWF to follow which allows it to exclude a certain stock from its portfolio based on non-economic considerations. An "Advisory Council" within the Ministry of Finance is tasked to review all of the SWF's investments and ascertain as to whether such investments would "imply an unacceptable risk of complicity" as outlined in the SWF's Ethical Guidelines. Afterwards, upon the Advisory Council's recommendation, the Ministry of Finance can then use its discretion to prevent that particular company's stock to be part of its SWF's portfolio. (cite)

How is it possible then that SWF's of such size and magnitude can have such differing standards when it comes to transparency and what lessons can China's SWF glean from all this? Well, first off, it is important to point out that much like The United Arab Emirates and Kuwait, China's political and governmental system is more authoritative in nature unlike that of Norway. Secondly, as a Western nation, Norway is likely more equipped with the institutional and regulatory foundation that makes such reforms and oversight possible. Although there is to a certain extent, bureaucratic congestion present in every country despite the form of government, such congestion is more prevalent in countries like China, the UAE and Kuwait. Moreover, the unique cultural and historical background of China would likely contribute to reasons why the type of oversight that is present in Norway would be less possible in a country like China.

ISSUES CONCERNING THE CIC AND POSSIBLE SOLUTIONS

As is the issue with most sovereign wealth funds that operate today or will operate in the future, the notion of transparency will always come into question. Given the inherent clandestine nature of sovereign wealth funds coupled with the size and scope of the capital these funds tend to manage, the prerequisite of a transparent apparatus must be satisfied. For China in particular, I would venture to suggest a six-pronged approach.

1) A complete and total legal split between China Investment Corporation and its subsidiary, Central Huijin. There has already been international scrutiny over this arrangement given the fact that there are problems reconciling the CIC's overall investment mission with Central Huijin's domestic investment focus. In fact, there have been a few potential deals involving CIC that were blocked in the United States by regulatory bodies due to the organizational structure and legal relationship between CIC and Central Huijin. Essentially, the legal relationship and close structural proximity between these two entities have not only brought about doubts regarding CIC's transparency but in certain cases, have actually been economically detrimental to CIC's overall investment objectives. As such, a complete legal split between these two entities might potentially

[48] Chesterman, Simon, *The Turn to Ethics: Disinvestment from Multinational Corporations for Human Rights Violations - The Case of Norway's Sovereign Wealth Fund*, AMERICAN UNIVERSITY INTERNATIONAL LAW REVIEW, Vol. 23, (2008).

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open the door to more business deals for CIC in the future and actually allow CIC to achieve a higher return on investment as well as realize substantially higher profit margins and other investment goals.

2) Strict adherence to the Santiago Principles. Actions speak louder than words and nothing would say to the international community clearer that CIC is serious about transparency than a continued and reinvigorated effort to follow the Santiago Principles. China was one of the original and main sponsors and proponents of the Santiago Principles. As such, by adhering strictly to the Principles that China advocated would show the world that China is indeed putting its money where its mouth is. It would lend legitimacy and credence to China and more importantly, to CIC's investment choices and strategies. It would make it more difficult for other countries to criticize and question CIC's investment motives and would ultimately allow CIC more investment options in which to invest in.

3) Select investments based on commercial criteria. Given the inherent aversion that certain nations have towards a foreign country's capital being infused and invested into one's home country and national commercial entities, it is important that every effort be made to assuage any fears or doubts that an investment might be for any objective other than a commercially sound goal. As such, there should be no room to interpret that an investment is for the purpose of attaining certain national and/or military state secrets.

4) Remain a passive investor and do not seek control of companies. Much like the intended goal of the previous recommendation, strict adherence to this potential solution would allow recipient nations to feel more comfortable about foreign capital infusion. As long as the country that is engaged in the investing does not seek a majority stake in the enterprises, recipient nations will not feel as threatened. This would also signify to the world that CIC is not interested in controlling such companies and is instead only concerned with the economic benefits and profits that come hand in hand with such investments.

5) Fully comply with the laws and regulations of the countries in which it makes investments. By complying with the recipient country's laws, it would make it clear to the recipient nation that CIC intends on being a team player as well as a reliable player. Furthermore, it would demonstrate to the recipient country that not only will CIC abide by its laws, CIC respects its laws and as such, would be willing to accept any of the consequences that comes with breaking their nation's laws. This would provide much needed security and assurance for any recipient nation who might have initially had reservations about accepting investments from CIC. Much like adhering to the Santiago Principles, this act alone would speak volumes and go a long way in quelling any worries vis-à-vis CIC's intentions as well as show the international investment community that China and CIC respects and adheres to the rule of law above all else.

6) Select investments based on research utilizing standard evaluation techniques. If a standard quantifiable set of techniques were put in place, this would allow other nations to see for themselves the type of methodology CIC uses in selecting its investments. It would show the international community that CIC is indeed transparent in its dealings. More importantly, it would demonstrate that CIC's investment motives and objectives contain no nefarious intentions because

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CIC's evaluation techniques would be free and open for all nations to evaluate and study.

CONCLUSION

Given China's historical past, present political situation and unique cultural customs, the issue of transparency as it pertains to its sovereign wealth fund presents a challenging dilemma. For centuries, China has been the recipient of nearly worldwide humiliation and ridicule. From the Opium Wars to numerous accounts of foreign invasions and meddlesome intrusions, China has a legitimate reason to distrust many of the nations that are now her allies. Coupled with the fact that cultural customs and traditions such as a deference to higher authority, an affinity for non-confrontational situations and the notion of "losing face", it is no wonder why issues like transparency can generate problems and crisis for China's SWF and for the global society in general. However, as seen in this paper, there are still a number of actions, steps and reforms China can take to allow its SWF to become more transparent both to its citizens and the world while allowing China to stay true to its cultural tendencies and business objectives. Such reforms and changes can allow China's SWF to not only gain increased international trust, a higher degree of lucidity and transparency but would also have the potential to let China's SWF reach newfound economic heights and goals.

Table 1. The World's Largest Sovereign Wealth Funds

Country	**Name**	**Date of Est.**	**Current Size ($ billions)**	**Source of Funds**
United Arab Emirates	Abu Dhabi Investment Authority	1976	500-875	Oil
United Arab Emirates	Mubadala Development Company	2002	10	Oil
United Arab Emirates	Isithmar	2003	4	Oil
Norway	Government Pension Fund – Global	1990	329	Oil
Singapore	Government of Singapore Investment Corporation	1981	100-330	Other
Singapore	Temasek Holding	1974	108	Other
Kuwait	Kuwait Investment Authority	1960	213	Oil
Russia	Stabilization Fund of the	2004	141	Oil

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	Russian Federation			
China	China Investment Corporation	2007	200	Other
Qatar	Qatar Investment Authority	2005	50	Oil
Australia	Future Fund	2006	49	Other
Algeria	Revenue Regulation Fund	2000	43	Oil
United States	Alaska Permanent Fund	1976	40	Oil
Brunei	Brunei Investment Agency	1983	30	Oil
Korea	Korea Investment Corporation	2005	20	Other
Kazakhstan	National Oil Fund	2000	19	Oil, Gas
Malaysia	Khazanah Nasional	1993	18	Other
Venezuela	National Development Fund	2005	15	Oil
Venezuela	Macroeconomic Stabilization Fund	1998	1	Oil
Canada	Alberta Heritage Savings Trust Fund	1976	15	Oil
Chile	Economic and Social Stabilization Fund	2006	10	Other
New Zealand	Superannuation Fund	2001	10	Other
Iran	Oil Stabilization Fund	2000	9	Oil

Source: Peterson Institute for International Economics

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