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Erasmus School of Law

Special Issue

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Reflections Upon Public and Private Regulatory Approaches to Globalisation

Alberto Quintavalla,* Marta Katarzyna Kołacz ,**
and Maria Fernanda Caporale Madi***

I. Introduction

Globalisation—interaction and integration across state boundaries—is no longer an abstract concept but has increasingly been affecting everyday life. This becomes readily apparent when considering different types of supply chains and investments, which are becoming more and more connected.[1] Prominent examples include the assembly of motorised vehicles and the production of clothing.[2] Globalisation also results in an increasing integration of people and ideas in one global marketplace. The ongoing digitalisation further reinforces the trend of globalisation, as business partners can communicate faster and adapt quicker to changing economic circumstances.[3] Indeed, to say that we currently live in an era of rapid changes is in all probability quite an understatement. These developments not only alters the market dynamics (relations between supply and demand) in

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1 John T Mentzer, William DeWitt, James S Keebler, Soonhong Min, Nancy W Nix, Carlo D Smith and Zach G Zacharia 'Defining Supply Chain Management' (2001) 22 Journal of Business Logistics 1, 2.

2 Two-well known cases include Toyota (largely responsible for developing the concept of "Just In Time") and Zara (renowned for short production times required in getting its products to the customers). John F Mathis and Joseph Cavinato, 'Financing the Global Supply Chain: Growing Need for Management Action' (2010) 52 Thunderbird International Business Review 467, 469.

3 Susan Lund, James Manyika and Jacques Bughin, 'Globalization is Becoming More about Data and Less About Stuff' (2016) 94 Harvard Business Review 2.

many different sectors, but also allow previously separated markets to become more integrated. This concerns the products and services offered, as well as their relevant geographical market.[4]

Meanwhile, evidence increasingly indicates that globalisation, together with the current technological innovations, do not benefit all the various actors to the same degree.[5] Indeed, the rise in technology-induced globalisation has sometimes resulted in new forms of abuse of economic power and violations of human rights. Disrupted labour regulation and unfair trade conditions are just a few examples. Developing countries, for a set of conjunctural factors, tend to suffer the negative consequences of globalization to a higher degree.[6] In this context, the combined effects of globalised trade and emerging technologies pose many novel questions to national legislators and other rule-making bodies.

These complex questions, however, require careful consideration. On the one hand, the fact that conceiving a mature regulatory response needs time will very likely not come as a huge surprise. The law cannot foresee problems that have not yet arisen.[7] On the other hand, implementing effective policies to mitigate the undesired effects of globalisation sometimes demands a concerted effort. Over the years, various national and international legal orders have become more intertwined through treaties and agreements, restricting the states' latitude for

4 The rise of AirBnB spurred the popularity of temporary residences. Georgios Zervas, Davide Proserpio and John W. Byers, 'The Rise of the Sharing Economy: Estimating the Impact of Airbnb on the Hotel Industry' (2017) 54 Journal of Marketing Research 687. Uber, a company that initially provided personal transportation services has, in some markets, started to distribute food as well. Judd Cramer and Alan B. Krueger, 'Disruptive Change in the Taxi Business: The Case of Uber' (2016) 106 American Economic Review 177; Katrina M Wyman, 'Taxi Regulation in the Age of Uber' (2017) 20 NYU Journal of Legislation and Public Policy 1.

5 Brishen Rogers, 'Employment Rights in the Platform Economy: Getting Back to Basic' (2016) 10 Harvard Law and Policy Review 479.

6 Eddy Lee and Marco Vivarelli, 'The Social Impact of Globalisation in Developing Countries' (2006) International Labour Review 145 (3).

7 Stuart Banner, 'What Causes New Securities Regulation? 300 Years of Evidence' (1997) 75 Washington University Law Quarterly 849, arguing there exists a boom-bust pattern of regulation, with stricter laws being adopted immediately after a crisis, and deregulation subsequently taking place upon the gradual improvement of the economic climate.

adopting unilateral measures.[8] On few occasions, though, actors have aimed to circumvent the deadlock by resorting to mechanisms of a more private character.[9]

Here, the distinction between public and private should be considered broadly. First, it can relate to either laws enacted by the constitutional legislator versus those implemented by other bodies that exercise some form of authority.[10] Second, the distinction may concern public and private tools in performance of public duties.[11] Both may effectively serve to influence behaviour. Whereas the regulatory arsenal has thus expanded almost exponentially, its complexity has risen accordingly. Thus, regulating globalizing economies will at least remain highly complex and contentious.

8 SE Merry, 'Legal Pluralism' (1988) 22 Law and Society Review 869. A prime example of multi-layered legal orders would concern the member states of European Union (EU). As the decision of the United Kingdom to leave the EU shows, some countries may prefer more room for manoeuvre.

9 A well-known example concerns the UK Corporate Governance Code (Code), originally introduced in 1992 and revised most recently in 2018. The Code is drafted by the semi-autonomous Financial Reporting Council, and implemented in the Listing Standards of the London Stock Exchange (LSE). Companies listed on the LSE should report annually on their application of the Code or explain why a specific provision has not been adhered to ("comply or explain"). The initiative has received widespread following. See Jill Solomon, *Corporate Governance and Accountability* (Wiley 2007) 47.

10 One may think of the English model for regulation of waste water and water industries. The model rests on private operators who are supervised by an independent economic regulator who applies regulatory tools to influence competition between water operators, thus encouraging performance improvement among water operators. The model is an opposite of the state ownership where the state is in charge of the industry's regulation. See: Christopher Decker, *Modern Economic Regulation* (CUP 2015) 373.

11 An example may be the situation of different compliance specialists who perform the tasks of public authorities in private companies. These specialists are the compliance officer, monitoring trustee and data protection officer. Compliance officers aim at achieving compliance in different fields of law. Their duties are similar to detecting crimes in undertakings. A monitoring trustee is appointed to monitor compliance with a commitment decision under Regulation No 139/2004. A trustee performs his tasks, on behalf of the EU Commission, based on contracts with a parties. Finally, the situation of a data protection officer is regulated by General Data Protection Regulation of 27 April 2016. *See* Monika Namysłowska, 'Monitoring compliance with contracts and regulation: between private and public law' in: Roger Brownsword, Rob AJ, van Gestel and Hans-W Micklitz, *Contract and Regulation A Handbook on New Methods of Law Making in Private Law* (EE 2017).

In essence, this Special Issue, building on the Erasmus Early-Career Scholars Conference,[12] considered these observations as the starting point for a deeper analysis. The collection of essays of this Special Issue focuses on public and private regulative approaches to the effects of globalisation and, to a lesser but nevertheless considerable extent, the effects of digitalisation. To create a relevant and homogenous sample, the various contributions revolve around two notable fields heavily impacted by globalisation, these being financial markets and cross-border investments—more on this in Section II. Each of the contributions has been carefully selected, based on the quality and novelty of the arguments presented, the depth and rigor of the analysis conducted and the fit with the other papers included.

II. Public and Private Regulatory Approaches to Globalisation

To shed further light on the interplay between public and private regulation and globalisation, this Special Issue consists of two parts. Part One contains two case studies that analyse different examples of the effects of globalisation on financial crimes and financial terrorism, describing how public and private regulators may respond to this phenomenon. Subsequently, Part Two takes a more fundamental approach and discusses how public and private regulation of investment and trade policies shapes globalisation. At an abstract level, Parts One and Two complement each other. The different contributions to this Special Issue are analysed in more detail in Sections II.A and II.B.

A. Responses of public and private regulators to globalised financial markets

In the opening paper to this Special Issue, Dimitrios Kafteranis (University of Luxembourg), compares internal and external whistle-blowing regimes of the UK, the United States (US), France and Ireland financial markets. The author

[12] The Erasmus Early-Career Scholars Conference was held from 11 April 2018 to 13 April 2018 at the Erasmus University Rotterdam on the very theme of globalisation and technologisation, with the (modest) aim of shedding at least some light on such a fundamental development. The Conference was co-hosted by the Erasmus School of Law, the Rotterdam School of Management and the Faculty of Philosophy, and as such had a truly interdisciplinary character. Financial support received from the Erasmus Initiative Dynamics of Inclusive Prosperity, the Erasmus Trustfonds and the Erasmus Graduate School of Law is gratefully acknowledged. The presence of researchers from different academic backgrounds clearly succeeded in fostering a lively and meaningful debate. As guest editors of this Special Issue, we would like to express our sincere gratitude to the Editorial Board of the Cambridge Law Review for their faith in this project and willingness to jointly pursue this opportunity. A special word of thanks goes towards Eirini Kikarea, who kindly brought all of us together.

analyses the changes in corporate environment mainly after the financial crisis of 2007–2009. Kafteranis argues that, whereas internal whistle-blowing (*i.e.* the employees of the company) might save an organisation from negative publicity and could prevent reputational damage, the organisation could prove unresponsive. Additionally, employees might hesitate to take internal action out of fear for informal repercussions. In light of the theme of this Special Issue, the contribution of Kafteranis is notable for the fact that it indicates a clear preference of public legislators for internal whistle-blowing to precede external whistle-blowing, although there does not appear to have been any formal coordination between them. The aforementioned pattern becomes especially apparent when Kafteranis compares Irish and United Kingdom (UK) law. The legislators' preferences for internal whistleblowing can be inferred mainly from the fact that immunity in the external variant is generally subject to more stringent conditions. The analysis of legislation and case law (mainly at the European level), allows the author to conclude that a more balanced regulatory framework is warranted. Treating internal and external whistle-blowers equally enhances flexibility and can be considered a more solid guarantee that justice will prevail.

The paper of Dimitrios Kafteranis is followed by that of Magdalena Jaczewska (University of Warsaw) who analyses the relationship between recent European anti-money laundering initiatives and fundamental civil rights. Specifically, she focuses on the 4th and 5th European Union (EU) Anti-Money Laundering Directive (AML) vis-à-vis the right to privacy and family life (Article 7 of the Charter of Fundamental Rights of the EU). To that end, Jaczewska also takes note of the Recommendations drafted by the Financial Action Task Force (FATF), an intergovernmental organisation founded by the G7. Again, this shows a tendency of public regulators towards harmonisation, but also highlights that concurrence between public and private regulation can occur in many forms. In her paper, Jaczewska meticulously describes how innovative technologies such as bitcoin allow for financial anonymity and therefore facilitate terrorism. The EU response to these developments has typically been to infer more money-laundering preventive duties upon private actors, by conscripting additional entities into the regulatory framework and applying a risk-based liability approach. However, Jaczewska argues that both the conception of this approach and the penalties in case of non-compliance might differ between EU Member States. Jaczewska furthermore observes that the European Court of Justice (ECJ) sanctioned restrictions on the freedom for businesses to conduct services (as enshrined in Article 51 of the Treaty on the Functioning of the EU) and the right to a fair trial (Article 6, European

Convention of Human Rights) in previous cases, as safeguarding the monetary system from illegally obtained funds was deemed a sufficiently relevant justification.

The author concludes that recent provisions of the 4th and 5th AML, granting national anti-money laundering authorities more powers to conduct data mining operations, will likely not be held in violation of EU law by the ECJ. Jaczewska warns for the potentially far-reaching consequences of these competences, and advocates restraint by authorities through strict adherence to the standard of proportionality. Given that the future will only become more data-driven, this topic deserves our close and continuing interest.

B. Responses of public and private regulators to international investment law

Part Two of this Special Issue commences with a paper by Cheng Bian (Erasmus University Rotterdam) on the appropriate regulatory framework in respect of Sovereign Wealth Funds (SWFs). Although SWFs can bring prosperity to their investee countries, they are sometimes regarded with suspicion due to the potential presence of ulterior (including strategic or political) motives. Bian describes some of the common traits of SWFs (such as the mineral origins of their funds) and the concerns their presence invariably gives rise to in great detail. Indeed, this discussion is also important when thinking about the EU level, whereas different EU Member States such as France and Germany have unilaterally adopted mechanisms to analyse Foreign Direct Investment, a uniform approach has so far been lacking. Bian develops a number of highly interesting policy proposals for SWFs to create a friendlier, less predatory image and to enable them to continue their contribution to welfare on a global scale. To achieve this, he draws inspiration from the Santiago Principles, adopted in 2008. Again, this is a good example of non-binding best practices potentially having thorough effects in the real world. Specifically, the proposals put forward by Bian include commitments of restricting investments to smaller, non-controlling stakes or the acquisition of non-voting stock. In conclusion, these developments suggest a more dispersed investment pattern by SWFs and less (direct) voice, both entailing a reduction in influence of developing countries on globalization. Thus, will be most interesting to see how SWFs will actually adapt their investing behaviour in the changing regulatory climate of the coming years.

Finally, the paper of Yawen Zheng (University of Edinburgh) concludes this Special Issue. In her contribution, she discusses the possibility of successfully concluding a Multilateral Investment Treaty (MIT) governing the One Belt, One Road-initiative (OBOR). Designing an adequate legal framework to grant OBOR

investments effective legal protection is a complicated matter, as the investments are usually made on a long-term basis and, given the investee countries, face heightened risks of political instability. Zheng also describes the existing treaty framework, which is primarily bilateral by nature and thus rather fragmented. A practical and effective solution would comprise the concluding of a multilateral treaty—similar to the strategy of the OECD in handling existing tax treaties to combat evasion. Zheng notes that China, as the main OBOR-sponsor, should initiate negotiations to conclude a multilateral treaty, but is well aware that, for the project to succeed, an equal-footed approach is paramount. Subsequently, Zheng describes various elements of an OBOR-treaty that she deems essential, including dispute resolution. Given the ever increasing investments China makes in the world economy, a clearer legal background and enforcement of the treaty could have a positive effect on the course of globalisation.

Reporting to the Boss or the Authorities: the Ongoing Dilemma of the Whistle-Blower

Dimitrios Kafteranis*

I. Introduction

The topic of this article can be introduced by mentioning two businesses: WorldCom and Enron, both based in the United States of America (US/USA), whose employees were alarmed by obscure practices of their companies and their difficult accounting situation.[1] These employees were whistle-blowers. The definition of whistle-blowing is "the disclosure by organisation members (former or current) of illegal, immoral or illegitimate practices under the control of their employers, to persons or organisations that may be able to effect action".[2] Although other definitions exist as well, this is the most common one.[3] In case of the aforementioned companies, no action was taken, neither by state authorities such as the Department of Justice nor by the companies themselves. As a result, WorldCom and Enron collapsed, harming the market and society.[4] The financial crisis of 2007-2009, coming only shortly after the one of 2000-2002, has reinvigorated the discussion on effectively regulating the financial markets.

The crisis of 2007–2009 demonstrated that globalised financial markets present significant risks to different actors. Again, the collapse of the market had not only financial, but also social consequences.[5] People in the US and Europe

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1 Michael Neal, 'Securities Whistleblowing under Dodd-Frank: Neglecting the Power of "Enterprising Privateers" in Favor of the "Slow-Going Public Vessel"' (2012) 15 Lewis & Clark Law Review 1124, 1124–1126.

2 Janet P Near and Marcia P Miceli, 'Organizational dissidence: the case of whistle-blowing' (1985) 4 Journal of Business Ethics 1.

3 Consensus on the definition of whistle-blowing does not exist in the legal community. Richard Haigh and Peter Bowal, 'Whistleblowing and Freedom of Conscience: Towards a New Legal Analysis' (2012) Comparative Research in Law & Political Economy, Research Paper No. 1974982.

4 Lewis Simpson, *Crimes et Délits financiers* (Infini Découverte 2016) 81–93.

5 Hilary J Allen, 'The Pathologies of Banking Business as Usual' (2015) 17 University of Pennsylvania Journal of Business Law 863.

lost their incomes, houses or retirement plans.[6] Additionally, the 2007–2009 crisis has highlighted the interconnectedness of national markets, since the US subprime mortgage crisis affected markets in other countries as well. Against this background, it was proposed that the regulation of financial markets should have an international, instead of national, character.[7] Indeed, the global financial crisis has demonstrated the need for fundamental reforms of the international financial and monetary system.[8]

Financial crimes are considered to be among the most difficult for the legal system to deal with, also because many financial wrongs are not strictly considered crimes.[9] Their detection is difficult due to their complex nature.[10] In addition, the development of new technologies and their influence on the financial and business sectors makes matters even more complicated.[11] Fast internet connections, complex computer structures, and algorithms are creating a sophisticated technological environment that has severe consequences on regulation.[12] These new technologies create new forms of crime, requiring additional techniques to detect them.[13] Whistle-blowing is one of these techniques, a kind of private justice where the whistle-blower can inform the authorities about illegalities and wrongdoings.[14] In

6 Sher Verick and Iyanatul Islam, 'The Great Recession of 2008-2009: Causes, Consequences and Policy Responses' (2010) Institute for the Study of Labor (IZA) Discussion Paper No. 4934, 12–22 <http://ftp.iza.org/dp4934.pdf> accessed on 20 July 2018; Ebru Terazi and Secil Senel, 'The Effects of the Global Financial Crisis on the Central and Eastern European Union Countries' (2011) 17 International Journal of Business and Social Science 186, 187–192.

7 Robert Kawadza, 'Revisiting financial services sector transparency through whistle-blowing: the case of South Africa and Switzerland' (2017) 61 Journal of African Law 83, 83-85.

8 Timothy J Sinclair, 'Institutional Failure and the Global Financial Crisis' in Wyn Grant & Graham K. Wilson (eds), *The Consequences of the Global Financial Crisis- The Rhetoric of Reform and Regulation* (OUP 2012).

9 Gary Wilson and Sarah Wilson, 'Is "This Time" really different?: Reflections on Risk in Financial Impropriety and Criminal Liability Past and Present in Looking to the Future' in Nic Ryder (ed) *White Collar Crime and Risk* (Routledge 2017).

10 International Monetary Fund, 'Chapter 3: Detecting Systemic Risk' in *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risk* (2009) 2 <https://www.elibrary.imf.org/abstract/IMF082/09833-9781616352080/09833-9781616352080/ch03.xml?rskey=4UK-9gE&result=28&redirect=true> accessed on 20 July 2018.

11 Maryke Silalahi Nuth, 'Taking advantage of new technologies: For and against crime' (2008) 24 Computer Law & Security Report 439.

12 ibid 444–45.

13 ibid 437–38.

14 Joyce Rothschild and Terance D Miethe, 'Whistle-blower Disclosures and Management Retaliation' (1999) 26 Work and Occupations 108.

this sense, private justice is the use of private persons to detect, prove, and deter public harms.[15]

The consequences of the financial crises and the need to combat financial crimes have led states to adopt a more interventionist approach.[16] The European Union (EU) reacted to the crisis by adopting the Single Supervisory Mechanism (SSM) to regulate and supervise the banking sector.[17] USA has also enacted legislation, aiming at better regulating and controlling the financial sector. The Sarbanes-Oxley Act of 2002 was amended in 2010 by the Dodd-Frank Act.[18] The Dodd-Frank Act offers protection against retaliation and even financial rewards for the whistle-blower who reports to the Securities and Exchange Commission (SEC).[19] In addition, the USA Supreme Court, in its decision *Digital Realty Trust v Somers*, has clarified that a whistle-blower who reports internally and not to the SEC cannot rely on protection under Section 922 of the Dodd-Frank Act.[20] Conversely, the United Kingdom (UK), Ireland and France adopted a gradual or "three-tiered model" of disclosure.[21] Firstly, this includes measures to encourage internal whistle-blowing; secondly, whistle-blowing to independent authorities; and thirdly, if none of the above two respond, whistle-blowing is permitted to the public (including the media). For instance, the Public Interest Disclosure Act (PIDA) 1998 promotes this model in the UK.[22] PIDA incentivises internal whistle-blowing, as it requires the employee to comply with less requirements than is the case for external disclosure, to be given the protections outlined in PIDA.[23]

The different regimes concerning internal and external whistle-blowing create confusion for the employee involved, especially as far as his legal protection is concerned.[24] As mentioned above, the reporting channel determines the requirements under which the disclosure will be granted protection by relevant

15 Pamela H Bucy, 'Information as a commodity in the regulatory world' (2002) Houston Law Review 905.

16 Wilson and Wilson (n 9) 266.

17 European Central Bank, *Guide to Banking Supervision* (Frankfurt 2014) 4.

18 18 U.S.C. (2002) and 15 U.S.C (2010), respectively.

19 Jenny Mendelsohn, 'Calling the boss or calling the press: a comparison of British and American responses to internal and external whistle-blowing' (2009) Washington University, 8 Global Studies Law Review 723, 723-24.

20 The analysis of this decision will follow later.

21 Wim Vanderkerckhove, AJ Brown and Eva Tsahuridu, 'Managerial responsiveness to whistle-blowing: expanding the research horizon', in AJ Brown, David Lewis, Richard Moberly and Wim Vandekerckhove (eds), *International Handbook on Whistle-blowing Research* (Routledge 2014) 299–300.

22 s 43C, 43D and 43E.

23 Mendelsohn (n 19) 737.

24 The legal protection of the whistle-blower may have different forms. The most common protection is against "penalisation" from his employer (labour law). In addition, the protection may be against civil or criminal liabilities or defamation.

legislation.[25] Consequently, this article juxtaposes advantages and disadvantages of internal and external whistle-blower protection. My main argument is that a whistle-blower should be legally protected, on equal terms, regardless whether he reports to his employer or the relevant authorities. To substantiate that claim, I adopt both an employee and company perspective and explain the trade-off that is to be made. In addition, the article will compare legislation in the UK, France, Ireland and the USA. This selection is based on the fact that all countries represent major financial centres that were influenced heavily by the financial crises.

This article is structured as follows. Part II presents an overview of relevant regulations related to a whistle-blower's legal protection. Subsequently, Part III analyses the relation between whistle-blowing and secrecy, whereas Part IV discusses the prevention of retaliation against employee. In Part V, I present the advantages of external whistle-blowing. Indeed, internal whistle-blowing may sometimes be ineffective, which is considered in Part VI. I conclude by arguing that both channels of disclosure present significant advantages to society, and should thus be protected equally.

II. Whistle-Blower's Legal Protection—an Overview of Relevant Regulations

In this Part, I will provide an overview of applicable legislation in the UK, France, Ireland, and the US and subsequently conduct an analysis on the legal protection offered to the whistle-blower. The "European" model of whistle-blowing comes into contrast with the US model.[26] The relevance of this comparison also lies in the internationalisation and interconnectedness of financial markets, in addition to the important supervisory and regulatory powers the authorities on both sides of the Atlantic possess.[27] A financial institution based in the USA can have its branches in Europe and vice versa, which means that there effectively is a chance for US authorities to intervene in Europe and the other way around.[28] In

25 These requirements differ from one national legislation to another. For instance, these requirements can be that the employee report in good faith, or he reasonably believes that the disclosed information is true.

26 By "European" model I refer to the preference of states in Europe to favour internal reporting contrary to the tendency in the US for external whistle-blowing.

27 Christina Parajon Skinner, 'Whistleblowers and Financial Innovation' (2016) 94 North Carolina Law Review 861, 911–17.

28 ibid.

light of this interconnectedness, better whistle-blowers' protection in the US will incentivise European employees to report there and vice versa.[29]

A. The United States of America (USA)

The Sarbanes-Oxley Act provided a legal regime for internal whistle-blowing in the USA.[30] The Sarbanes-Oxley Act came as a response to scandals such as those of WorldCom and Enron, which dramatically influenced the US financial markets and created hostility and distrust towards big corporations and the government.[31] One of the relevant provisions of the Sarbanes-Oxley Act about whistle-blowing is Section 806.[32] It specifies that internal whistle-blowing is an appropriate channel for disclosure, encouraging internal reporting and affording legal protection against retaliation.[33] Internal whistle-blowers are protected under the Sarbanes-Oxley Act if they bring a claim to Occupational Safety and Health Administration (OSHA) within 180 days of the alleged violations.[34] Nevertheless, Sarbanes-Oxley

[29] ibid.
[30] 18 U.S.C. (2002).
[31] Terry M Dworkin, 'SOX and Whistleblowing' (2007) 105 Michigan Law Review 1757, 1758.
[32] Timothy J Fitzmaurice, 'The Scope of Protected Activity Under Section 806 of SOX' (2012) 80 Fordham Law Review 2041, 2056.
[33] Dworkin (n 31) 1760.
Section 806 reads:
No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. § 78L), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. § 78(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee—
(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders when the information or assistance is provided to or the investigation is conducted by—
(A) a Federal regulatory or law enforcement agency;
(B) any Member of Congress or any committee of Congress; or
(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or
(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law
Sarbanes-Oxley Act, 18 U.S.C. (2002).
[34] Sarbanes Oxley Act, 18 U.S.C. §1514A.

is remarkable for the fact that rarely an employee wins a case under Section 806.[35] This turned the attention of whistle-blowers to the Dodd-Frank Act, which offers better legal protection and significant financial incentives.

The protection offered by the Dodd-Frank Act is made more attractive by its bounty programme.[36] The Dodd-Frank Act defines a whistle-blower as an individual who provides information relating to a violation of securities law to the SEC.[37] Section 21F prohibits retaliation against employees who report information about potential violations of federal securities laws.[38] In addition, the whistle-blower may be eligible to receive a financial reward that is between ten to thirty per cent of the monetary sanctions imposed in respect of the reported actions.[39] The whistle-blower as well as the information provided should meet certain criteria with regard to factors such as the significance of the information and the degree of assistance given, to be eligible for the financial reward.[40]

With regard to internal whistle-blowing under the Dodd-Frank Act, a recent decision of the US Supreme Court has indeed had negative repercussions.[41] The question the Supreme Court had to answer was the following: "Do the anti-retaliation provisions of Dodd-Frank protect a whistle-blower that reports internally and not to the SEC?" Paul Somers was working at the Digital Realty Trust Company; in 2014 he sued his employer because he was fired due to complaints he had made to senior management about violations of the Sarbanes-Oxley Act.[42] Despite his internal complaints, Somers failed to report to the SEC. Digital Realty dismissed him, as the Dodd-Frank Act does not protect the employee that reports

[35] Beverley H Earle and Gerald A Madek, 'The Mirage of Whistleblower Protection Under Sarbanes-Oxley: A Proposal for Change' (2007) 44 American Business Law Journal 1, 19–24.
[36] 15 U.S.C. § 78n (2012).
[37] 15 U.S.C § 78u-6 (2012).
[38] 15 U.S.C. § 78u-6(h) (2012).
"No employer may discharge, demote, suspend, threaten, harass, directly or indirectly, or in any other manner discriminate against, a whistle-blower in the terms and conditions of employment because of any lawful act done by the whistle-blower"
(i) in providing information to the Commission in accordance with this section;
(ii) in initiating, testifying in, or assisting in any investigation or judicial or administrative action of the Commission based upon or related to such information; or
(iii) in making disclosures that are required or protected under the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201 et seq.), this chapter, including section 78j–1(m) of this title, section 1513(e) of title 18, and any other law, rule, or regulation subject to the jurisdiction of the Commission.
[39] 15 U.S.C § 78u-6 (2012).
[40] 15 U.S.C § 78u-6 (2012).
[41] *Digital Realty Trust Inc. v. Somers*, 138 US 767 (2018).
[42] Ilya Shaphiro, '*Digital Realty Trust v. Somers*: Hasn't *Chevron* deference gone too far?' (Harvard Law Review Blog, 17 October 2017) <https://blog.harvardlawreview.org/digital-realty-trust-v-somers/> accessed 26 April 2018.

internally but only the employee that reports directly to the SEC.[43] The Supreme Court in *Digital Realty Trust v Somers* held unanimously that internal whistle-blowing is not protected under the Dodd-Frank Act. It noted the following: "when a statute includes an explicit definition, we must follow that definition "…" Courts are not at liberty to dispense with the condition—tell the SEC—Congress imposed".[44]

It also clarified that the term was not worded ambiguously and as a result, the *Chevron* deference could not be applied.[45] The outcome of this decision is that the whistle-blower is protected under Dodd-Frank only when he reports directly to the SEC. A long history of allowing the citizens to enforce US laws justifies this preference.[46] The *qui tam* writ, dating back to Lincoln's Presidency, is the first example where the USA government authorised citizens to sue, in the name of the USA government, individuals that committed fraud against federal economic interests.[47] The Internal Revenue Service (IRS) exercises the same practice, among other authorities.[48] To conclude, the US approach focuses on external whistle-blowing, fostering a culture of reliance and trust of reporting to the authorities.

Following the USA Supreme Court decision in *Digital Realty Trust v Somers*, the SEC voted, on 28 June, 2018, to propose amendments to the rules governing its whistle-blower program. These recent developments come in stark contrast with the corporate compliance culture created under Sarbanes-Oxley. USA employees may be discouraged to use internal reporting channels after this decision, since if they go internally, they will enjoy no legal protection. This approach may weaken the function of internal compliance regimes or other departments such as internal audit or risk management.[49]

43 Bradley J McAllister, 'The impact of the Dodd-Frank Whistle-blower provisions on FCPA enforcement and modern corporate compliance programs' (2017) 14 Berkley Business Law Journal 45, 51–52.
The conflict was between the definition of whistle-blower in section 21F(a)(6) and the requirements to qualify as a whistle-blower when an employee makes an internal disclosure under 21F(h)(1)(A)(iii). The USA Courts were divided on this issue before the decision of the Supreme Court.

44 *Digital Realty Trust, Inc v Somers*, 138 US 767, 772 (2018).
Matt Reeder, 'Proceeding legally: clarifying the SEC/Dodd-Frank Whistle-blower incentives' (2017) 7 Harvard Business Law Review 270, 296–304. In *Asadi*, the Fifth Circuit concluded that the provision for whistle-blower protection applies to those individuals who provide information to SEC. In *Berman*, the Second Circuit had a different view considering that the wording is ambiguous and gave *Chevron* deference to the reasonable interpretation of the agency. The SEC had given an interpretative rule of the provision stating that internal whistle-blowers are protected from retaliation. Consequently, the Second Circuit followed the interpretation of the SEC protecting the internal whistle-blower under Dodd-Frank.

45 The *Chevron* deference is an important principle of administrative law coined after the landmark case *Chevron USA, Inc v Natural Resources Defence Council, Inc* 468 US 837 (1984) where the Supreme Court created a legal test as to when the Court should refer to an agency's interpretation for a specific issue. The interpretation of the agency should be reasonable; Congress has not given any specific answer to this question.

46 Parajon Skinner (n 27) 39.

47 David Freeman Engstrom, 'Harnessing the Private Attorney General: Evidence from Qui Tam Litigation' (2012) 112 Columbia Law Review 1244, 1246.

48 Yehonatan Givati, 'Of Snitches and Riches: Optimal IRS and SEC Whistleblower rewards' (2018) 55 Harvard Journal on Legislation 106, 112.

B. Europe

UK, Ireland and France have all adopted comprehensive legislation on the protection of whistle-blowers. These laws require whistle-blowers to report internally first and, if this is somehow not possible, externally. UK is a pioneer, among the European countries, having adopted its legislation on the protection of whistle-blowers as early as 1998. The PIDA provides different thresholds for protection, depending on the reporting channel the whistle-blower will choose.[50] The scheme is a three-tiered disclosure model.[51] Sections 43C, 43D and 43E of the PIDA constitute the first tier, also known as internal disclosures.[52] Section 43C requires the whistle-blower to report to his employer; Section 43D to the legal adviser; and Section 43E to the Minister of the Crown.[53]

Ireland enacted legislation on the protection of whistle-blowers in 2014, with the adoption of the Protected Disclosures Act (PDA).[54] The Irish legislation is modelled after PIDA, although some differences exist.[55] On the matter of internal reporting, PDA followed PIDA. The disclosure should be addressed to the employer or other responsible persons.[56] The purpose of the PDA is to encourage workers to report internally. If their voices are not heard, alternative channels for reporting are provided, including disclosure to a Minister, an authority or the public.[57]

France has recently adopted the Law of 9 December 2016 related to transparency, the fight against corruption and the modernisation of economic life,

49 McAllister (n 43) 75.

50 Jeremy Lewis, John Bowers QC, Martin Fodder and Jack Mitchell, *Whistle-blowing – Law and Practice*, (3rd edn, OUP 2017) 101.

51 *Street v Derbshire Unemployed Worker's Centre* [2005] ICR 97.

52 Lewis, Bowers, Fodder and Mitchell (n 50) 102.

53 If the whistle-blower reports to his employer, under section 43C of PIDA, he will only have to prove good faith. On the contrary, if the worker reports to a prescribed person (such as a relevant authority), the whistle-blower, apart from proving his good faith, will have to prove that he reasonably believes that the relevant failure falls within any description of matters in respect of which that person is so prescribed, and that the information disclosed, and any allegation contained in it, are substantially true.

54 n 14 of 2014.

55 Joanne Hyde, 'The Protected Disclosures Act 2014: An Overview' (2014) 11 Irish Employment Law Journal 114.

56 Part 2 PDA, para 6.

57 Lauren Kierans, 'A whistle-stop tour of the Protected Disclosures Act 2014' (2014) 4 Law and Regulation, Accountancy Plus 12.

commonly known as the Law Sapin II.[58] This new law establishes a unified legal regime for whistle-blowers in France.[59] In its Article 8, it analyses the reporting scheme that whistle-blowers should follow. The concerns, in the first place, should be addressed to the employer or another employee that has a superior position or to another person prescribed by the employer.

At the European level, the efforts of the Council of Europe and the European Court of Human Rights (ECtHR) are significant.[60] The ECtHR, in its landmark judgement *Guja v Moldova*, has established six criteria that should be examined to recognise an employee as a whistle-blower.[61] One of these criteria is the way of disclosing the information.[62] The ECtHR has ruled that the employee should report internally first and if this is impossible, he may address the authorities and, finally, the public.[63] This approach was confirmed by the ECtHR in its subsequent case-law, thus leaving no doubt that internal reporting is the favoured channel for disclosure.[64] At the level of the EU, the draft Directive presented by the European Commission on 23 April, 2018 proposes a stepped disclosure regime, similar to the ECtHR and as adopted by the countries discussed above.[65] Under Article 13, the person reporting externally shall qualify for protection only if one of five conditions is met. These conditions are related, inter alia, to the ineffectiveness of internal reporting mechanisms or the unavailability of internal reporting

[58] Law n° 2016-1691 of 6 December 2016 related to transparency, the fight against corruption and the modernisation of economic life, JORF n°0287.

[59] Disant Mathieu and Pollet-Panoussis Delphine, *Les lanceurs d'alerte* (Lextenso éditions LGDJ 2017) 3–4.

[60] Recommendation CM/Rec (2014)7, Protection of Whistle-blowers, adopted by the Committee of Ministers of the Council of Europe, 30 April 2014.

[61] *Guja v Moldova* App no 14277/04 (ECtHR 12 February 2008).

[62] ibid [73].

[63] ibid [73].

[64] *Heinisch v. Germany* App no 28274/08 (ECtHR, 21 July 2011); *Bucur and Toma v Romania* App no 40238/02 (ECtHR, 8 January 2013); Valérie Junod, 'Lancer l'alerte: quoi de neuf depuis "Guja"?' (2014) 98 Revue trimestrielle des droits de l'homme 459.

[65] European Commission, Proposal for a Directive of the European Parliament and of the Council on the protection of persons reporting breaches of Union law COM (2018) 218 final <https://ec.europa.eu/info/sites/info/files/placeholder_8.pdf> accessed on 10 May 2018.

structures.[66] The employee who reports internally has to satisfy less requirements to be legally protected than the employee who reports externally.[67]

From the above examples, it may be concluded that internal reporting is to be considered as the first important step the whistle-blower should take to be protected. The abovementioned national acts provide the possibility for external whistle-blowing, but legal protection is available only under stricter requirements. For instance, French law requires the employee to report internally, in the first place, and to report externally only if his employer did not respond to his concerns in a reasonable amount of time.[68] This preference for internal whistle-blowing aims to protect various interests. In the following subsections, an analysis of the advantages of internal whistle-blowing will be provided.

III. Whistle-Blower and Information Secrecy

An advantage of internal whistle-blowing is that information remains confidential and is not exposed to the authorities or the public.[69] Information, and more specifically financial information is an important component of the financial markets.[70] The importance of information is well-established. Thus, it needs to be protected.[71] In the business sector, this concept is translated to corporate secrecy that seeks to protect the interests of the corporation and in legal terms, is translated to the duty of professional secrecy or confidentiality.[72] The whistle-blower, by reporting internally does not breach his duty of professional secrecy, contrary to external whistle-blowing that exposes (confidential) information to the authorities

[66] The conditions are: (a) he or she first reported internally but no appropriate action was taken in response to the report within the reasonable timeframe referred to in Article 5; (b) internal reporting channels were not available for the reporting person or the reporting person could not reasonably be expected to be aware of the availability of such channels; (c) the use of internal reporting channels was not mandatory for the reporting person, in accordance with Article 4(2); (d) he or she could not reasonably be expected to use internal reporting channels in light of the subject-matter of the report; (e) he or she had reasonable grounds to believe that the use of internal reporting channels could jeopardise the effectiveness of investigative actions by competent authorities; (f) he or she was entitled to report directly through the external reporting channels to a competent authority by virtue of Union law.

[67] Naturally, the draft Directive is not yet a legally binding document. The negotiations between the European Parliament and the European Council will decide on the final text.

[68] Law n° 2016-1691 of 6 December 2016 related to transparency, the fight against corruption and the modernisation of economic life, JORF n°0287, Article 8.

[69] Richard Moberly, 'Confidentiality and Whistleblowing' (2018) 96 North Carolina Legal Review 752.

[70] Rothschild and Miethe (n 14) 124.

[71] Bok Sissela, *Secrets: On the Ethics of Concealment and Revelation* (Vintage Publishing 1989).

[72] Moberly (n 69) 751.

or the public.[73] Keeping the information inside the business is one of the major concerns to avoid harm for the whistle-blower and the corporation.[74]

In France, the duty of secrecy is protected under the auspices of criminal law.[75] The French criminal code, in Article 226-13, penalises the divulgation of confidential information by the employee who is in a position to have this information, because of the nature of his job.[76] In the UK, the duty of confidentiality was born in the *Tournier v National Provincial and Union Bank of England*.[77] In this case, the English Court of Appeal recognised that a duty of confidentiality exists between the bank and its customers. As a result, divulgation of confidential information is permitted only under certain conditions.[78] The Supreme Court of Ireland followed the opinion of the English Court of Appeal in *National Irish Bank Limited v Radio Telefis Eireann*, inserting the duty of confidentiality into the Irish legal order.[79]

Thus, the whistle-blower often risks breaching his duty of confidentiality and secrecy if he does not respect the procedural aspects of national legislation. For instance, if he reports to the authorities but cannot prove that the internal reporting systems were ineffective, the whistle-blower may face civil or criminal charges. In the UK and Ireland, the employee who breaches his duty of confidentiality would be liable for damages.[80] In France, he risks being held criminally liable as

[73] Moberly (n 69) 752.

[74] Moberly (n 69) 751.

[75] For instance, in Luxembourg, the duty of professional secrecy is protected under criminal law and the whistle-blower may be prosecuted for breaching his duty of professional secrecy, as was the case with "Luxleaks". Concerning the "Luxleaks case", the Luxembourg Cassation Court acquitted Mr Deltour for the charges related to his reporting as it recognised his status of whistle-blower as a justification. The Luxembourg Cassation Court used the case-law of the Strasbourg Court for the purposes of the whistle-blower status. See CSJ, cass, 11 Janvier 2018, n° 3912.

[76] Article 226-13 of the French Criminal Code.

[77] *Tournier v National Provincial and Union Bank of England* [1924] 1 KB 461 (CA).

[78] ibid 471 (Bankes LJ) said: "At the present day I think it may be asserted with confidence that the duty is a legal one arising out of contract, and that the duty is not absolute but qualified. It is not possible to frame any exhaustive definition of the duty. The most that can be done is to classify the qualification, and to indicate its limits... In my opinion it is necessary in a case like the present to direct the jury what are the limits, and what are the qualifications of the contractual duty of secrecy implied in the relation of banker and customer. There appears to be no authority on the point. On principle I think that the qualifications can be classified under four heads: (a) where disclosure is under compulsion by law; (b) where there is the duty to the public to disclose; (c) where the interest of the bank require disclosure; (d) where the disclosure is made by the express or implied consent of the customer."

[79] *National Irish Bank Limited v Radio Telefis Eireann* [1998] 2 IR 465, 494.

[80] Breach of confidentiality constitutes breach of the employment contact. In addition, the employer has the right to sue the employee for breach of confidentiality and if successful, he can obtain monetary damages for the employee. See Tanya Aplin, Lionel Bently, Phillip Johnson & Simon Malynicz, *Gurry on Breach of Confidence* (OUP 2012).

the breach of professional secrecy constitutes a criminal offence.[81] However, in these cases, national laws provide protection for the whistle-blower. In the UK, PIDA renders void any agreement of confidentiality between the employer and the employee that precludes the latter from making a protected disclosure.[82] In Ireland, PDA offers immunity from civil liability.[83] The French Law Sapin II, in Article 7, offers criminal immunity to the whistle-blower if he breaches his duty of professional secrecy.[84] However, the common point of these provisions is that protection is available only under strict requirements. One of the requirements is that the whistle-blower reporting externally should explain the reasons that prevented him from reporting internally. It is possible he will not be able to provide such reasons and in addition, he may not fulfil other requirements. Consequently, the whistle-blower has more chances to be in breach of his duty of confidentiality and secrecy if reporting externally than internally.

By reporting internally, the whistle-blower does not breach his duty of professional secrecy, as confidential information remains inside the organisation.[85] The whistle-blower does not risk any legal consequences by his employer. It is in the best interests of the corporation, at the same time, to maintain confidentiality and loyalty among employees.[86] In this regard, internal reporting is regarded as a new form of loyalty of employees towards the employer, characterised as rational loyalty by Wim Vandekerckhove.[87] The systems of national law analysed previously provide protection when the employee breaches his duty of secrecy by reporting, but only under certain strict requirements.[88] However, due to the technical aspects of the legislation involved,[89] the reporting employee risks breaching his duty of secrecy, as he may not be able to respect the strict requirements imposed. In that

[81] Article 226-13 of the French Criminal Code.

[82] s 43J.

[83] s 14.

[84] Law n° 2016-1691 of 6 December 2016 related to transparency, the fight against corruption and the modernisation of economic life, JORF n°0287 Article 7.

[85] Andrea Bather and Martin Kelly, 'Whistleblowing: The advantages of self-regulation' (2005) 82 Working Paper Series, Department of Accounting, University of Waikato 6.

[86] David Lewis, 'Whistleblowing in a challenging legal climate: is it time to revisit our approach to trust and loyalty at the workplace?' (2011) 20 Business Ethics: a European Review 80.

[87] Wim Vandekerckhove, Whistleblowing and organizational social responsibility: A global assessment (Aldershot: Ashgate 2006) 124–134.

[88] ibid.

[89] Technical aspects of the legislation are the requirements that the whistle-blower should comply for to be legally protected. They tend to be strict and not effective.

case, the employee can, as a last resort, invoke a public interest defence, where the Courts have to balance the interests of the company and the employer.

IV. Prevention of Employer Retaliation and the Corporation's Public Image

A clear internal whistle-blowing policy promotes good corporate governance, which is essential for a corporation's growth. Corporate governance is a regulating system, applied to an organisation to maintain good order and to treat correctly its affairs.[90] Corporate governance ensures an ethical environment in which business processes take place.[91] Reporting internally creates a stronger feeling of loyalty from the employee to his organisation.[92] By establishing internal whistle-blowing structures, the organisation has the opportunity to address misconduct internally, avoid legal costs, minimise damages to others and avoid any regulatory intervention and exposure. In some cases the employer can resolve a problem more quickly and efficiently than an external authority. This is particularly the case when the employee is mistaken about the employer's conduct or its legality and the employee can have his concerns allayed by the employer quite easily.

A. Legislation in the UK, Ireland, France, and the USA

The UK PIDA 1998 does not mandate the establishment of formal internal whistle-blowing structures. Instead, it remains at the discretion of the employer to do as such.[93] However, in July 2003 the Financial Services Authority introduced a new version of the Combined Code on Corporate Governance, which does contain a provision about whistle-blowing.[94] The Combined Code is not an Act of

90 Ruth V Aguilera, Michel Goyer and Luiz Ricardo Kabbach de Castro, 'Regulation and Comparative Corporate Governance' in Mike Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev (eds), *The Oxford Handbook of Corporate Governance* (OUP 2013) 31.

91 Alex Knell, Corporate governance: a practical implementation guide for unlisted companies (CIMA publishing 2006) 6.

92 Ravishankar Lilanthi, 'Encouraging internal whistle-blowing in internal organisations' (2003) Markkula Center for Applied Ethics, 7 <https://www.scu.edu/ethics/focus-areas/business-ethics/resources/encouraging-internal-whistleblowing/> accessed 03 May 2018.

93 Kelly Bouloy, 'The Public Interest Disclosure Act 1998: Nothing more than a "Cardboard Shield" (2012) 1 Manchester Student Law Review 3, 3-4.

94 Financial Services Authority (FSA): 2003, The Combined Code on Corporate Governance (FSA, London) 52.

Parliament as such, but all listed companies have to report on its implementation and consequently demonstrate that internal reporting structures exist.[95]

Irish legislation on protected disclosures has followed the same logic. Even though internal whistle-blowing is incentivised, the PDA 2014 does not oblige but invites the employer to set up internal reporting mechanisms as a sign of good corporate governance.[96] French law obliges legal persons that have more than fifty employees to establish appropriate internal reporting structures.[97] The whistle-blower should report internally to be legally protected. Reporting externally may happen under certain circumstances.[98] Finally, under Section 301 of the Sarbanes-Oxley Act, audit committees should develop reporting mechanisms for recording, tracking, and acting on information provided by the whistle-blower, going beyond merely encouraging companies to be more responsive to whistle-blowers' concerns.[99]

The employee who reports internally is protected against retaliation under the laws of the UK, Ireland, France and the USA. The benefit of legal protection is important when the whistle-blower uses an internal reporting channel.[100] In Ireland, the whistle-blower who reports internally is protected from unfair dismissal or any other type of "penalisation" such as harassment.[101] In addition, Irish law provides for civil and criminal immunity and identity protection.[102] UK law provides the whistle-blower the right not to suffer detrimental developments in his position, and grants the right to lodge a complaint to an employment tribunal if that would nevertheless be the case.[103] In addition, UK law protects the whistle-blower from unfair dismissal if he has made a protected disclosure.[104] The French

95 Financial Reporting Council (FRC): 2005, <http://www.frc.org.uk/corporate/combinedcode.cfm> accessed 09 May 2018.

96 Department of Public Expenditure and Reform, 'Statutory Review of the Protected Disclosures Act 2014' (2018) 37.

97 Law n° 2016-1691 of 6 December 2016 related to transparency, the fight against corruption and the modernization of economic life, JORF n°0287, Article 8.

98 Law n° 2016-1691 of 6 December 2016 related to transparency, the fight against corruption and the modernization of economic life, JORF n°0287, Article 8.

99 Tim V Eaton and Michael D Akers, 'Whistleblowing and Good Governance' (2007) 77 The CPA Journal 68.

100 It has to be noted that the employee will not be immediately protected if he reports internally. Irish law demands that the employee reasonably believed that the information is correct to characterise his disclosure as a protected disclosure and allow him to be protected. Under French law, the whistle-blower should report in good faith and without having any personal interests. If he fulfils those criteria, he may be granted protection.

101 Department of Public Expenditure and Reform, 'Statutory Review of the Protected Disclosures Act 2014' (2018) 37.

102 Protected Disclosures Act 2014, part 3.

103 Public Interest Disclosures Act 1998, s 43K(2).

104 Public Interest Disclosures Act 1998, s 43K(5).

Law Sapin II equally protects the whistle-blower from unfair dismissal or any other type of "penalisation" from his employer.[105] The situation in the US is similar as well, following Section 806 of the Sarbanes-Oxley Act. Additionally, the US Department of Labour may authorise the Department of Justice to criminally charge those responsible for any form of retaliation.[106]

B. Benefits for the organisation

Organisations prefer internal whistle-blowing because the wrongdoing can be corrected internally and without any outside upheaval.[107] The corporation, by providing anonymity and thoroughly investigating the complaint, ensures that tensions do not arise among employees and frivolous complaints will be dropped.[108] Indeed, whistle-blowing has become an ever more important element of the corporate governance system.[109] The development of the concepts of corporate social responsibility, consumer protection and accountability has led corporations to pay more attention to ethical issues and, thus, the detection of these issues though internal reporting.[110]

Apart from the fact that the organisation will gain nothing when employees use external channels,[111] the establishment of effective internal reporting channels is a sign of commitment to integrity and social responsibility.[112] Striving towards good corporate citizenship and ethical business policies is a non-financial factor that positively affects investment decisions.[113] Internal reporting mechanisms are a signal for investors and the public that a corporation is giving priority to

105 Law n° 2016-1691 of 6 December 2016 related to transparency, the fight against corruption and the modernization of economic life, JORF n°0287 Article 10.

106 18 U.S.C. (2002).

107 Richard Moberly, 'To persons or organisations that may be able to effect action': whistle-blowing recipients' in A.J. Brown, David Lewis, Richard Moberly and Wim Vandekerckhove (eds), *International research handbook on whistle-blowing* (Routledge 2014) 277.

108 Eaton and Akers (n 99) 70–71.

109 Teen Yuen Mak, 'Whistle-blowing: recent developments and implementation issues' (2007) 5 Global Corporate Governance Forum, 3.

110 P-O Bornfelt, Markus Arvidson, Jonas Axelsson and Roland Ahlstrand, Whistle-blowing in the light of loyalty and transparency, Paper to the 7th Nordic Working Life Conference, Goteborg, Sweden, June 2014, 2.

111 Christian Chamorro-Courtland and Marc Cohen, "Whistle-blower laws in the financial markets: lessons from emerging markets", (2017) 34 Arizona Journal of International and Comparative Law 188.

112 Jacqueline de Gramont, 'The business case for speaking-up' (Transparency International 2017) <https://www.transparency.org/whatwedo/publication/business_case_for_speaking_up> accessed 4 September 2018.

113 Ernst & Young, Is your nonfinancial performance revealing the true value of your business to investors? (2017) 22.

risk management,[114] and corporate social responsibility can offer considerable advantages to investors.[115] This commitment to enhance corporate social responsibility should be ensured by the organisation through incentives and secure channels for whistle-blowing.[116] A culture of openness should be developed, alongside a culture of informing the employees about internal reporting channels.[117]

V. Advantages of External Whistle-Blowing

A. Europe

UK, Ireland and France have all adopted legislation on the protection of external reporting by whistle-blowers as a second possible disclosure channel, in case the internal channels are not effective or responsive. For instance, Section 43F of the PIDA creates the opportunity to report to a prescribed person.[118] This provision sets out different requirements that the employee should fulfil to report correctly.[119] The Secretary of State designs the prescribed persons.[120] Irish law also considers reporting to a prescribed person as the second possible channel for disclosure.[121] The Minister for Public Expenditure and Reform is responsible for prescribing the relevant officials.[122] The French Law Sapin II, pursuant to Article 7, allows the employee to report to administrative or judicial authorities or professional orders, if the employer is not responsive.[123] For the banking and financial sector, the Law Sapin II designates two specific authorities that should be contacted: the Financial Markets Authority (Autorité des marchés financiers,

114 de Gramont (n 112)

115 Stelios Andreadakis, 'Enhancing whistle-blower protection: it's all about culture' (2017) Selected Papers from the International Whistleblowing Research Network Conference in Oslo, 6.

116 Stephen J Brammer and Stephen Pavelin, 'Corporate Governance and Corporate Social Responsibility' in Mike Wright, Donald Siegel, Kevin Keasey & Igor Filatotchev (eds), *The Oxford Handbook of Corporate Governance* (OUP 2013) 725.

117 Those internal reporting channels can take the form of confidential hotlines or a special designated body, inside the organisation, that can receive whistle-blowers' concerns. *See* Andreadakis (n 115); Harold Hassink, Meinderd De Vries and Laury Bollen, 'A content analysis of whistle-blowing policies of leading European companies' (2007) Journal of Business Ethics 37.

118 Public Interest Disclosure Act 1998, United Kingdom.

119 Lewis, Bowers, Fodder and Mitchell (n 50) 115–124.

120 For the prescribed persons in the United Kingdom see: The Public Interest Disclosure (Prescribed Persons) Order 2014, no. 2418 <http://www.legislation.gov.uk/uksi/2014/2418/pdfs/uksi_20142418_en.pdf> accessed on 20 July 2018.

121 Protected Disclosures Act 2014, s 7.

122 S.I No. 339&2014 – Protected Disclosures Act 2014 (Section 7(2)) Order 2014 <http://www.irishstatutebook.ie/eli/2014/si/339/made/en/print> accessed on 25 July 2018.

123 Law n° 2016-1691 of 6 December 2016 related to transparency, the fight against corruption and the modernisation of economic life, JORF n°0287.

"AMF") and the Prudential Control and Resolution Authority (Autorité de contrôle prudentiel et de résolution).[124] In addition, the ECtHR, in *Guja v Moldova*, considered whistle-blowing to the relevant authorities the second best solution if and only if the whistle-blower proves that he was not able to report internally.[125]

B. USA

The USA Dodd-Frank Act, as analysed in Part II of this article, protects the whistle-blower who reports to the SEC (externally). Following the Supreme Court decision in *Digital Realty Trust, Inc. v Somers*,[126] the employee who reports internally cannot invoke legal protection under the Dodd-Frank Act.[127] The preference towards external reporting in the USA is justified by various interests, which I will present in the following Part.

VI. Ineffectiveness of Internal Reporting Systems

A positive aspect of external whistle-blowing is that it may accelerate the process when the internal variant does not deliver any tangible results.[128] Research has shown that whistle-blowers choose to address an external recipient in case of the inactiveness or non-trustworthiness of an internal reporting system.[129] In that case, the whistle-blower might be afraid that either the institution will not respond to his concerns or that top management will cover-up the problem without resolving it.[130] Thus, it is the irresponsiveness of the institution itself that is driving the whistle-blower to blow the whistle outside the institution and potentially to the competent authorities.[131]

Apart from the apprehension that an institution might not react at all, the whistle-blower might also fear facing formal or "informal" consequences inside the institution.[132] These actions may come in the form of humiliation, discrimination, or threats.[133] The whistle-blower may not always feel safe from retaliation in his workplace, as often the top management is hostile to whistle-blowing.[134] The

[124] Law n° 2016-1691 of 6 December 2016 related to transparency, the fight against corruption and the modernisation of economic life, JORF n°0287 Article 16.
[125] Lewis, Bowers, Fodder and Mitchell (n 50) 549.
[126] *Digital Realty Trust, Inc v Somers*, 138 US 767, 772 (2018).
[127] See Part 2.
[128] Moberly (n 107) 278.
[129] Mendelsohn (n 19) 741.
[130] Bucy (n 15) 946.
[131] Kate Kenny, 'Censored: Whistleblowers and impossible speech' (2017) 71 Human Relations 1025.
[132] Andreadakis (n 115) 64.
[133] ibid 64.
[134] Kenny (n 131) 16–27.

term "retaliation" should be conceived widely and covers any form of action the employer can take against the employee. Scepticism over internal whistle-blowing was an evident concern of the early advocates of whistle-blower protection.[135] Indeed, many stories have demonstrated that the structures for internal whistle-blowing have been inadequate.[136] External whistle-blowing thus cures institutions' inability and inappropriateness to facilitate or handle internal reporting.[137] The whistle-blower may also demonstrate the disregard of internal reporting systems to the relevant authorities.[138]

Another important advantage of external disclosure is that potentially incriminating evidence is less likely to be destroyed. Indeed, there will be no time for the employer to let evidence disappear.[139] Although authorities tend to demand institutions to solve minor problems without external intervention, this scenario is unlikely when it concerns the destruction of evidence of a crime, as it may have disastrous consequences for the public perception of the authority itself.[140] Perhaps unsurprising, attorneys and legal experts on whistle-blowing are advising future whistle-blowers to obtain the necessary evidence to be able to substantiate their claim when discussing with the authorities.[141] Social scientists have even argued that external whistle-blowing, without providing evidence, may be characterised as unethical.[142] As a result, the employee may resort to external whistle-blowing, after having obtained strong evidence of the wrongdoing, to be certain that his claim will be heard and the evidence will not be destroyed.[143]

[135] Randi L Sims and John P Keenan, 'Predictors of External Whistleblowing: Organisational and Intrapersonal Variables' (1998) 17 Journal of Business Ethics 419.
[136] Robert Vaughn, The successes and failures of whistle-blower laws (EE publications 2012), 324. Kate Kenny, Banking compliance and dependent corruption: towards an attachment perspective (2014) Law and Financial Markets Review 170.
[137] Vaughn (n 136) 324.
[138] ibid 324.
[139] Chamorro-Courtland and Cohen (n 111) 220.
[140] ibid 220.
[141] Terry Morehead Dworkin and Melissa S Baucus, 'Internal vs. External whistle-blowers: a comparison of whistleblowing processes' 17 (1998) Journal of Business Ethics 1281, 1284.
[142] Janet P Near and Marcia P Miceli, *Blowing the whistle* (Lexington books, New York, 1992).
[143] It should be noted that it is highly probable that the internal management will impede the collection of evidence and may transfer the employee to another position where he does not have access to the evidence he needs. *See* Dworkin and Baucus (n 141) 1285.

VII. Combining Internal and External Whistle-Blowing

The above analysis demonstrates that the whistle-blower is in a delicate position, as he cannot be sure whether to report internally or not.[144] The technical legal requirements are not always clear and the employee is not always in the position to understand them correctly.[145] Therefore, a good-faith attempt to correct wrongdoings may disappoint the employee, as he may not be protected at the end. When legislation denies protection to the employee on technical grounds, future whistle-blowers may be discouraged to report.[146] Hence, this article proposes that legislation should be clear and precise while, at the same time, less technical by adopting a more lenient approach. This means that the whistle-blower should be protected under the same requirements whether he reports internally or externally. This entails that internal reporting should not be preferred over external reporting. External reporting should be subject to the same requirements with regard to protection (or immunity) as internal reporting. This will enhance whistle-blowing and the protection of the whistle-blower. There should, of course, be certain limits and boundaries to ensure effective and honest whistle-blowing. It is up to the legislator to set these limits (for instance, prescribing a good faith requirement from the side of the whistle-blower).

It should be acknowledged that internal reporting channels are not always effective. Although legislation favours internal reporting mechanisms, their results are difficult to establish empirically.[147] A more lenient approach would allow the whistle-blower to report to the authorities even if the internal reporting channels are effective and legislation will offer him protection. A good precondition to granting protection should be that the employee believes that the recipient of his concerns will be able to effectively remedy the situation. Then, it is no longer highly relevant whether the recipient is internal or external.[148] The whistle-blower should not feel entrapped due to legislation entailing that he should report internally at first. Normally, the external recipient is an authority that has the obligation to receive and treat disclosures on wrongdoings.[149]

The core problem are the many different requirements a whistle-blower should fulfil to be protected from retaliation. According to the laws in the UK, Ireland and France, whistle-blowers' legal protection is more easily ensured by reporting internally. On the other hand, the recent developments in the US favour external whistle-blowing. The whistle-blower who reports to the SEC may enjoy protection under Dodd-Frank. If he reports internally, he may enjoy protection under the Sarbanes-Oxley Act. However, the protection of the Dodd-Frank Act is significantly more attractive than that of Sarbanes-Oxley.

Both reporting channels present significant advantages, but they are not complementary. The whistle-blower may opt for one channel over another, making his choice not only on legal grounds but also considering other arguments. In certain cases, an employee's choice is driven by pragmatic considerations[150] and not decided upon statutory requirements.[151] Additionally, the whistle-blower is not always in a position to follow the applicable statutory requirements. This article suggests that instead of creating a problematic situation for whistle-blowers, the fundamental goal should be to protect the messenger and to rectify wrongdoings, instead of introducing procedural steps that complicate this path.

[144] Elletta Sangrey Callahan and Terry Morehead Dworkin, 'Who blows the whistle to the media, and why: organisational characteristics of media whistle-blowers' (1994) 96 American Business Law Journal 151, 168.
[145] Estelle Feldman, 'Whistleblower Protection' (2011) 24 Annual Review of Irish Law 9.
[146] Gerard Sinzdak, 'An analysis of current whistle-blower laws: Defending a more flexible approach to reporting requirements' (2008) 96 California Law Review 1633, 1661.
[147] Vaughn (n 136) 326.
[148] Moberly (n 107) 283.
[149] ibid 293.

[150] Callahan and Dworkin (n 144), 162–163.
[151] Dworkin and Baucus (n 141) 1299.

Public-Private Cooperation In European Anti-Money Laundering And Counteracting Terrorism Financing Regulations—Challenges For Fundamental Freedoms And Rights

Magdalena Jaczewska*

I. Introduction

The last twenty-five years have been a vibrant and dynamic time for the European Union's (EU) legal regime aimed at counteracting money laundering[1] and terrorism financing.[2] As will be discussed, Anti-Money Laundering Directives are the European legal instruments of choice to tackle ML and TF. Up to 2018, five successive Directives have been drafted. Even though some of the Member States have not yet implemented the Fourth Anti-Money Laundering (AML)

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1 The Financial Action Task Force describes money laundering as a process of allowing criminals to disguise the illicit origins of profits (resulting from the sale of weapons, drug trafficking, smuggling, prostitution, corruption, insider trading and cybercrime), enabling them to freely use the proceeds.

2 Terrorism financing is understood as collecting, transferring or offering means of payment, securities, foreign currencies, financial instruments, property rights or rights to other movable or immovable property in order to finance a terrorist offense or to make assets available to an organised group or union seeking to commit such a crime or a person involved in such a group. Money laundering and terrorist financing are characterised by rather opposing dynamics and objectives. The former aims to rub out the illicit origin of funds. The latter, instead, diverts "clean money" into terrorist activities. Thus, terrorism financing mirrors money laundering.

Directive,[3] the subsequent, Fifth AML Directive[4] entered into force in July 2018. Its final transposition date is January 2020. This creates the interesting situation of both of them being applicable (the previous AML Directives have been repealed). The adoption of the last two Directives followed terrorist attacks that struck the EU and the extensive financial dealings uncovered by the "Panama Papers".[5] This represents a significant step in improving the effectiveness of the EU's efforts to counteract money laundering and terrorism financing.

Nevertheless, this article critically evaluates the EU anti-money laundering initiatives. I focus primarily on the preventive aspects of the AML regime, introduced via the imposition of a series of duties on the private sector, and through the adoption of a risk-based approach. Importantly, the prevention of money laundering and terrorism financing crimes is based on the direct and dynamic involvement of the private sector. EU legislation attempts to elicit high levels of compliance through a system of public-private cooperation. However, due to the wide involvement of private entities, there exist considerable opportunities for inconsistencies of the AML regime with fundamental rights and freedoms to arise. Therefore, the article will especially scrutinise the impact of anti-terrorism financing legislation on fundamental freedoms and rights—the freedom to provide services, the right to a fair trial, and the rights to privacy and data protection.

The EU is required to comply with fundamental freedoms and rights while exercising its legislative power. Since the 1970's judgement in the *Internationale Handelsgesellschaft* case,[6] fundamental rights have been considered a general principle of the EU legal system. Also, the Charter of Fundamental Rights of the EU (Charter)[7] has eventually acquired EU primary law status. However, whether

3 Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC [2015] OJ L 141/73 (Fourth AML Directive).

4 Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU [2018] OJ L 156/43 (Fifth AML Directive).

5 The world's largest whistle-blower case, reported by media on 3 April, 2016, which to date consists of eleven-and-a half million documents and involves a year-long effort by the International Consortium of Investigative Journalists to expose a global pattern of crime and corruption where millions of documents reveal heads of state, criminals and celebrities using secret hideaways in tax havens.

6 Case 11/70, *Internationale Handelsgesellschaft mbH v Einfuhr- und Vorratsstelle für Getreide und* Futtermittel [1970] ECR 1125.

7 Charter of Fundamental Rights of the European Union, [2012], OJ C 326 (Charter).

EU AML and counteracting terrorism financing (CFT) law is always consistent with the abovementioned freedoms and rights remains questionable.

In particular, this article will explore the interplay between AML and CFT-measures and the freedom to provide services, the right to a fair trial, and the right to privacy and data protection. These rights and freedoms are specifically important, as AML and CFT- regulations may potentially violate them, due to the strong involvement of private entities under the AML-regime. An attempt will be made to determine if and in which direction changes should take place, not to exclude entire classes of customers or terminate customer relationships and not to overburden the private sector with further responsibilities, but to help it to gain confidence and to perform its duties in an effective manner. Thus, the article aims to balance technological achievements, transparency and social entrepreneurship.

This article consists of four sections. Part II presents the influence of globalisation on the evaluation of the AML- and CFT-regime. Part III presents the private-public cooperation and enforcement of AML- and CFT-regulations, which is concluded mainly through the preventive role of the private sector and an obligation to enforce the preventive duties by public subjects. In Part IV, I analyse how AML- and CFT-regulations interfere with fundamental freedoms and rights. I conclude with the observation that whereas the AML fight is recognised in the EU as a general interest, its effect on fundamental freedoms and rights must be constantly evaluated in light of the principle of proportionality.

This article is based on a theoretical and legal analysis of legislation at the EU level, relevant existing studies on the application of existing rules by Member States, newly established international requirements (in particular, the revised Financial Action Task Force (FATF) Recommendations, FATF Guidelines) as well as a legal analysis of communications and reports of EU bodies and international organisations.

II. The AML Legal Framework: Shaped by Globalisation

The globally interconnected financial system, fuelled by the development of financial technologies (FinTech), makes the anonymous movement of funds around the world, across borders and jurisdictions, possible at any time. In such an environment, the fight against money laundering and terrorism financing is increasingly difficult. Emerging platforms offering a high level of anonymity—such as crowdfunding and virtual currencies trading—appear to be significantly exposed from a risk perspective. Also, a growing variety of financial instruments, such as virtual currencies or blockchain, may facilitate the perpetration of illegal conduct. To adapt to the ongoing technological developments, it is of utmost importance to understand the risks resulting from products in these fast-developing sectors, and how to leverage the possibilities of new technologies to improve anti-money laundering and terrorism financing efforts. Additionally, launderers and terrorists have obtained new possibilities because of deregulation and progressive internationalisation of financial markets, and fragmentation of public controls. Loopholes in legal oversight of many financial means, ranging from cash and trade in cultural artefacts to anonymous pre-paid cards, still exist.[8] Against this background, local jurisdictions and authorities often fall short of tackling crimes, which have an international or even global dimension. It is thus indisputable that international cooperation is vital to create an efficient system. Measures adopted at a national or even EU level would, considering the international scale of money-laundering, have a very limited effect. The actions taken by the EU should therefore be compatible with those taken in the international context.

EU law in the area of money laundering is shaped by internal and external initiatives. Being aware of the global character of money laundering and terrorism financing crimes, the EU has been active in international initiatives, mainly those of the United Nations[9]. The need to arrange a global strategy to tackle the proceeds of profit-generating criminal offences was implemented via a combination of "hard law" treaty instruments and "soft law" standards, elaborated within the confines of the FATF.

The FATF is an intergovernmental organisation founded in 1989 at the initiative of the G7, to develop policies to combat money laundering. In 2001, its mandate was expanded to include terrorism financing. This *ad hoc* body became the institutional centre of a supra-national legal regime.[10] Although the FATF output takes the form of Recommendations, which should be characterised as "soft law", their influence on the development of EU anti-money laundering law has been undeniable. Indeed, all of the AML Directives have highlighted the need to implement the Recommendations. As to their content, the FATF Recommendations consists of forty provisions. Overall, they tackle two main aspects: (a) the criminalisation of money laundering and terrorism financing; and

[8] European Commission, 'Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/EC' COM(2016) 450 Final.

[9] See the UN Convention against Illicit Traffic in Narcotic Drugs and Psychotropic Substances, the UN Convention against Corruption, the U.N. Convention against Transnational Organized Crime and the UN International Convention for the Suppression of the Financing of Terrorism.

[10] Leonardo Borlini, 'Regulating Criminal Finance in the EU in the Light of the International Instruments' (2017) 36 Yearbook of European Law 553.

(b) measures designed to prevent the proceeds of crime from entering into the legitimate financial system.

The prevention of money laundering and terrorism financing crimes is based on the direct and dynamic involvement of the private sector. EU legislation, therefore, attempts to elicit high levels of compliance from a system of public-private cooperation, imposing preventive obligations on a wide array of private actors. The following analysis aims to assess the main elements of the current EU AML and CFT-preventive framework and the related problems for fundamental freedoms and rights.

III. Preventive Aspect of the AML and CFT EU Regulations—Public-Private Cooperation

An effective enforcement of AML and CFT law, as described by Mitsilegas and Vavoula, which is also in line with the FATF Recommendations, should be based on three pillars: (a) the criminalisation of money laundering and terrorism financing; (b) the prevention of money laundering via the imposition of a series of duties on the private sector; and (c) the establishment of a cooperation regime between private and public sectors.[11] Nowadays, the borders between the public and private sectors are becoming smoother.[12] The traditional model of command and control is more and more often replaced with a model in which enforcement is being shared between public and private actors.[13] The EU legislator has noticed this change in perspective, and has wisely implemented it in EU regulations, creating a paradigm of security governance, based on the so-called "responsibilisation strategy".[14] Its dominant concern is to delegate responsibility for crime prevention to private entities which are outside the scope of the state and persuade them to act as a "private policeman". The market, in turn, has opened up the EU for private authority and placed the emphasis on output legitimacy.[15] In Section III.A, I will analyse the role of private entities in the AML regime. Then, in Section III.B, public enforcement will be described.

A. The role of private actors

Taking the new tendencies in EU governance into consideration, the imposition of a series of preventive duties upon the private sector has become the cornerstone of the AML regime.[16] Private actors are here defined as for-profit organisations, such as banks, financial institutions and lawyers. Public actors, instead, are governments, governmental international organisations and agencies. The EU legislator imposes a wide array of obligations on private actors. These, in the present context, constitute: (a) identification of the customer; (b) customer due diligence; (c) reporting of suspicious transactions; and (d) report keeping. To enhance the prevention pillar, financial and professional intermediaries should be involved directly at as many stages of the AML and CFT-process as possible. These subjects, who have tangible, constant and direct contact with their clients, are in a better position to assess risk and to detect potentially suspicious activities. The need for greater involvement of private actors is linked to the importance of getting access to their resources.[17] Private subjects possess valuable knowledge of their clients, which cannot be assessed at the state or EU level. Companies have control over databases and customer data which are normally out of the reach of the public authorities. Hence, the wider the range of business entities engaged in the AML process, the more valuable the information to assess risks the public authorities will be able to gain.[18]

The development of anti-money laundering preventive duties has been elaborated in a two-fold manner.[19] Firstly, this was implemented via a broadening of the scope of *ratione personae* and imposing, on the entities concerned, an increasingly broad range of responsibilities, which are of greater detail and are more sophisticated in their content. Secondly, a risk-based approach has been adopted. Both aspects will be discussed in more detail below.

(I) The Extension of the Ratione Personae Scope

The list of concerned entities (*i.e.* subject to AML-preventive obligations) is closed (*numerus clausus*). It has grown with each subsequent directive. The First

11 Valsamis Mitsilegas & Niovi Vavoula, 'The Evolving EU Anti-Money Laundering Regime: Challenges for Fundamental Rights and the Rule of Law' (2016) 23 Maastricht Journal of European and Comparative Law 261.

12 Maria Bergström & Karin Helgesson Svedberg Ulrika Mörth, 'A New Role for For-Profit Actors? The Case of Anti-Money Laundering and Risk Management' (2011) 49 Journal of Common Market Studies 1043.

13 Ulrika Mörth, *European Public-Private Collaboration: A Choice Between Efficiency and Democratic Accountability?* (Edward Elgar, Cheltenham 2008).

14 David Garland, 'The Limits of Sovereign State' (1996) 36 British Journal of Criminology 445.

15 Ulrika Mörth, 'The Market Turn in EU Governance -The Emergence of Public–Private Collaboration' (2009) 22 Governance 120.

16 Mitsilegas and Vavoula (n 11).

17 Bergstrom and Svedberg Morth (n 12).

18 ibid.

19 Mitsilegas and Vavoula (n 11).

AML Directive[20] included only bankers and financial institutions. The Second AML Directive[21] recognised a trend of increased money-laundering by non-financial businesses.[22] Thus, the scope of obliged entities addressed also a limited number of professions, such as notaries and other independent legal professionals, casinos, insurance companies and remittance offices, which have been shown to be exposed to money laundering. As the tightening of controls in the financial sector has prompted money launderers and terrorist financers to seek alternative methods for camouflaging the origins of the proceeds of their crimes,[23] the Third AML Directive[24] further covered life insurance intermediaries, and trust and company service providers. After adoption of the Third AML Directive, the use of (online) gambling sector services became a concern. To mitigate it, the Fourth AML Directive included professionals from the gambling sector ('the providers of gambling services'). Due to the latest achievements of the FinTech industry, new threats have emerged. Terrorist groups may be able to transfer money into the EU financial system through virtual currencies networks, by camouflaging transfers or by benefiting from a certain degree of anonymity on those platforms.[25] It therefore became essential to again widen the scope of the obliged entities, as was done in the Fifth AML Directive. Currently, AML-procedures apply to entities that are in charge of holding, storing and transferring virtual currencies. Moreover, due to the leakage of information concerning tax havens (because of the "Panama Papers"), the provisions of the Fifth AML Directive also apply to auditors, external accountants and tax advisors, and any other person that undertakes to provide material aid, assistance or advice on tax matters as a principal business or professional activity. Additionally, after the devastation of heritage sites in Syria and Iraq, art trafficking became one of the most profitable illegal trades in the

20 Council Directive 91/308/EEC of 10 June 1991 on the prevention of the use of the financial system for the purpose of money laundering [1991] OJ L 166 (First AML Directive).

21 Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001 amending Council Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering [2001] OJ L 344 (Second AML Directive).

22 Recital 14 of the Second AML Directive.

23 European Commission, 'Proposal for a Directive of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering, including terrorist financing' COM (2004) 448 Final.

24 Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing [2005] OJ L 309 (Third AML Directive).

25 Fourth AML Directive, Recital 8.

world. Thus, under the Fifth Directive, persons trading in works of art (such as galleries or auction houses) are also included in the compliance list.[26]

Although more and more sectors are involved in the AML-regime, it must also be highlighted that the extension of anti-money laundering preventive duties to sectors, which are not under the supervision of national regulators (such as auction houses), may raise questions of the feasibility of compliance and effectiveness.[27] In case of large financial institutions, such as banks, which have compliance and law departments working on the adjustment of internal procedures to provisions of law, compliance might be more feasible. Smaller private entities may however be overburdened with obligations and compliance costs. To make requirements more flexible, unburden market participants, and facilitate the delivery of regulatory actions, a risk-based approach has been adopted.

(II) Risk-Based Approach

The second feature in the development of money laundering-preventive public-private cooperation is the risk-based approach. The risk-based analysis has been applied successfully in different academic disciplines, such as management and economics. Under the AML regime, it means that countries, state authorities and obliged entities should have an understanding of the risks associated with money laundering and terrorism financing to which they are exposed, and apply measures in a manner and to an extent which would ensure the mitigation of these specific risks.[28] At first, the set of AML and CFT-measures was required only to be based on an understanding of the risks actually present. Such an approach was notably present in the 2003 FATF Recommendations. The EU transposed these attempts to risk-based standards through the Third AML Directive.

However, in the 2003 FATF Recommendations, the risk-based model was supposed to be applied only in certain circumstances. Conversely, under the 2012 FATF Recommendations, it is an underlying requirement, constituting the foundation for an effective implementation of all the recommendations.[29] Thus, with the revised 2012 FATF Recommendations, the risk-based approach has become central to an effective implementation and enforcement of all requirements set out therein. In the EU, this extended risk-based approach was implemented through the Fourth AML Directive. It can be seen as an attempt to move from mechanical compliance to a system where the quality of compliance is

26 Fifth AML Directive, Article 1(1).

27 Mitsilegas & Vavoula (n 11).

28 Council of Europe, 'Risk-based approach' <https://www.coe.int/en/web/moneyval/implementation/risk-based-approach> accessed 8 September 2018.

29 ibid.

enhanced.[30] Since the adoption of the Fourth AML Directive, there exist basically three dimensions of risk-assessment and risk-management: the EU dimension (located at the European Commission (EC) to be exact), the national dimension, and the private sector dimension.

At EU level, the EC is entrusted with the obligation to assess the risks which may emerge on the internal market. It is also the EC's duty to identify high-risk countries so as to protect the proper functioning of the cross-border market.[31] In terms of the national dimension, Member States are placed under the obligation to identify, assess, understand, and mitigate the risks of money laundering and terrorism financing by constructing a mechanism or authority that would organise the national response to the risks identified.[32] As to the private sector dimension, the obliged entities are required to ensure the preparation of an analysis in which business activities would be identified and holistically assessed in light of the risk adequate for customers, countries or geographic areas, offered services or products, delivery channels, and transactions. Therefore, the risk-based approach is in fact a self-assessment regime. All steps taken by private entities need to be proportionate to the nature and size of the obliged entities.[33] Furthermore, the risk analysis must be documented and kept up to date.[34] Obliged entities should have policies and procedures in place according to which they can manage risks properly.[35]

The risk-based approach implies that components of AML-procedures, *i.e.* regulation, compliance and control, should be framed in light of the risks that are to be mitigated. According to FATF, the principle is that 'resources should be directed in accordance with priorities, so that the greatest risks receive the highest attention'.[36] Alternative approaches are that resources are either applied evenly, so that all customers, financial institutions and products receive equal attention, or that resources are targeted, but on the basis of factors other than the risk assessed.[37] Thus, the regulatory framework must be determined by the regulated entities themselves, in light of the concrete circumstances and potential risks. As soon as

30 Earlier, the emphasis was placed on a rule-based approach, *i.e.* a system of AML rules that does not take into consideration the different nature and risk profiles of the business.
31 4th AML Directive, Article 9(1) and Article 9(2).
32 ibid, Article 7.
33 ibid, Article 8(1).
34 ibid, Article 8(2).
35 ibid, Article 8(3).
36 FATF, 'RBA Guidance for Dealers in Precious Metal and Stones' (2008).
37 ibid.

risk indicators are signalling, the obliged entities are expected to react in line with readily prepared AML-procedures.

Under a risk-based approach, the legislator delegates to the obliged entities both design and implementation of model AML- and CFT-controls, which will be monitored and assessed by public supervisors, in the format of a self-assessment.[38] Moreover, businesses are expected to make a risk assessment of their customers and divide them into low and high risk segments, to whom simplified or enhanced measures will be taken. If the risk-based approach is applied in a reasoned and well-enunciated way, it will justify the determinations of financial institutions with regard to managing potential money laundering and terrorism financing risks. It will also allow these subjects to exercise equitable business judgement with respect to their customers.[39] It should be emphasised that client monitoring is to be conducted in a continuous manner, and that the risk evaluation is not concluded only once. Instead, ongoing monitoring of the business relationship must be undertaken throughout the course of the relationship. On a daily basis, obliged entities collect information about their clients, in particular concerning the source of their wealth, the possible destination and economic rationale of a given transaction.[40] Of particular relevance is the identification of beneficial owners, *i.e.* 'any natural person who ultimately owns or controls the customer and/or the natural person on whose behalf a transaction or activity is being conducted'[41]. If the transaction raises suspicions of the obliged entity, it must be reported to a Financial Intelligence Unit.

The adoption of a risk-based approach to counteracting money laundering and terrorism financing can be beneficial for all parties, including public entities. Applied effectively, it should allow lower administrative costs. Financial institutions and supervisory authorities applying risk should be more effective and efficient while using their resources and minimising burdens on customers. When the focus is on higher-risk threats, beneficial policy effects can be achieved more effectively. Efforts to combat money laundering and terrorism financing should also be flexible, to adapt as risks evolve. Obliged entities use their knowledge, judgment and expertise to calibrate an appropriate solution for their particular organisational structure and business activities. Thus, cooperation between private and public entities is an indispensable element to achieve an effective risk-based process.

However, a risk-based approach is not inevitably an easy option, and there may be barriers to overcome in the implementation process. It must be noted that

38 Borlini (n 10).
39 FATF, 'Guidance on the risk-based approach to combating money laundering and terrorist financing' (2007).
40 Fourth AML Directive, Article 20.
41 ibid Article 3(6).

granting a greater degree of discretion to the private sector may also create a greater degree of legal uncertainty for those who have to comply with the preventive AML duties.[42] Moreover, private entities might have incentives not to comply, as incentive costs might be lower. From a law and economics perspective, incentive costs shall outweigh the administrative costs so that policy becomes more effective. Additionally, given the higher risk of money laundering, terrorism financing and other predicate offences associated with certain intermediary structures, the risk-based approach might not allow for the timely disclosure and assessment of issues. It is therefore important to ensure that some clearly particularised categories of existing customers are also monitored on a regular basis.[43] Attempting to pursue a risk-based approach without sufficient expertise may lead to obliged institutions making flawed judgments. They may overestimate risk, which could lead to a wasteful use of resources, or they may underestimate risk, thereby creating susceptibilities.[44] Also, staff members of the obliged entities might be uncomfortable making risk-based judgements. This may lead to overanalysed decisions, or an excessive amount of time spent documenting the decision process.[45] Another problem may arise in the context of the allocation of the responsibility between sectors; for instance, the issue of who is to be called to account when the system disappoints.[46] In general, the risk-based approach implies a transfer of responsibility regarding the quality of the assurance from public authorities towards the private sector, by changing the focus from the regulator to the regulatees.[47] Thus, there exists a risk that responsibilities would be diluted and that the involvement of multiple subjects encourages processes of blame shifting.

Taken together, the risk-based approach makes regulation more flexible and intensifies the responsibilities of professional intermediaries. These subjects, under the supervision of regulatory or other public entities, design and implement a model of AML and CFT.

B. Role of the public sector

As described above, private-public collaboration constitutes the basis for an efficient AML- and CFT-regime. In general, in this partnership the public sector is entrusted with the obligation to enforce the preventive duties laid down on private actors. However, the division of responsibilities between private and public actors

42 Mitsilegas and Vavoula (n 11).
43 Fifth AML Directive, recital 24.
44 FATF (n 39).
45 ibid.
46 Bergström, Svedberg and Mörth (n 12).
47 ibid.

is not clearly defined in the AML Directives. Although the "risk-based approach" is presented as a general device that can be used for structuring the AML-regime and for combating terrorism financing, its operationalisation may differ across Member States, as legislators are left to set up national procedures at their own discretion. Such standards may be implemented in two ways: (i) by the national regulator, who sets hard rules for the private sector, or (ii) by actors across the public-private divide (for example, the "rubber stamping" system adhered to in the UK).[48]

(I) Procedures Introduced by National Regulators

As the main role of the public sector is to enforce the preventive duties of private entities, it should have appropriate tools for this task. Public subjects must be able to ensure that obliged entities can be held liable for breaches of national provisions transposing the AML Directives. In terms of sanctions for non-compliance, the national rules may differ, as considerable discretion is left to the Member States in this regard.[49] Nevertheless, any resulting sanction or measure should be effective, proportionate and dissuasive. Article 59 of the Fourth AML Directive presents the minimum scope of the implemented sanctions, those being sanctions for breaches on the part of obliged entities that are serious, repeated and systematic. The Fourth Directive presents also a list of basic penalties, which include a public statement which identifies the natural or legal person and the nature of the breach, a temporary ban on discharging managerial responsibilities in the obliged entity, and administrative pecuniary sanctions of at least twice the amount of the benefit derived from the breach where that benefit can be determined, or EUR 1,000,000, whichever is higher.[50]

(II) Procedures Resulting from Public-Private Cooperation

The most important role from the public entities' perspective is entrusted to financial intelligence units (FIUs). The purpose of FIUs is to collect and analyse information which they receive from the private sector, with the aim of establishing links between suspicious transactions and concealed criminal activities.[51] FIUs convey the results of their analysis to the competent authorities.[52] Indeed, FIUs are of fundamental importance in uncovering the collaboration of terrorist offences and networks of terrorist organisations. Therefore, as is the case in the majority of the Member States, FIUs should be established outside the state's criminal

48 ibid.
49 Fourth AML Directive, Article 58(1).
50 ibid, Article 59(2).
51 Fifth AML Directive, Recital 18.
52 ibid.

prosecution sector, to prevent the public authorities from using the information gathered from the private sector for other purposes. Such a solution would also help to safeguard the privacy of the private entities involved and would be helpful in building trust between regulatees and the regulator.

The competences of FIUs have been constantly expanded in subsequent directives, in particular in the most recent Fifth AML Directive. FIUs play an important role in identifying the financial operations of terrorist networks, especially in cross-border relationships, and in detecting their financial supporters.[53] Thus, in the Fifth AML Directive, the cooperation between FIUs has been strengthened – the exchange of information between FIUs should not be restricted for reasons such as a lack of identification of an associated predicate offence or differences between definitions – but be conducted spontaneously or upon request.[54]

According to the Fifth AML Directive, differences between Member States must not hamper the flow of information between FIUs, and the cooperation with FIUs outside the EU should be facilitated. A huge change lays also the possibility to obtain information from any obliged entity, even without a prior report. In the past, delayed access to information concerning the identity of holders of bank accounts and safe-deposit boxes by FIUs and other competent authorities constrained the detection of transfers of funds immensely. Thus, under the Fifth AML Directive, FIUs will have access to more information through centralised bank account registers or data retrieval systems. In all cases, information should flow directly and without undue delays to ascertain effective action. It is therefore essential to enhance the cooperation between FIUs.

In conclusion, the role of the public sector is implemented mainly through FIUs. They are the link between private entities and public authorities. Private entities report to the FIUs using a risk-based approach analysis. To enforce their preventive and reporting duties, the public sector is equipped with relevant sanctions.

IV. The Compatibility of AML Preventive Measures with Fundamental Freedoms and Rights

The involvement of private actors in AML- and CFT-measures may require the restriction of individual fundamental freedoms and rights. The issue is how to set the correct balance between the fight against transnational crime and the protection of human rights and fundamental freedoms. The fundamental rights

[53] Fifth AML Directive, Recital 16.
[54] ibid, Recital 18.

and freedoms particularly relevant to this research are the freedom to provide services, the right to a fair trial, and the right to privacy and data protection.

The analysis of the compatibility of the AML regime and the freedom to provide services and the right to a fair trial, presented in Sections IV.A and IV.B, focuses on the judgments rendered by the European Court of Justice (ECJ). Part V considers the interferences between the AML measures and the provisions concerning data protection. Contrary to Sections IV.A and IV.B, Part V is based on the Fourth AML Directive as amended by the Fifth AML Directive, and on the opinions of the European Data Protection Supervisor (EDPS) rather than case-law.

A. The AML and CFT-regimes as a restriction of freedom to provide services

The prohibition on restrictions on the freedom to provide services is not absolute. Member States may interfere on either the specific grounds designated in the Treaty on the Functioning of the EU (TFEU),[55] or by relying on the more general justifications that can be found in the case law of the ECJ. Article 51 TFEU provides for an exemption, which may emerge when the provision of services is combined with the exercise of public authority. Moreover, the freedom to provide services may also be limited in the event of a threat to public security, policy or health.[56] In case law, considering the enshrinement of fundamental freedoms, the general approach of the ECJ is quite strict (an example may be found in the jurisprudence related to so-called “golden shares”).[57]

According to the ECJ, restrictive measures provided for in national law can be justified if they satisfy the following conditions: (a) they are non-discriminatory; (b) the Member State protects a certain social value that can be considered as an overriding public interest; (c) the mean is proportionate; and (d) the value to be protected in the host country is not protected in the country of origin.[58] The catalogue of values to which the ECJ has granted public interest status is open and constitutes, inter alia, maintaining the good reputation of the financial sector.[59] In *Cassis de Dijon* case, the ECJ ruled that:

> Obstacles to movement within the Community resulting from disparities between the national laws relating to the marketing of the

[55] Consolidated version of the Treaty on the Functioning of the European Union [2012] OJ C 326 (TFEU).
[56] ibid, Article 52.
[57] See for example Case C- 543/08 *European Commission v Portuguese Republic* [2010] E.C.R. 669.
[58] Anna Zawidzka-Łojek & Robert Grzeszczak *Prawo materialne Unii Europejskiej. Vademecum* (4th edn, Instytut wydawniczy Europrawo 2015).
[59] Case C-384/93 *Alpine Investments BV v Minister van Financiën* [1995] E.C.R. 1141.

> product in question must be accepted in so far as those provisions may be recognised as being necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer.[60]

Therefore, national measures must serve a purpose which is recognised as a general interest and is proportionate and necessary.[61]A landmark case regarding the restriction of the freedom to provide services by anti-money laundering polices is the *Jyske Bank Gibraltar*[62] case, which was ruled under the provisions of the Third AML Directive. Jyske, a branch of a Danish bank, was a credit institution established in Gibraltar which operated in Spain under the freedom to provide services, that is to say, without being incorporated there. Under the provisions of the Third AML Directive, each Member State was required to establish a FIU responsible for receiving, analysing and conveying to the responsible authorities information concerning potential money laundering or terrorism financing. The Third AML Directive required that the information be forwarded to the FIU of the Member State where the institution was situated. Jyske was requested by the Spanish FIU to provide it with certain information. Jyske partially complied with the request, but refused to provide data relying on the banking secrecy rules applicable in Gibraltar. Jyske considered that the Third AML Directive imposed an obligation of disclosure only vis-à-vis the FIU of the country of origin and that, therefore, the Spanish legislation did not comply with EU law. The bank brought an action before the Spanish Supreme Court, which decided to refer the question to the ECJ. The ECJ decided that, according to Article 22(2) of the Third AML Directive,

> [T]he entities referred to must forward the requested information to the FIU of the Member State in whose territory they are situated, that is to say, in the case of operations performed under the rules on the freedom to provide services, to the FIU of the Member State of origin.[63]

In the absence of harmonisation at EU level, Member States may adopt national measures restricting the free movement of capital, persons, goods and

[60] Case C-120/78 *Rewe-Zentrale AG v Bundesmonopolverwaltung fur Branntwein* [1979] ECR 649 (Cassis de Dijon).
[61] ibid.
[62] Case C-212/11 *Jyske Bank Gibraltar Ltd. v Administraction del Estado* [2013] ECR 270 (*Jyske Bank Gibraltar*).
[63] *Jyske Bank Gibraltar* [43].

establishment, as well as the freedom to provide services, provided that these measures "serve important interests recognised by the Union as valuable".[64] The solution adopted in Spanish legislation was of a more restrictive nature than the one adopted in the Third AML Directive and, as such, was considered a restriction on the freedom to provide services. Therefore, the ECJ further considered whether the Third AML Directive precluded host Member States from requiring a credit institution to forward the information also directly to its own FIU. To this end, it was necessary to consider the scheme and purpose of the Third AML Directive. All in all, the ECJ decided that the mechanism subscribed to the general aims of the Third AML Directive, which is the assertion of the proper functioning of the internal market and prevention of the use of the financial system for the purposes of money laundering and terrorism financing. Such legislation would make it possible to obtain information to more effectively combat money laundering and terrorism financing, and accordingly would pursue a similar aim to that of the Directive. Therefore, the host Member State is not precluded from requiring a credit institution, which carries out activities on its territory under the freedom to provide services, to forward the information concerned directly to the FIU of this Member State "in so far as such legislation seeks to strengthen, in compliance with EU law, the effectiveness of the fight against money laundering and terrorist financing".[65]

As legislation of one Member State, such as that at issue, constitutes a restriction to provide services, the ECJ assessed next whether Spanish legislation complied with the freedom to provide services. Indeed, Member States can restrict the four EU freedoms when they aim to protect a certain social value that can be considered an overriding public interest. Similar to what is stated in the first recital of the preamble to the Third AML Directive, "massive flows of dirty money can damage the stability and reputation of the financial sector and threaten the single market, and terrorism shakes the very foundations of our society". Likewise, the third recital notes that, "in order to facilitate their criminal activities, money launderers and terrorist financers could try to take advantage of the freedom of capital movements and the freedom to supply financial services".

Moreover, the ECJ had already accepted that combating money laundering, which is related to the aim of protecting public order, constitutes a legitimate aim, capable of justifying a barrier to the freedom to provide services. It did so in a ruling concerning gambling services in France.[66] The ECJ also positively assessed the suitability of Spanish legislation for attaining the aims it pursues. Indeed, the ECJ considered the obligation imposed on credit institutions carrying out their activities under the freedom to provide services a proportionate measure, pursuing

[64] Catherine Barnard, *The Substantive Law of the EU The Four Freedoms* (5th edn, OUP 2016).
[65] *Jyske Bank Gibraltar* [45] [49].
[66] Case 212/08 *Zeturf Ltd v Premier Ministre* [2011] ECR I-5633.

its aim in the absence of any effective mechanism guaranteeing full and complete cooperation between FIUs.

In the *Jyske Bank Gibraltar* case, the ECJ gave priority to AML and CFT over the EU freedoms. The desire to effectively combat money laundering is not merely that of one EU Member State, but also the objective of the entire EU. Usually, the ECJ examines the balance of interests, correlating the national objective with the EU objective. In the given case, both interests are equally "European"—the freedom to provide services and the effective fight against money laundering. Although the case was ruled under the provisions of the repealed Third AML Directive, the ruling confirmed that AML is seen by the ECJ as a free-standing public interest or overriding requirement[67] and a supranational interest, which is still prevailing under the regulations currently in force.

B. AML and CFT-regimes as a limitation of human rights

It has also been analysed in case law whether the fight against money laundering or terrorism financing could be considered a legitimate reason for the limitation of human rights. The ECJ analysed the compatibility of AML and CFT-regimes with the right to a fair trial in the *Ordre des barreaux* case,[68] which was ruled on under the First AML Directive as amended by the Second AML Directive.

The right to a fair trial constitutes a fundamental right, which the EU respects as a general principle under Article 6(2) Treaty on the EU (TEU)[69]. Article 6 of the ECHR provides that 'everyone is entitled to a fair hearing, whether in the determination of their civil rights and obligations or in the context of criminal proceedings'. It entails that individuals must have the possibility to attain legal advice and assistance from a lawyer. To protect the lawyer-client trust relationship, a lawyer has the right not to disclose any information covered by secrecy to third parties, including law enforcement agencies.[70] Carrying out the tasks of advising, defending and representing their clients in a satisfactory way would be impossible if lawyers were obliged, in the context of judicial proceedings or the preparation for such proceedings, to cooperate with the authorities by passing them information obtained in the course of legal consultations. Although the legal professional

[67] Sara De Vido, 'Anti-Money Laundering Measures Versus European Union Fundamental Freedoms and Human Rights in the Recent Jurisprudence of the European Court of Human Rights and the European Court of Justice' (2015) 16 German Law Journal 1272.

[68] Case 305/05 *Ordre des Barreaux Francophones et Germanophone v Conseil des Ministres* [2007] ECR I-5305 (*Ordre des Barreaux*).

[69] Consolidated version of the Treaty on the European Union [2012] OJ C 326 (TEU).

[70] Michiel Luchtman and Rob van der Hoeven, 'Case C–305/05, *Ordre des barreaux francophones et germanophone et al v Conseil des Ministres*, judgement of the Court of Justice of 26 June 2007, Grand Chamber [2007] ECR I–5305' (2009) 46 Common Market Law Review, 301.

privilege is generally not regarded as absolute, it is maintained that limitations are only possible when they are strictly necessary and accompanied by adequate safeguards.[71]

The legal obligations of the First AML Directive have been expanded to subjects outside the financial sector, including lawyers and other legal professionals. Lawyers are obliged to inform the competent authorities when they notice facts which they know or suspect are linked with money laundering. Such activities might be considered to impinge unjustifiably on the professional secrecy and independence of lawyers - which are an ultimate element of the fundamental right of every individual to a fair trial and the right to defence. The *Ordre des Barreaux* case revolved exactly around this matter. The Belgian legislator had transposed the provisions of the First AML Directive (as amended by the Second AML Directive) to the extent that lawyers should report these alleged irregularities. Before the national court, the Belgian bar associations argued that these provisions breached several rights, because they affected the legally privileged lawyer-client relationship. The Belgian court decided to ask the ECJ preliminary questions. The ECJ, in turn, confirmed the legality of the challenged articles, for two main reasons. Firstly, the lawyer-client privilege is limited. The obligation to inform and cooperate with competent authorities applies equally to lawyers, in case they advise or act on behalf of their client in any financial or real estate transaction. The nature of such activities is that they take place in a context with no link to judicial proceedings, and so those activities fall outside the scope of the right to a fair trial. Secondly, as soon as the lawyer, acting in connection with a transaction, is called upon to defend the client in judicial proceedings, that lawyer is absolved from the obligations laid down by the First AML Directive, regardless of whether the information has been received or obtained before, during or after the proceedings. These exemptions safeguard the clients' right to a fair trial.

However, the legal professional privilege is not absolute. Limits must pursue an objective of general interest, recognised by the EU, and be proportionate to that objective.[72] In the *Ordre des Barreaux* judgment, AML policies emerged as a general interest. In the opinion of the Advocate General,[73] provided that the proportionality principle is maintained, the waiver of the lawyer's secrecy may be justified (provided that this does not affect the context of the lawyer's core activities). However, AML and CFT-regulations may still come into conflict with fundamental rights, as it is difficult to demarcate lawyers' activities related to a trial

[71] ECtHR, *Iliya Stefanov v Bulgaria* [2008] Application No 65755/01.

[72] Case 305/05 *Ordre des Barreaux Francophones et Germanophone v Conseil des Ministres* [2007] ECR I-5305, Opinion of AG Maduro [49].

[73] ibid [78].

and those which are unrelated to court representation. So far, the matter has not been resolved by the ECJ. Thus, the proper balance must be defined by national judges in each of the Member States.

V. AML and CFT-Regimes and Interferences with the EU Data Protection Provisions and the Right to Privacy

The problematic coexistence between the AML and CFT-regulations and data protection is not new, but the General Data Protection Regulation (GDPR)[74] and the Fourth AML Directive, as amended by the Fifth AML Directive provisions, certainly bring the problem into focus. Undoubtedly, the AML regime requires the processing and exchange of personal data, for example during customer identification, due diligence, transaction monitoring, reporting duties, internal and external data sharing, or when creating a central beneficial ownership information register. The GDPR places restrictions on why, when and how personal data can be collected and processed. It also broadens the definition of personal data, bringing all information gathered under the AML regulations directly within the jurisdiction of the GDPR. Therefore, there are a number of tension points between the AML regime and the GDPR. To assess the problematic interaction between the Fourth AML Directive (as amended by the Fifth AML Directive), the provisions concerning data protection, and the right to privacy, a brief analysis on the EU data protection framework is required.

The right to privacy can be defined as the right to be protected from unjustified interferences by states or other public entities in individuals' private lives, or simply as the right "to be left alone".[75] Violations of the right to privacy may take various forms. The one which is of the greatest significance for this study is linked to the processing of personal data. The right to privacy is protected under Article 7 of the Charter, where it is stated that, "Everyone has the right to respect for his or her private and family life, home and communications". Personal data is also protected under Article 8 of the Charter, which states that, "Everyone has the right to the protection of personal data concerning him or her. Such data must be processed fairly for specified purposes and on the basis of the consent of the person concerned or some other legitimate basis laid down by law. Everyone has the right

[74] Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data, and repealing Directive 95/46/EC (General Data Protection Regulation) [2016] OJ L 119.

[75] Samuel D. Warren & Louis D. Brandeis 'The Right to Privacy' (1890) 4 Harvard Law Review 193.

of access to data which has been collected concerning him or her, and the right to have it rectified."

The problematic interaction of public policy with fundamental rights is not new. The existence of the EU's interest to interfere with the data protection prerogatives for AML and CFT-purposes is acknowledged directly in Article 43 of the Fifth AML Directive, which states that the processing of personal data for the prevention of money laundering and terrorism financing shall be considered a matter of public interest under GDPR provisions. However, according to the EDPS,[76] the provisions of the Fifth AML Directive may still interfere with the purpose of limitation principle and the principle of proportionality.

Under the principle of purpose limitation, personal data may only be collected for precisely defined purposes and must not be further processed in a manner inconsistent with those purposes.[77] The Fifth AML Directive clearly indicates two purposes which may be the reason for a limitation of data protection—the prevention of money laundering and terrorism financing. Additionally, the provisions of the Fifth AML Directive introduce another policy purpose, which is the fight against tax evasion. In this respect, the description of the purpose of processing personal data progressively departs from the original AML-objective. The processing of any personal data must serve a legitimate, specific and determined purpose and must be proportional and necessary. The processing of personal data for one purpose, which was collected for another purpose which was a completely unrelated one infringes the data protection principle of purpose limitation and the principle of proportionality.[78]

The principle of proportionality is enshrined in Article 52(1) of the Charter, which provides that "any limitation on the exercise of the rights and freedoms recognised by this Charter must be provided for by law and must respect the essence of those rights and freedoms". Under this principle, limitations may be made only if they are necessary and accurately meet the objectives of general interest recognised by the EU. The issue of proportionality has been addressed by the ECJ in *Digital Rights Ireland*,[79] in which the fight against international terrorism and serious crime constituted an objective of general interest.

Consequently, there are three aspects which might be problematic in connection with an appropriate application of the proportionality rule. The first alarming matter is that the Fifth AML Directive seems to depart, in some

[76] EDPS, *1/2017 EDPS Opinion on a Commission Proposal amending Directive (EU) 2015/849 and Directive 2009/101/EC – Access to beneficial ownership information and data protection implications* (2017).

[77] GDPR, Article 6(3).

[78] EDPS (n 76).

[79] Case C-293/12 *Digital Rights Ireland Ltd v Minister for Communications, Marine and Natural Resources and Others and Kärntner Landesregierung and Others* [2014] ECR 238.

respects, from the previously described risk-based approach. Indeed, it is stated that certain categories of customers must be monitored on a methodical basis—it is however not clear on what basis, if not risk, these categories would be identified.[80] It is clear that the risk-based approach is more compatible with the principle of proportionality and tends to lead to a more positive outcome, also on the grounds of data protection. The second distressing aspect, from the data protection point of view, is connected with the extended scope of the powers of FIUs. To gain additional information from obliged entities, FIUs may no longer be triggered by suspicious transactions but also by their own analysis, even without prior reporting. With such an approach, FIUs might be incentivised to pursue data mining rather than targeted investigation purposes. This may obviously have questionable consequences in terms of data protection, because personal data would be analysed for completely different purposes. The third concerning aspect is public access to beneficiary information, by both competent authorities and public entities. Beneficiary information is very valuable and can be used in many ways (for example for marketing strategies). Here, the question is how to avoid opportunistic behaviour and how to design access to beneficial information in line with the principle of proportionality, restricting access only to law enforcing entities.[81]

In conclusion, it is clear that there are questions as to why certain forms of personal data processing are necessary and whether they are proportionate. In particular, it is of concern that the collected data should not be used for purposes completely different than the one for which they have been obtained.

VI. Conclusions

My analysis has painted a picture of a multi-layered, continuously evolving and rapidly emerging anti-money laundering and counteracting terrorism financing framework. Consequently, it can be noticed that an AML-regime should be based on a number of regulatory prescriptions, including: (a) a better emphasis on the preventive aspects of AML-regulations; (b) a stronger involvement of private entities, which is necessary because of an asymmetry of information between private subjects and regulatory agencies, and to reduce compliance costs; (c) a greater calibration of the regulatory framework based on risks; (d) broader cooperation on the international level, mainly between FIUs; and (e) better recognition of AML and CFT as a "European" general interest.

In the field of prevention, consecutive EU directives have expanded the list of professions which are covered by the scope of the AML Directives to deliberately

[80] EDPS (n 76).

[81] ibid.

include non-financial and non-regulated professions. Concurrently, the objective of protecting the European community from criminals and the protection of the integrity and stability of its financial system should be harmonised with the need to create a regulatory environment that allows companies to flourish without incurring overburdening compliance costs. Therefore, the risk-based approach has been implemented. The involvement of private actors in AML and CFT-measures often causes tensions as far as the compatibility with fundamental freedoms and rights protected at the EU-level is concerned. The tensions arises especially because the prevention of money laundering and terrorism financing is recognised at EU level as a security issue. In analysed case-law, the ECJ correlated AML and CFT-measures with the freedom to provide services and the right to a fair trial. The fight against money laundering and terrorism financing is considered as an objective of general interest of the EU. However, any requirement imposed on obliged entities to fight money laundering and terrorism financing should be proportionate and justified. Tensions also occur between AML and CFT-instruments and the right to privacy and the right to data protection. As far as proportionality is concerned in that respect, a number of issues, such as the possibility of gathering data for purposes other than those for which they are allowed in the provisions of law to be collected, raise concerns and allow a considerable amount of leeway for misuse.

In conclusion, the fight against money laundering has infiltrated the European legal system and is considered as general interest. Thus, AML policies may be a basis for the restriction of or limitations on fundamental rights and freedoms. The tensions between the attempts to effectively fight money laundering and terrorism financing and the fundamental rights and freedoms will not go away, and the AML regime in its nature will always have to evaluate things in a flexible manner to provide a ready solution for every security threat emerging in the international political sphere. The assessment of the effects on the aforementioned rights should be always concluded in light of the principle of proportionality. Such an approach, especially the thorough use of the proportionality test, should also guide the ECJ if other and more contentious issues of compatibility of EU AML and CFT-legislation with fundamental rights should arise.

China's Sovereign Wealth Fund: Perceived Risks, Corporate Weaknesses, and Future Reform

Cheng Bian*

I. Introduction

Sovereign Wealth Funds (SWFs) are entities that manage state assets for investment purposes. Although the establishment of the world's first SWF, the Kuwait Investment Board, dates back to the 1950s,[1] SWFs have experienced an upsurge in the 21st century.[2] There are currently over forty known states globally that own SWFs, with some states having more than one SWF. It was reported that, by March 2017, total assets under management of SWFs worldwide recorded over $6.5 trillion.[3]

SWFs raise particular policy concerns in the host state (*i.e.* the country receiving the SWF investments). Some of the most controversial regulatory issues include the massive size of SWFs and their potential to destabilise the market of the host state as a consequence. Other additional causes for concern involve the blurred line between private and public investments, a common lack of transparency in the structure and management of the SWF, the covert political agenda of the SWF's home state and strategic investment purposes that the SWF aims to pursue in addition to profit maximisation. Finally, one could refer to the potential detriment to the host state's national security and public interests in juxtaposition to the strategic or sensitive sectors.[4]

In addition to the above policy concerns that are perceived by host states in general, there are also implications raised particularly by the host state that are country-specific. China's outbound foreign investment is on the rise in recent years. China (including Hong Kong) remained the world's second largest FDI exporter in 2017.[5] Chinese outbound FDI always attracts elevated attention and vigilance from the host state, because of the combination of the massive size of the investments made and the peculiar nature of the Chinese state-led economy. What makes Chinese outbound FDI more high-profile, especially in recent years, is the promulgation of the Chinese government's systemic national campaigns that have a significant geopolitical and economic impact in the world, such as the One-Belt-One-Road Initiative[6] and the Made in China 2025 Plan.[7] These national campaigns are made at the central level of the government, aiming at, *inter alia*, the promotion of Chinese outbound investment for the purpose of strategic assets seeking motives and the upgrading of the domestic manufacturing value chain. These nation-wide and high-profile strategies have attracted much unease for several reasons, one

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1 The Kuwait Investment Board is the predecessor of the current Kuwait Investment Authority (KIA) established in 1982.

2 PwC, *Sovereign Investors 2020: A Growing Force (PwC Publications*, 2016*)* 7 <https://www.pwc.com/gx/en/sovereign-wealth-investment-funds/publications/assets/sovereign-investors-2020.pdf> accessed 25 August 2018.

3 Claire Milhench, 'Global Sovereign Fund Assets Stall at $6.59 Trillion – Preqin' *Reuters* (London, 13 April 2017) <https://www.reuters.com/article/global-swf-assets/global-sovereign-fund-assets-stall-at-6-59-trillion-preqin-idUSL8N1HL2GC> accessed 30 July 2018.

4 Simone Mezzacapo, 'The So-Called "Sovereign Wealth Funds": Regulatory Issues, Financial Stability, and Prudential Supervision' (European Commission Economic Papers 378, 2009) 26-27. For a comprehensive discussion of the regulatory concerns raised by SWFs, see Part III.B.

5 UNCTAD, *World Investment Report 2018: Investment and New Industrial Policies* (UN Publication 2018) 6.

6 The Belt and Road Initiative, also known as the Silk Road Economic Belt and the 21st-century Maritime Silk Road, and the One Belt One Road (abbreviated OBOR), is China's national development strategy proposed by Xi Jinping, which focuses on connectivity and cooperation among countries primarily between China and the rest of Eurasia, which consists of two main components, the land-based 'Silk Road Economic Belt' and oceangoing 'Maritime Silk Road'. The strategy underlines China's ambition to play a bigger role in global affairs, and its need for priority capacity cooperation in geo-political as well as economic areas. For a more comprehensive grasp of the Belt and Road Initiative, see, the State Council of the People's Republic of China, 'The Belt and Road Imitative' <http://english.gov.cn/beltAndRoad/> accessed 30 July 2018. See also the contribution of Yawen Zheng in this Special Issue.

7 The Made in China 2025 is a national strategy promulgated by the Chinese central government in 2015. The aim of the Made in China 2025 Plan is to boost China's domestic manufacturing to go up in the international value chain. The plan focusses on China's technological leadership in high-tech, strategic, and innovative industries, as it aims to increase the domestic content of core materials in manufacturing to 40% by 2020 and 70% by 2025. For a more detailed discussion, see, Scott Kennedy, 'Made in China 2025' (*Centre for Strategic and International Studies*, 1 June 2015) <https://www.csis.org/analysis/made-china-2025> accessed 30 July 2018.

of which relates to the heavy governmental dominance and planning to achieve the set objectives. This seems to direct China more towards a state-led economy instead of a market-led one. In such a context, Chinese firms investing overseas, both private and state-owned, may suffer from certain predetermined negative perceptions in the host state. This is because China's sovereign investors would manifest certain policy concerns raised by SWFs in general, as well as specific implications raised by Chinese outbound investments in particular.

To shed some light on the topic of China's SWFs in response to the diverse concerns raised, this paper embraces two main objectives. The first and foremost objective is the identification of the risks posed by FDI in general and by SWFs in specific in the host state. To clarify how these risks arise and why they are perceived in the host state, this paper aims to provide a narrative in which SWFs are considered 'high-risk'. The second objective is related to China's SWF, the China Investment Corporation (CIC). This paper aims at presenting some of the weaknesses and ambiguities in terms of CIC's corporate governance, and putting forward policy proposals for future reform.

To this end, this paper is arranged as follows. Part I provides a general introduction and analyses why China's SWFs are considered as particularly high risk and thus become the subject of discussion in this paper. Part II provides a mapping of SWFs, including their definitions, features, legal nature, and global magnitude. Part III aims at shedding some light on the identification of the risks posed by FDI in general and by SWFs in specific in the host state. In Part IV, the Santiago Principles promulgated by the International Working Group of Sovereign Wealth Funds in 2008 are discussed as a model of 'supranational self-regulation' of SWFs. In Part V, this paper conducts a case study, in which the trajectory and corporate weaknesses of the China Investment Corporation (CIC) identified in the literature are presented. Part VI puts forward normative proposals to alleviate such corporate governance concerns. This paper ends with a conclusion.

II. A Mapping of SWFs: Definitions, Features, Legal Nature, and Magnitude

The phenomenon of SWFs usually lacks a precise definition.[8] According to the concept endorsed by the Organization for Economic Co-operation and Development (OECD), SWFs are "pools of assets owned and managed directly or indirectly by governments to achieve national objectives."[9] This definition is

[8] PwC (n 2) 5.

[9] A Blundell-Wignall, Y Hu and J Yermo, 'Sovereign Wealth and Pension Fund Issues' (OECD Working Papers on Insurance and Private Pensions No. 14, OECD Publishing 2008) 4.

considered a rather broad one, as it may include all types of state-owned entities that function entirely or partially as investment vehicles.

Other attempts at defining SWFs prescribe certain limits to the notion, resulting in a more discerning conceptualisation. According to the standards of the International Monetary Fund (IMF), for instance, SWFs refer to:

> [S]pecial 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. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports.[10]

Pursuant to the above characteristics endorsed by the IMF, SWFs are unique in their features compared with other government-related undertakings, such as state-owned enterprises. First of all, a SWF is owned by the central government and usually originates from either a commodity, *i.e.* representing the revenues of 'mineral wealth', or a non-commodity, *inter alia* fiscal surpluses and foreign exchange reserves. According to a statistical survey conducted by the Statistics Department of IMF, mineral royalties accounts for the majority (65%) of funds in the worlds' top twenty major SWFs.[11] Moreover, a SWF is an entity that makes its major investments overseas, which differs from state-owned funds that only make investments domestically. Finally, a SWF aims at profit maximisation for macroeconomic purposes, which includes boosting overall social welfare and the wellbeing of its citizens in the SWF's home country. To that end, SWFs usually employ investment strategies that are mid-term or long-term oriented.[12]

With regard to the legal nature of the SWF, its statutory basis and form may vary from country to country. According to a voluntary survey conducted by the initial twenty Members of the International Working Group of Sovereign Wealth Funds (predecessor of the International Forum of Sovereign Wealth Funds), 50% of the SWFs are established as legal entities with independent legal personality

[10] 'Sovereign Wealth Funds – Generally Accepted Principles and Practices' (hereinafter "the Santiago Principles") (*International Working Group of Sovereign Wealth Funds (IW G-SWF)*, October 2008) 27 <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf> accessed 30 July 2018.

[11] International Monetary Fund, 'The Statistical Work on Sovereign Wealth Funds' (*Twenty-First Meeting of the IMF Committee on Balance of Payments Statistics Washington, DC, BOPCOM-08/19*, 2008) 9 <https://www.imf.org/external/pubs/ft/bop/2008/08-19.pdf> accessed 30 July 2018.

[12] Dominic Barton and Mark Wiseman, 'Focusing Capital on the Long Term' (2014) 92 Harvard Business Review 44, 47.

under national company law. The other half are regarded as a pool of assets which do not have independent legal identity, operating under the control of the ministry of finance or the central bank of the home state.[13]

SWFs have been rapidly growing since the beginning of the 21st century, and will likely continue to do so.[14] There are currently over forty known states globally that own SWFs; some states have more than one SWF. By March 2017, it was reported that total assets under management of SWFs worldwide recorded over $ 6.5 trillion.[15] China ranks first in the list in terms of the assets its SWFs manage (see Table I below).

Table I

Top 10 countries that own SWFs (assets from high to low).[16]

Rank	Country	SWFs	Assets (Billion USD)	Origin
1	China (excl. Hong Kong)	CIC; SAFE; NCSSF; CADF	1,554	Non-Commodity
2	United Arab Emirates	ADIA; ADIC; EIA; ICD; MDC; RIA	1,298	Oil
3	Norway	GPF	1,063	Oil
4	Saudi Arabia	PIF; SAMA	697	Oil
5	Singapore	GIC; TH	556	Non-Commodity
6	Kuwait	KIA	524	Oil
7	Hong Kong	HKMA	456	Non-Commodity
8	Qatar	QIA	320	Oil
9	United States	APF; NMSIC; PWMTF; SIFTO; IEFIB; PSF; PUF; ATF; NDLF; LEQTF; CSF; WVFF	150	Oil; Non-commodity; Minerals; Public Lands
10	Australia	AFF; WAFF	134	Non-Commodity

13 Cornelia Hammer, Peter Kunzel, and Iva Petrova, 'Sovereign Wealth Funds: Current Institutional and Operational Practices' (*IMF Working Paper WP/08/254*, 2008) 5.
14 PwC (n 2) 7.
15 Claire Milhench (n 3).
16 Sovereign Wealth Funds Institute (SWFI), 'Sovereign Wealth F und Rankings' <https://www.swfinstitute.org/sovereign-wealth-fund-rankings/> accessed 30 July 2018.

III. The Perceived Risks and Policy Concerns of SWFs

A. The security-related risks posed by foreign investment in general

The regulatory challenges posed by SWFs in the host state can be two-fold. The first layer, which is the focus of this subsection, involves security-related concerns that are raised in the general context of foreign direct investment (FDI), regardless of the private or state-controlled nature of the origin of the investment. The potential threats that foreign acquisitions of a domestic company could pose may be constituted in three categories.[17] The first type of threat concerns a foreign acquisition of a domestic company that would result in the dependence of the host state on a foreign-controlled supplier of goods and services that are critical for the survival and essential security of the host state, when there is credible evidence suggesting that the foreign controlled supplier would "delay, deny, or place conditions on" the availability and continuity of such goods and services.[18] This could pertain to the foreign acquisition of a domestic company controlling critical infrastructure, *inter alia*, seaports, electric power grids or petroleum production facilities, whereby the delay, denial or conditional restrictions of these goods or services would be disastrous to the host state once the foreign investor decides to abuse its power.

The failed CNOOC-Unocal merger makes an exemplary demonstration of the first type of threat. China National Offshore Oil Corporation (CNOOC), a Chinese state-owned-enterprise, announced its bid of $18.5 billion for Unocal, a US based oil and gas company, in 2005.[19] The merger announcement immediately faced vehement governmental opposition in the US. In the meanwhile, CNOOC voluntarily filed a request for a review by the Committee of Foreign Investment in the US (CFIUS), an inter-departmental agency responsible for the review and possible prohibition of foreign acquisitions based on national security considerations. CNOOC later announced that it withdrew its filing with CFIUS as well as the bid for Unocal.[20] Opponents of this transaction claim that, had the CNOOC deal been completed, CNOOC would likely hoard Unocal's oil reserve

17 Theodore H Moran, *Three Threats: An Analytical Framework for the CFIUS Process* (Peterson Institute for International Economics 2009).
18 ibid 1ff.
19 Ben White, 'Chinese Drop Bid to Buy U.S. Oil Firm' *Washington Post* (New York, 3 August 2005) <http://www.washingtonpost.com/wp-dyn/content/article/2005/08/02/AR2005080200404.html??noredirect=on> accessed 2 September 2018.
20 Souvik Saha, 'CFIUS Now Made in China: Duelling National Security Review Frameworks as A Countermeasure to Economic Espionage in the Age of Globalization' (2012) 33 Northwestern Journal of International Law and Business 199, 211.

and supply exclusively to China, which compromises US control over its own energy resources.[21] Furthermore, as a Chinese state-owned enterprise, CNOOC does not behave as normal commercial companies. Instead, it may infiltrate the US economy and inject a foreign power into it.[22]

The second type of threat concerns a proposed transaction that would result in the transfer of technology, or other intangible expertise of the target entity, to the foreign investor, which might be later abused in a manner that goes against the interests of the host state.[23] This type of threat was perceived by the US in the failed Thomson-LTV deal that dates back to 1992. Thomson CSF, a US subsidiary of a French government-owned company named Thomson S.A. that produced consumer electronics and semiconductors, proposed to acquire the US based LTV Corporation's missiles and aerospace divisions in 1992. Although bankrupted, LTV was still in possession of US government-funded technological advances and US military contracts.[24] Due to its sensitive nature, this merger quickly grabbed the attention, and later caused a public outcry. In April 1992, a CFIUS review of the deal took place. The whole review process was permeated with Congressional opposition and contentious political debate.[25] Eventually, Thomson withdrew its filing with CFIUS, and quit all attempts to acquire LTV.[26]

The third type of threat involves the insertion of a foreign investor in the host state, whereby such insertion is intended to achieve infiltration, surveillance, sabotage, espionage, and other illicit purposes of a disruptive nature.[27] Such a case might arise when a foreign investor purchases a domestic entity that is in the vicinity of an important military base in the host state. The botched Northwest-Firstgold merger case serves as an example. In 2009, Northwest, a Chinese SOE, proposed the acquisition to Firstgold, a US based gold mining company, of 51% of its stock.[28] Notably, the extraction site is adjacent to the US Navy's Fallon Naval Air Station, one of the Navy's top tactical training centres.[29] CFIUS reviewed the proposed deal, and later concluded that the national security perils

[21] Edward M Graham and David M Maechick, *US National Security and Foreign Direct Investment* (Institute for International Economics 2006) 130.

[22] Michael Petrusic, 'Oil and National Security: CNOOC's Failed Bid to Purchase Unocal' (2006) 84 North Carolina Law Review 1373, 1378–1379.

[23] Theodore H. Moran (n 17) 1ff.

[24] Jeremy David Sacks, 'Monopsony and the Archers: Rethinking Foreign Acquisitions after Thompson-LTV' (1994) 25 Law & Policy in International Business 1019, 1020.

[25] ibid 1031.

[26] ibid 1031.

[27] Theodore H. Moran (n 17) 1ff.

[28] Jingli Jiang and Gen Li, 'CFIUS: For National Security Investigation or for Political Scrutiny?' (2013) 9 Texas Journal of Oil, Gas and Energy Law 67, 88.

[29] ibid 88.

posed in this deal were "serious, significant and consequential", and impossible to be mitigated.[30] As a result, both parties withdrew the notification and aborted the transaction before CFIUS officially rejected the deal. This failed acquisition is unique in CFIUS history, due to the fact that it is the very first rejected acquisition in the US, not because of the sensitive nature of the deal itself, but the geographic vicinity to a US military facility.[31]

B. The particular risks and concerns raised by SWFs

In addition to the generally recognised national security-related concerns FDI may bring to the host state, SWFs pose additional concerns other than private investors and state-owned-enterprises acting as private market participants.

The first concern results from the magnitude of the SWFs. The world's top ten largest SWFs control aggregated assets of over $ 5727 billion as of June 2018 (see Table II below), which surpasses the total GDP of dozens of sovereign countries.[32] The formidable financial power of SWFs leads to a potentially systemic problem, whereby SWF investments may "contribute to the creation of asset bubbles" or "collectively withdraw their investments thus causing market crashes."[33] This is particularly the case if SWFs aim at short-term investments where the sale of assets is frequent.

[30] ibid 89.

[31] Margaret L Merrill, 'Overcoming CFIUS Jitters: A Practical Guide for Understanding the Committee on Foreign Investment in the United States' (2011) 30 Quinnipiac Law Review 1, 17.

[32] According to the International Monetary Fund, in 2017, Fiji had a recorded GDP of 5054 billion USD, ranking No. 150 out of 191 countries of the world in terms of the value of GDP. This means that 42 countries in the world have a lower number of GDP than the aggregated assets of world's top 10 SWFs combined. See, IMF, 'World Economic Outlook Database, Gross Domestic Product 2017' <http://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx> accessed 25 July 2018.

[33] Georges Kratsas and Jon Truby, 'Regulating Sovereign Wealth Funds to Avoid Investment Protectionism' (2015) 1 Journal of Financial Regulation 95, 107.

TABLE II

Largest SWFs by assets under management worldwide [34]

Rank	Country	Name of the SWF	Asset (Billion USD) as of June 2018	Origin of Capital
1	Norway	Government Pension Fund Global	1035	Oil
2	China	China Investment Corporation	941	Non-commodity
3	UAE	Abu Dhabi Investment Authority	683	Oil
4	Kuwait	Kuwait Investment Authority	592	Oil
5	Saudi Arabia	SAMA Foreign Holdings	494	Oil
6	Hong Kong	Hong Kong Monetary Authority Investment Portfolio	456	Non-commodity
7	China	SAFE Investment Company	441	Non-commodity
8	Singapore	Government of Singapore Investment Corporation	390	Non-commodity
9	Singapore	Temasek Holdings	375	Non-commodity
10	Qatar	Qatar Investment Authority	320	Oil & Gas

The second concern relating to SWFs is their lack of transparency. Currently, there are no regulations regarding the disclosure of information by SWFs concerning matters such as their size, investment strategy, institutional structure, management and governance, or current holdings. SWFs are not legally obliged to

[34] SWFI (n 16).

disclose information to any stock-holders or state-holders.[35] Minimal transparency also results in low accountability, which in turn creates more policy concerns such as obscure governance, risk-management problems, asymmetries of information between SWFs and regulators of the host state, and corruption.[36] Some have associated the opacity of SWFs with information asymmetries as one of the market imperfections and failures that inherently occur.[37]

The third concern of SWFs resides at the corporate level, regarding their non-commercial investment motives and use of political leverage. Government control of the SWF could result in investment decisions not always being in the best interest of commercial value creation. Instead, government-controlled assets may be used to seek strategically important stakes in businesses in host states around the globe such as critical infrastructure, telecommunication, emerging high-technology, energy resources, and financial institutions.[38] There is a general suspicion that SWFs might abuse their voting power in the acquired entity once they gain control.

IV. The Santiago Principles as a Model of 'Supranational Self-Regulation' of SWFs

In October 2008, the International Working Group of Sovereign Wealth Funds, which is an organisation under the administration of International Monetary Fund (IMF), endorsed the Sovereign Wealth Funds, Generally Accepted Principles and Practices (hereinafter "Santiago Principles") in Santiago, Chile. The Santiago Principles are a set of twenty-four 'best practices' that promote transparency, accountability, effective operations and good corporate governance of SWFs, which currently only act as non-binding code, or 'international soft law'.[39] Specifically, the Santiago Principles promote three key components to achieve better governance of SWFs, namely, their legal framework, institutional framework, and investment and management framework.[40] These components underpin an independent position and governance structure that separates the functions of the governing body and the management of the SWF, so as to avoid

[35] Martin A Weiss, 'Sovereign Wealth Funds: Background and Policy Issues for Congress' (*US Congressional Research Service RL34336*, 15 January 2009) 9–10.
[36] ibid.
[37] Georges Kratsas and Jon Truby (n 33) 108–109.
[38] Yvonne C L Lee, 'The Governance of Contemporary Sovereign Wealth Funds' (2010) 6 Hastings Business Law Journal 197.
[39] Locknie Hsu, 'Multi-Sourced Norms Affecting Sovereign Wealth Funds: A Comparative View of National Laws, Cross-border Treaties and Non-binding "Codes"' (2009) 10 Journal of World Investment & Trade 793.
[40] The Santiago Principles (n 10) 5.

excessive political influence.[41] At the same time, the Santiago Principles promote transparency in all levels of governance, a clear investment policy that demonstrates "an SWF's commitment to a disciplined investment plan and practices", and a reliable risk management framework that adheres to the soundness of operations and accountability.[42]

The Santiago Principles do not create any international law obligations for states to comply with. Instead, what the Santiago Principles advocate is an alternative model that differs from state regulatory intervention through public law of the host state. It is a model of "supranational self-regulation" that is buttressed by a set of generally accepted principles and values which aim to achieve "the effectiveness and legitimacy of a governance structure".[43]

The Santiago Principles are regarded as "an inventory of best practices that already exist", a set of rules that in practice have already been adopted by at least one or a few SWFs.[44] The deference to the Santiago Principles is conducive to better compliance with the regulatory framework of the host state. An effective program of self-regulation by SWFs would significantly assure the regulators of the host state that the perceived risks posed are either non-existent or exaggerated. Hence downright rejecting SWF investments would be irrational, considering the economic benefits those benign SWF investors may bring about to the host state.

V. The Trajectory and Corporate Weaknesses of the China Investment Corporation (CIC)

A. The trajectory of CIC

The inception of CIC in 2007 has re-invoked the already heated debate regarding SWFs in global society. CIC was founded as a wholly state-owned-enterprise incorporated under China's company law. CIC was registered with a capital of $200 billion out of China's then $1.4 trillion in foreign exchange reserves. As of June 2017, CIC has become world's second largest single SWF, managing assets of over $900 billion in total.[45] CIC is purported to act as "a vehicle to diversify China's foreign exchange holdings and seek maximum returns for its

[41] ibid.
[42] ibid.
[43] Georges Kratsas and Jon Truby (n 33) 127.
[44] Katinka Barysch, Simon Tilford and Philip Whyte, 'State, Money and Rules: An EU Policy for Sovereign Investments' (Centre for European Reform Essays, 1 December 2008) 14 <https://www.cer.eu/publications/archive/essay/2008/state-money-and-rules-eu-policy-sovereign-investments> accessed 30 July 2018.
[45] See Table II.

shareholder within acceptable risk tolerance". [46] CIC has successively established three subsidiaries, namely CIC International Corporation Limited (hereinafter "CIC International 2011"), CIC Capital Corporation (hereinafter "CIC Capital 2015"), and Central Huijin Investment Limited (hereinafter "Central Huijin 2003"). CIC International 2011 and CIC Capital 2015 undertaking investment overseas while Central Huijin 2003 only making equity investments in domestic state-owned financial institutions. According to the CIC official website, both CIC International 2011 and CIC Capital 2015 are market-oriented commercial investors with individual mandates, conducting investments in public market equities and bonds, hedge funds, real estate, private equity and other long-term assets.[47]

CIC is a founding member of the International Working Group of Sovereign Wealth Funds back in 2008 and participated in the preparation as well as publication of the Santiago Principles. CIC has made it quite clear that it appreciates the need for compliance with international best practice and is willing to cooperate with the International Forum of Sovereign Wealth Funds (the successor of the International Working Group of Sovereign Wealth Funds since 2009), by making several laudable gestures. For instance, CIC published its first annual report right after being founded in 2008.[48] Commentators commend CIC's consistent endeavour to build a fairly transparent and public image, and so far, there is no substantial evidence suggesting that CIC has been abused by the Chinese government to achieve any clandestine political agenda, nor is it wielded as a "political weapon" to pursue any geopolitical goals.[49]

With regards to past investment patterns of the CIC, in an empirical study conducted on all CIC investment transactions made from 2007 to 2013, it was found that "CIC usually holds significant but non-controlling equity stakes". Further, "CIC's voting rights, to the extent the relevant information is available,

[46] China Investment Corporation, 'Abut CIC, Overview' <http://www.china-inv.cn/wps/portal/!ut/p/a1/jZFBc4IwEIX_Si8caZYQCR7TQBFbWqs4CpdMsEGZwcCI48FfX-8AzqXvazXxv32YeytEe5VreqqO8Vo2W9TDnnvgCDxy-gSUk7B2YD2Hy7S7jj9Drg-WwSwBHBz-l5xBaEfgIA8THEwdsioPMEIPae08NEMfhPn_V6OgVwcNEG5Sjf8US-sYpQ5w8DT3tSCw6nS0q707aVtLldZW3BqzkoobUESBjEbu9VFdZ1Yq1rJTnX907BAd-8LoKUY7eVSvLj3QosClPXMLxyaUYLsgVNmu_-vP6Nx3So-iDKPdsNbwUU7NQJSagUe-SI2CKagRMWRiP7C3a83a7v6equJdtuA5__gDaBDC3/dl5/d5/L2dBISEvZ0FBIS9nQSEh/> accessed 30 July 2018.
[47] ibid.
[48] China Investment Corporation, '2008 Annual Report' <http://www.china-inv.cn/wps/wcm/connect/7c8d7b47-d278-4900-b3b5-4e50061d4e2a/CIC_2008_annualreport_en.pdf?MOD=AJPERES&CACHEID=7c8d7b47-d278-4900-b3b5-4e50061d4e2a> accessed 27 August 2018.
[49] Jean-Marc F. Blanchard, 'The China Investment Corporation: Power, Wealth or Something Else?' (2014) 12 China: an International Journal 155, 172.

are often restricted in the investment contracts it entered into with their targets", and that "there is no evidence of CIC pursuing shareholder activism by exercising its voting rights or bringing up proposals, neither in shareholder or board meetings of its portfolio companies".[50] The empirical study concludes that, based on its track records, CIC did not actively seek control over target firms and was largely a passive investor, with only a few exceptions, where CIC did make a representation in the board of directors in the target company.[51]

B. Corporate weaknesses of CIC

The concerns regarding CIC can be divided into three categories. The first concern relates to the debatable character of CIC as either a financial investor or a strategic one. The second concern is the questionable commitment made by CIC to passive investments; the third involves the internal weakness of CIC.

First of all, CIC has been questioned as to its investment strategies. Questions are raised whether investments are made on purely commercial merits, or for strategic and political reasons as part of the Communist Party of China (CPC)'s larger policy.[52] Since 2009, CIC has made direct investments in companies of strategic importance in the host state, including IT, telecommunications, energy and natural resources.[53] This shift in investment strategy has invoked some speculation that these developments might reflect the Chinese government's overall strategy to gain better access to energy and natural resources, to support China's rapid domestic economic growth, among other macroeconomic considerations[54] Another speculation is that Central Huijin 2003, one subsidiary of CIC which only makes investment in major Chinese state-owned banks, has been indirectly financing large Chinese state-owned-enterprises and private companies for their overseas acquisitions, as those Chinese state-owned-enterprises and private companies

[50] Jing Li, 'State as an Entrepreneur: A Study of the Investment Contractual Terms and Level of Control of China's Sovereign Wealth Fund in Its Portfolio Firms' (2015) 3 Peking University Transnational Law Review 1, 9.
[51] ibid 98.
[52] Michael F Martin, 'China's Sovereign Wealth Fund: Developments and Policy Implications' (US Congressional Research Service, Report for Congress, R41441, 23 September 2010) 9-10.
[53] See below Table III.
[54] Michael F. Martin (n 52) 9–10.

investing overseas seek financial support from major Chinese state-owned banks.[55] As a result, CIC might also be involved in strategic investments overseas indirectly.

Table III

CIC global investment portfolio distribution by sector as of December 2017[56]

Ranking	Sector	Percentage
1	Financials	20.1%
2	Information Technology	19.4%
3	Consumer Discretionary	11.7%
4	Healthcare	10.6%
5	Industrials	10.5%
6	Consumer Staples	7.9%
7	Energy	5.4%
8	Materials	4.4%
9	Utilities	2.7%
10	Real estate	2.5%
11	Telecommunication services	2.4%
12	Others	2.4%

The second concern is CIC's inconclusive character as either an active investor or a passive one. There are, in principle, two kinds of institutional investors, namely financial investors and strategic investors.[57] Financial investors are those who make investment solely for the purpose of financial return maximisation, with little or no intention in gaining control over the target company, whereas strategic investors seek control over the target company so that they can play a more influential role in the management of the investee. Hence, the decisive factor that distinguishes a financial investor from a strategic one is whether control over the target company is sought. Because of the strong governmental backgrounds SWFs inherit, most SWFs choose to act as a sheer financial investor so as to assure the host state that there will be no control sought over the target company. Thus, investments made by

[55] ibid.
[56] China Investment Corporation, '2017 Annual Report' <http://www.china-inv.cn/wps/wcm/connect/e6947335-0efd-492b-bd2f-09a3a9187f69/CICAnnualReport2017.pdf?MOD=AJPERES&CACHEID=e6947335-0efd-492b-bd2f-09a3a9187f69> accessed 31 August 2018.
[57] Ming Zhang and Fan He, 'China's Sovereign Wealth Fund: Weakness and Challenges' (2009) 17 China & World Econonmy 101, 108.

SWFs would face less opposition in the host state. With regard to CIC's position, its investment strategy is to a large extent mixed, although CIC depicts itself as a pure financial investor. CIC has retained the option, in some of its recent investments, to appoint representatives to the board of directors, so that it may have the choice to exert substantial influence.[58] Due to a lack of disclosure from CIC itself, there is no evidence suggesting that CIC has never sought control in its investment portfolio.

The last concern regarding CIC is its weak internal governance. The CIC management team is composed of government officials, who may be appointed not because of their outstanding professional expertise and experience, but because of their political position. The current board of directors of CIC is composed of nine directors, all of whom are either former government officials or are still in service. The Vice President of CIC, Tu Guangshao, for instance, was the Vice Mayor of Shanghai immediately prior to his appointment as the Vice President in CIC.[59] The possible bureaucratic management of CIC and the management's close linkage to the government make it less credible that CIC operates under a completely independent corporate management. This invites further suspicion that CIC might be subject to political interventions when making investment decisions. Some have contended that "if SWFs are run by politically connected but financially inexperienced managers, we might expect that not only would they make poor choices in their home and foreign investments, but they would also display poorer stock-picking ability even looking solely at the international portfolio of the fund".[60] If CIC is managed by generalist politicians instead of specialist professionals, there is a concern that politicians may exploit their position

58 Michael F Martin (n 52). See also, Fridrich Wu and Arifin Seah, 'Would China's Sovereign Wealth Fund Be a Menace to the USA?' (2008) 16 China & World Economy 33.

59 China Investment Corporation, 'Governance, Board of Directors' <http://www.china-inv.cn/wps/portal/!ut/p/a1/jZTBcoIwEIZfpRePNEsSEjwioqJirdoqXBiwUZlRdMTx4NOX0E57Y-mO4EOb78i-wCUnIhiRldi_22a04l9lRzxORzkCA7S9hDJE3AM-FIHpj43AyZTUQtwJ0y-CnqO_Dr-0NvxOUUALhLIez3Rn3ZjQBC8ZwPLcMDxKdez1C_BjB_4Rj8GsD8mTD-4M4H6A2rwBxT1P7nBrwHEfwfAfQ1g-WODrwHs_7v492-Ap_oHAQz9H9e-bAN8YGR-JEpKs_SidhyS29cRf1aEd2B6KMrOK8v5yOV9v2bEDh_NJparsQBT0Q6-5m19VVaULd-VRZpar6kV6grFI0M23isr16ZXIr85zuLIfltsUlp1bOpbKY--U6suvaOyFJTMlaL4u8qC9xYL-jCgZ-ToAGwrd4A2F5Gi_yLaOumJTMAwjYAkTAAATUUOeHkcvr4H5vHSuWP3SVYNN-c3On_ysA!!/dl5/d5/L2dBISEvZ0FBIS9nQSEh/> accessed 30 July 2018.

60 Shai Bernstein, Josh Lerner and Antoinette Schoar, 'The Investment Strategies of Sovereign Wealth Funds' (2013) 27 Journal of Economic Perspectives 219, 223.

in CIC for the purpose of pursuing their personal political agenda instead of profit maximisation.

VI. Proposals for Reforming the CIC

A. Increased transparency

The first step of reform is the promotion of better transparency and information disclosure. As laid down in the Santiago Principles, "the key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and other state bodies, should be publicly disclosed (GAPP 1.2)", "there should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations (GAPP 4)", and 'the relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets (GAPP 5).'[61]

It is worth mentioning that, according to the 'Linaburg-Maduell transparency ranking' of SWFs, CIC's has already improved from the one of the lowest scores of two (out of ten) to a significantly higher score of eight.[62] This means CIC is already considered more transparent than the average SWF. Yet, CIC has not publicly disclosed its holdings on its official outlet. To promote better transparency, this paper proposes that CIC should act in accordance with the desirable level of transparency the Norway Government Pension Fund Global has adhered to. The Norway Government Pension Fund Global lists all investments and their returns regardless of the size of the holding in the target companies on its official information outlet in the public domain, along with its debt and equity mix, as well as identifications of its managers.[63]

B. Diversified investment strategy

The foregoing leads to a second proposal to reform CIC, which involves a voluntary commitment to purchase only small stakes in diversified target companies. This proposal originates once again from the practices of the Norway Government Pension Fund Global, which in principle holds less than 1% of the shares of every

61 The Santiago Principles (n 10) 7.

62 Sovereign Wealth Fund Institute, 'Linaburg-Maduell Transparency Index' <http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index/> accessed 30 July 2018.

63 Norges Bank, 'Government Pension Fund Global, Annual Report 2017, Part 3 Investments' <https://www.nbim.no/contentassets/49715a01ed684b1686ff3c017f1efa12/annual-report-2017--government-pension-fund-global.pdf> accessed 27 August 2018.

investee company in over three-thousand companies worldwide. SWFs have the potential to destroy target firms or even destabilise an entire industry in the host state, when a massive amount of capital made by a single investment of a SWF enters the market, and the SWF subsequently decides to unwind the investment because of unsatisfactory returns. A diversified investment strategy of the SWF will effectively alleviate the policy concerns of the host states. When there is an ownership ceiling in the SWFs investment strategy in place, it "mitigates fears that large capital flows from SWFs will be used to destabilise markets or governments".[64] Hence, the most viable solution available to guarantee market stability against the potent power of SWFs is to self-limit the equity stake in the target company.

C. Passivism in voting rights in the investee

The third reform option is the voluntary commitment to purchase non-voting shares in the target company, or the commitment of refraining from exerting voting rights. Non-voting stock is a type of stock which provides all other legitimate rights a shareholder is entitled to, except that it does not grant the right to vote on various (important) matters, such as the election of the board of directors or mergers. When CIC seeks to purchase only non-voting stocks of a target company, or otherwise, voluntarily forfeits its voting rights and seat(s) in the board of directors in the target company, it ensures the target company that it will not pursue any management role. As a matter of fact, CIC has already implemented the refrainment of its voting rights in practice in a couple of transactions. For instance, in 2007, CIC acquired 9.9% of total outstanding shares in Morgan Stanley while agreeing to have no managerial role in the company as a sole passive investor.[65] This paper hence advises that CIC consider adopting a self-restraint clause in its Articles of Association, stating that either it will only invest in non-voting equity shares of the target company, or it will not exert any voting-rights, even if it becomes a substantial shareholder, so as to solidify its stance as a sheer financial investor.

VII. Conclusion

Unlike private investors, SWFs are ultimately owned by sovereign governments, which has regulatory implications that cannot be easily reconciled with the host state. The rapid growth of SWFs from emerging market countries, in combination

[64] Jason Buhi, 'Negocio De China: Building Upon the Santiago Principles to Form an Effective International Approach to Sovereign Wealth Fund Regulation' (2009) 39 Hong Kong Law Journal 197, 214.

[65] Christian Plumb, 'China Investment Corp Buys $5 Billion in M. Stanley Units' *Reuters* (New York, 19 December 2007) <https://www.reuters.com/article/morganstanley-china/china-investment-corp-buys-5-bln-in-m-stanley-units-idUSN1957628320071219> accessed 30 July 2018.

with their financial significance, lack of transparency and potential political and strategic motivations have worried policy makers regarding how these SWFs have been investing.[66]

Chinese investors in general are believed to pose additional concerns, because of China's particular socialist-political economy. Following the Western countries' long-held doubt on China's one partisanship and its questionable position as a market economy, there is a general perception that governmental intervention in the market can be excessive and ubiquitous in China.[67] Chinese outbound investments are hence regarded as exuding 'high-risks' because of the suspicion of containing a hidden political agenda or even espionage in the host state. Under such circumstances, it is no surprise that Chinese SWFs would pose more of a concern in the host state than SWFs of a country that is considered an 'ally' of the host state.

It is then not entirely surprising to see that Chinese sovereign investment vehicles such as CIC would raise some particular policy concerns in the holistic FDI policy context of the host state. As the President of CIC stated in a press interview in January 2018, "countries have 'specifically' targeted China as it makes more foreign investments", and CIC is increasingly facing obstacles and resistance in its investments overseas due to protectionism on the rise.[68] Security-related risks are perceived when the host government believes that CIC wishes to gain control in target firms in strategically important sectors in the host state, and possibly abuse such control for non-economic purposes. Often, however, alleged ulterior motives have not been observed in practice. Although apparently, a good track record is in place, it is the particular character of CIC that alerts the regulators of the host state. The abundant financial power of CIC and its association with the Chinese government, both in terms of ownership and management, make it typically susceptible to heightened governmental scrutiny. To effectively address the security-related concerns, this paper concludes that CIC should emphasise the importance of self-regulation promoted by the Santiago Principles. This may include a combination of measures that warrant the non-controlling nature of the investments of CIC, so as to assure the host state that CIC is a sheer financial investor with only passive investment motives, but not a strategic, activist investor.

[66] Martin A. Weiss (n 35) 7.

[67] Gisela Grieger, 'Foreign Direct Investment Screening – A Debate in Light of China-EU FDI Flows' (European Parliamentary Research Service Briefing, May 2017) 4.

[68] Cheang Ming and Bernie Lo, 'Countries are "Specifically Targeting" China with "Protectionism", Official Says' (*CNBC Finance*, 16 January 2018) <https://www.cnbc.com/2018/01/15/china-wealth-fund-faces-protectionism-says-cic-president.html> accessed 2 September 2018.

The Establishment of a Multilateral Investment Treaty for the 'One Belt, One Road' Initiative

Yawen Zheng*

I. Introduction

The 'One Belt, One Road' (OBOR) initiative was proposed by Chinese president Xi Jinping in 2013. It comprises the "New Silk Road Economic Belt" and the "21st Century Marine Silk Road",[1] covering altogether seventy countries.[2] This initiative aims at realising development and prosperity of the OBOR states in various areas, removing barriers for investment.[3] Following the progress of the initiative, the majority of these countries have become important destinations for China's outbound foreign direct investment (FDI). In 2016, Chinese enterprises executed one-hundred fifteen merger and acquisition projects in OBOR states, for a total consideration of $6.64 billion. Meanwhile, China's FDI stock in OBOR states has reached $129.41 billion.[4] These investments have clearly stimulated the

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1 The National Development and Reform Commission (NDRC), Ministry of Foreign Affairs (MFA) and Ministry of Commerce of the People's Republic of China (MOFCOM), 'Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road' (2015), <http://www.ndrc.gov.cn/gzdt/201503/t20150330_669392.html> accessed 12 December 2017.

2 See Belt and Road Portal, 'Profiles' <https://eng.yidaiyilu.gov.cn/info/iList.jsp?cat_id=10076> accessed 12 December 2017.

3 NDRC, MFA and MOFCOM (n 1).

4 MOFCOM, National Bureau of Statistics of China (BSC) and State Administration of Foreign Exchange (SAFE), '2016 Statistical Bulletin of China's Outward Foreign Direct Investment' (2017) <http://fec.mofcom.gov.cn/article/tjsj/tjgb/201709/20170902653690.shtml> accessed 19 December 2017.

development of the countries involved. For instance, China's first industrial zone in Ethiopia has generated 13,000 employment positions.[5]

To achieve further success with the OBOR initiative, it is worth considering how to provide a legal environment that can promote investment flows. One important requirement for any legal regime is granting sufficient investment protection. Most foreign investments in OBOR states are prioritised to certain sectors of cooperation like agriculture, infrastructure or energy.[6] These investments are vulnerable due to their inherent characteristics. First, they are normally capital intensive, particularly in their initial stage. Secondly, they tend to have a long-term horizon, during which unexpected significant legal, political, economic and social changes can occur. Thirdly, they may closely relate to the public interest and become politically sensitive. Hence, they can trigger public protest or political interference.[7] Accordingly, investments in these sectors have occupied a large proportion of investment dispute settlements.[8]

This paper intends to explore the appropriate approach to ensure effective international legal protection for foreign investments in OBOR states and, as such, contribute to the success of the initiative as a whole. Part II offers a more detailed assessment of existing international legal protection mechanisms for foreign investments, and finds that the current framework is unsatisfactory. Under these circumstances, a multilateral investment treaty can be a better choice, both for investors and states. Therefore, the subsequent sections of this paper deal with designing multilateral investment treaty-clauses in detail. Specifically, Part III proposes that China should lead the OBOR treaty-making process while other

5 Jianing Cao, 'The Eastern Industrial Zone in Ethiopia has attracted 83 enterprises settled in, and generated 13 thousand employment posisions' *The People's Daily* (Beijing, 10 August 2018).

6 NDRC, MFA and MOFCOM (n 1).

7 Jan M Schüpbach, 'Foreign direct investment in agriculture: the impact of outgrower schemes and large-scale farm employment on economic well-being in Zambia' (*PhD thesis, Logo of ETH Zurich*, 2014) <https://www.research-collection.ethz.ch/bitstream/handle/20.500.11850/99536/eth-47518-02.pdf> accessed 21 December 2017; Jun He, 'One Belt, One Road': China's New Strategy and Its Impact on FDI', in Julien Chaisse, Tomoko Ishikawa and Sufian Jusoh (eds), *Asia's Changing International Investment Regime: Sustainability, Regionalization, and Arbitration* (Springer 2017) 163; Huaxia Lai and Gabriel M Lentner, 'Paving the Silk Road BIT by BIT: An Analysis of Investment Protection for Chinese Infrastructure Projects Under the Belt & Road Initiative' (2017) 14(3) Transnational Dispute Management (TDM); Aweis Osman, 'China's Maritime Silk Road and the Future of African Arbitration' (2017) 14(3) TDM; Glenn Zacher, 'The Guide to Energy Arbitration Review' (2017) <http://globalarbitrationreview.com/static/the-guide-to-energy-arbitrations-review> accessed 20 December 2017.

8 Investment claims implicating sectors of agriculture, construction, energy (including electric power, oil, gas and mining) account for approximately 51% of the total ICSID caseload. See ICSID, 'cases', <https://icsid.worldbank.org/en/Pages/cases/searchcases.aspx> accessed 21 December 2017.

states actively participate; Part IV suggests that the treaty can draw inspiration from existing international instruments; and Part V proposes essential contents of the treaty. Finally, its significance is briefly evaluated at the end.

II. International Legal Protection for Foreign Investments

The most widespread international legal tools for protecting foreign investments are international investment agreements (IIA), including bilateral investment treaties (BIT) and other treaties containing investment provisions. Unfortunately, the existing IIAs between China and OBOR states are not satisfactory for the protection of FDI. One reason is the lack of valid IIAs. There has no IIA been concluded between China and ten OBOR states, and two other IIAs have not entered into force.[9] Another reason is that most existing IIAs fail to sufficiently protect foreign investments from both a substantial and a procedural point of view. For instance, national treatment, as one of the most common substantive standards of treatment, is not provided in BITs between China and forty-two OBOR states (although some of them are complemented by co-existing free trade agreements (FTAs)). Additionally, three other national treatment clauses are not legally binding. From a procedural point of view, BITs with China and forty-nine OBOR states only provide limited or no access to investor-state dispute settlement. The majority of them only allow disputes concerning the amount of compensation for expropriation to be submitted to international arbitration. Only in a few exceptional cases, access to arbitration is provided for other BIT breaches.[10] To the extent that bilateral and regional treaties overlap, or BITs and FTAs,[11] this may trigger confusion and uncertainty with regards to both investment protection and dispute settlement.[12]

Under such circumstances, the establishment of a multilateral treaty covering all OBOR states can be useful to creating a suitable legal framework. Although it is very challenging to establish a single framework that covers seventy different states compared to negotiating or upgrading BITs separately, it would have the several advantages. First, the multilateral treaty can apply to all states

9 See United Nations Conference on Trade and Development (UNCTAD), 'Investment Policy Hub' <http://investmentpolicyhub.unctad.org/IIA> accessed 23 December 2017.

10 ibid.

11 China has concluded both BITs and FTAs with OBOR states (such as South Korea), and some regional investment treaties have been concluded or are being negotiated, like the China-ASEAN BIT and the Regional Comprehensive Economic Partnership. See ibid.

12 Wolfgang Alschner, 'Regionalism and Overlap in Investment Treaty Law: Towards Consolidation or Contradiction?' (2014) 17(2) Journal of International Economic Law 271.

in a more standardised and predictable manner.[13] Secondly, States with relatively weak negotiation powers could avoid the prolonged and burdensome process of concluding several BITs successively. Thirdly, the multilateral treaty could further guarantee the success of the OBOR initiative in several ways. Indeed, it would ensure long-term cooperation between and participation by the states in promoting and facilitating foreign investment. Given the long-term nature of the initiative, continuous commitment would be essential,[14] something that would be difficult to achieve without a binding instrument. Moreover, directly reducing investment risks,[15] an investment treaty would also indirectly improve developing states' domestic legal regime, as they would need to adjust their regulations to comply with the treaty.

III. States' Roles in the OBOR Investment Treaty-Making

According to the principle of "wide consultation, joint contribution and shared benefits" that China adheres to,[16] this paper suggests that the OBOR investment treaty should be concluded with China playing a leading role, but with all states involved participating actively in the process. This has the following reasons.

First, as the proposer of the OBOR initiative, China should assume responsibilities commensurate to its stature. Secondly, China is the largest host and home state for FDI among OBOR participants.[17] Thirdly, China is the most experienced investment treaty negotiator, having concluded more BITs than any other of the states involved.[18] However, China's leading role would not mean it should act as the main decider. Although China employs three model BITs to guide its investment treaty negotiations, the differences between the model BITs and the BITs subsequently concluded suggest that it also adapts to the circumstances of its

13 Maria Bun, 'The Energy Charter Treaty and Central Asia: Setting an International Standard for Energy-Related Disputes' (2017) 14(3) TDM.

14 Peter Ferdinand, 'Westward ho – the China dream and 'one belt, one road': Chinese foreign policy under Xi Jinping' (2016) 92(4) International Affairs 941.

15 UNCTAD, 'The Role of International Investment Agreements in Attracting Foreign Direct Investment to Developing Countries' (2009) <http://unctad.org/en/Docs/diaeia20095_en.pdf> accessed 10 January 2018.

16 Jinping Xi, 'Towards a Community of Common Destiny and A New Future for Asia' (Keynote Address, the Boao Forum for Asia Annual Conference, 28 March 2015) <http://news.xinhuanet.com/english/2015-03/29/c_134106145.htm> accessed 11 January 2018.

17 UNCTAD, World Investment Report 2017 <http://unctad.org/en/PublicationsLibrary/wir2017_en.pdf> accessed 13 January 2018.

18 ibid.

partners, and is open to their opinions and comments.[19] Indeed, the participation of other OBOR states would be important as this can make the treaty contents more palatable. The OBOR initiative is designed to respect the independent choices of, and align with the development strategies of all participants.[20] This can only be achieved through equal-footed consultation and negotiation. I would like to add that it appears also in the best interest of each state to participate actively in the process of treaty-making.[21] However, major western economic powers like the UK and Germany not involved.[22] Even if these countries eventually were to join the OBOR initiative, they may have less interest in the multilateral treaty, as it offers limited investment protection (to suit the need of developing countries) compared to the one being negotiated between China and the European Union.[23]

IV. The Process of the OBOR Investment Treaty-Making

China has signed various international instruments, including treaties and Memorandums of Understanding (MOU) with OBOR states, regarding either general cooperation or more specific issues. These mechanisms can contribute to China's leading role in the treaty-making process, while their acceptance by the OBOR states makes them decent templates for concluding the multilateral treaty. While treaties create binding international obligations, MOUs imply that the state parties have no intention of making legally enforceable rules.[24] These instruments

19 For example, there exist significant differences between the 2003 Chinese Model BIT and the China – Republic of Korea BIT (adopted 07 September 2007, entered into force 1 December 2007) as well as the China – Mexico BIT (adopted 11 July 2008, entered into force 6 June 2009). See also Leon E Trakman, 'China's Regulation of Foreign Direct Investment', in Julien Chaisse, Tomoko Ishikawa and Sufian Jusoh (eds), *Asia's Changing International Investment Regime: Sustainability, Regionalization, and Arbitration* (Springer 2017) 67.

20 MFA, 'Foreign Minister Wang Yi Meets the Press' (8 March 2015) <http://www.fmprc.gov.cn/mfa_eng/wjb_663304/wjbz_663308/2461_663310/t1243662.shtml> accessed 11 January 2018.

21 Justin Yifu Lin, '"One Belt and One Road" and Free Trade Zones – China's New Opening-up Initiatives' (2015) 10(4) Front. Econ. China 585.

22 Asian News International (ANI), 'UK flags concern, doubts over OBOR project' *The Economic Times* (London, 02 February 2018).

23 Reuters Staff, 'China, EU exchange market access offers for investment treaty talks' *Reuters* (Beijing, 16 July 2018).

24 Paragraph VII of the Memorandum of Arrangement on Strengthening Cooperation on the Belt and Road Initiative between the Government of the People's Republic of China and the Government of New Zealand (adopted and entered into force 27 March 2017) stipulates that the instrument only indicates the will of the parties. Such statement evinces its non-legally binding status. Terminology and form of the MOU also confirms this status. For the distinction between a treaty and an MOU, see Anthony Aust, *Modern Treaty Law and Practice* (3rd edn, Cambridge University Press 2013) 28–35.

are either formal or informal, and can be divided into three categories: MOUs on OBOR cooperation; agreements or MOUs on sectoral cooperation;[25] and IIAs.

Accordingly, this section proposes that the treaty-making process can develop in three directions. Namely, OBOR states could transform (a) MOUs into investment agreements; (b) MOUs on sectoral cooperation into sectoral investment agreements; and (c) existing IIAs into a multilateral treaty. The first two directions can reach an acceptable standard of treatment between MOUs and agreements,[26] whereas the last one can be the point of reference regarding form and substance of the treaty. As is discussed below, these three directions can operate concurrently and supplement each other to establish the treaty more efficiently. Meanwhile, IIAs between other OBOR states can also be used as important points of reference After the conclusion of the OBOR investment treaty, a multilateral FTA can be negotiated, which may incorporate the investment treaty as one of its components.

A. From MOUs to investment agreements

Although MOUs on OBOR cooperation are not legally binding, they do record states' political commitment to an initiative,[27] especially with regards to investment cooperation.[28] These MOUs require parties to formulate detailed plans of bilateral cooperation within a certain period of time after the MOUs coming into effect.[29] The practice gained in the intermediate period can make the cooperation sufficiently mature to be subsequently governed by a legally binding agreement. In the future, this agreement can perhaps serve as a common base for the negotiation of a future investment treaty.

This approach complies with the common sense notion that the OBOR initiative should be implemented in a practical way.[30] It may also be more acceptable to state parties, as the benefits of the cooperation have already been shown. However, one would need to ensure that the progress with each party involved is

25 See Xinhua, 'Full text: List of deliverables of Belt and Road Forum' (2017) <http://www.xinhuanet.com/english/2017-05/15/c_136286376.htm> accessed 11 January 2018.

26 Donald J Lewis and Diana Moise, 'One Belt One Road (OBOR) Roadmaps: The Legal and Policy Frameworks (2017) 14(3) TDM.

27 China – New Zealand Memorandum of Arrangements (n 24) paragraph I: Cooperation Objectives.

28 ibid paragraph III: Cooperation Areas.

29 ibid. Some plans have been published, like the Five-Year Plan of Action on Lancang-Mekong Cooperation (2018–2022). See Belt and Road Portal, 'Bilateral Documents' <https://eng.yidaiyilu.gov.cn/info/iList.jsp?cat_id=10061> accessed 1 February 2018.

30 Li Zhu, 'The Construction Model of "One Belt and One Road": Mechanisms and Platforms' in Rong Wang and Cuiping Zhu (eds) *Annual Report on the Development of the Indian Ocean Region (2015): 21st Century Maritime Silk Road* (Springer 2015).

relatively similar and no deep disparities arise. Consistency in this respect may be achieved through soft powers and influence.[31]

B. From MOUs on sectoral cooperation to sectoral investment agreements

China has signed MOUs or agreements with OBOR states in various key sectors, such as infrastructure, energy and agriculture.[32] Compared to general MOUs, MOUs or agreements on specific sectors are more detailed with regards to the industries involved.[33] The parties to these MOUs and agreements are the departments responsible for the sectors concerned, instead of the states.[34]Their tasks include adopting measures and policies to promote investments, determining key cooperation industries and proposing major projects.[35] Therefore, these MOUs and agreements are more practical and implementable, and can serve to formulate concrete plans and roadmaps.

Sectoral plans can cover various aspects of investments, including salient issues like market access, approval procedures, substantive treatment, post-entry investment management and supervision. As the plans are not legally binding, they provide more flexibility for states to modify their cooperation. Again, once the scheme has matured, reference to existing practices can serve as a stepping stone for concluding legally binding sectoral agreements.

C. From IIAs to an OBOR investment treaty

There exists a spaghetti bowl of IIAs between OBOR states, including bilateral and regional investment treaties and FTAs containing investment provisions. The tangle is becoming even more intricate as new IIAs like the Regional Comprehensive Economic Partnership (RCEP)[36] are being negotiated. Although the fragmented regime can pose daunting challenges and risks, it also provides

[31] For examples of China's means of exerting influence, see Council on Foreign Relations, 'China's Big Bet on Soft Power' (2018) <https://www.cfr.org/backgrounder/chinas-big-bet-soft-power> accessed 11 August 18.

[32] See Xinhua (n 25).

[33] The Framework Agreement on Enhancing Industrial Capacity and Investment Cooperation between the NDRC of China and the UAE (signed 2017), art 1 stipulates that priority sectors for investment cooperation are oil and gas processing, and nonferrous metals; art 6 provides that each party shall bear respective expenses arising from the cooperation.

[34] MOUs on transport cooperation are signed between the Ministry of Transport of China and relevant government departments of other OBOR states. See Xinhua (n 25).

[35] The Framework Agreement (n 33) art 4 and 5.

[36] See Association of Southeast Asian Nations, 'RCEP' <http://asean.org/?static_post=rcep-regional-comprehensive-economic-partnership> accessed 2 February 2018.

ample materials for the construction of a comprehensive OBOR investment treaty. After several generations, IIAs have gradually evolved from brief to more sophisticated and balanced.[37] While older IIAs are inconsistent with the needs of both investors and states, due to insufficient investment protection, absence of investor-state arbitration and regulatory latitude, newly-concluded IIAs, as well as those underway, offer a decent point of reference. Besides, existing multilateral initiatives covering some of the OBOR states, like the Energy Charter Treaty and the Trans-Pacific Partnership, can be consulted. Their conclusion seems to imply that the standards adhered to are acceptable to at least some of the OBOR states.

After its conclusion, the multilateral treaty can serve as a stepping stone towards a full-fledged FTA. China has proposed already to establish and expand free trade areas with OBOR states.[38] An OBOR FTA would promote FDI flows and trade and regional integration even more strongly.[39] Moreover, it could further reduce investors' transaction costs and allow states to make coordinated decisions on economic matters.[40] As the making of FTAs tends to attract considerably more public attention than BITs,[41] negotiating the OBOR FTA at a later stage may be appropriate, as it reduces the intensity of public concerns.

V. Essential Contents of the OBOR Investment Treaty

Although the international investment treaty landscape is extremely fragmented, comprising around three-thousand IIAs,[42] core elements of most investment treaties are substantively rather similar. They generally include the definition of foreign investments, rules on the establishment and admission of investments, expropriation and compensation.[43] Provisions concerning investment protection standards, permitted exceptions and dispute settlement are essential, and their design is decisive to the success of the OBOR initiative. To promote common security and sustainable development,[44] on the one hand, the OBOR

[37] Meg Kinnear, 'ICSID and International Investment Treaty Arbitration: Progress and Prospects' in Wenhua Shan (ed), *China and International Investment Law: Twenty Years of ICSID Membership* (BRILL 2015) 9.

[38] NDRC, NFA and MOFCOM (n 1).

[39] Molly Lesher and Sébastien Miroudot, 'Analysis of the Economic Impact of Investment Provisions in Regional Trade Agreements' in OECD Trade Policy Papers No. 36 (OECD Publishing 2006).

[40] Chang-fa Lo, 'A Comparison of BIT and the Investment Chapter of Free Trade Agreement from Policy Perspective' (2008) 3 Asian Journal of WTO & International Health Law and Policy 147.

[41] Qingjiang Kong, 'Bilateral Investment Rule-Making: BITs or FTAs with Investment Rules?' (2013) 13 The Journal of World Investment & Trade 638.

[42] See UNCTAD, 'World Investment Report 2017' (n 9).

[43] UNCTAD, 'Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking' (2007) <http://unctad.org/en/docs/iteiia20065_en.pdf> accessed 4 February 2018.

[44] NDRC, MFA and MOFCOM (n 1).

investment treaty should provide advantageous treatment of investments. On the other, carefully structured provisions are necessary, in particular with respect to the applicable reservations and exceptions, to ensure that states retain enough regulatory space. Therefore, a balanced approach should be adopted when designing these clauses.

Moreover, the dispute settlement mechanism is also important, as it can ensure the correct application of substantive clauses, thus implementing the intention of state parties and the aim of the OBOR initiative. Additionally, as State-Owned Enterprises (SOEs) play a leading role in the OBOR investment strategy,[45] special concerns regarding the regulation and protection of FDIs by SOEs must also be considered. Against this background, this section develops essential treaty provisions. A summarising table has been included at the end.

A. Standards of investment treatments

The three most common standards of protection in IIAs are national treatment (NT), most-favoured nation treatment (MFN) and fair and equitable treatment (FET). Over the years, these provisions have generally become longer and more complex. There are two main developments that merit further discussion. One is that an increasing number of IIAs grant foreign investors a right of establishment by expanding NT and MFN into the pre-establishment phase, subject to certain reservations and exceptions.[46] The other is that more details and carve-outs are being included, resulting from prior rulings in investment dispute cases.[47] To achieve the goals of the initiative and be palatable to the states involved, standards of protection clauses in the OBOR investment treaty should follow both trends.

With regards to the former trend, it should be observed that a right of establishment can guarantee predictability, security and transparency concerning market access. While protections in the pre-establishment phase are becoming commonplace, liberal market access rules can distinguish a treaty from others and effectively lure foreign investors, especially into emerging markets that lack other appealing features.[48] Therefore, the inclusion of these provisions in an investment

45 MOFCOM Trade Remedy and Investigation Bureau, 'China's SOEs lead the OBOR investment' (2017) <http://trb.mofcom.gov.cn/article/zuixindt/201709/20170902641583.shtml> accessed 4 February 2018.
46 UNCTAD, 'Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking' (n 43).
47 Kinnear (n 37)
48 Axel Berger, *et al*, 'Do trade and investment agreements lead to more FDI? Accounting for key provisions inside the black box' (2013) 10 International Economics and Economic Policy 247.

treaty is particularly beneficial to OBOR states with an otherwise relatively unattractive investment climate.

However, the right of establishment is rarely provided for in China's IIAs with OBOR states. Currently, there are only four IIAs that manifestly provide MFN in the pre-establishment phrase, while no valid IIAs so far provide pre-establishment NT.[49] Indeed, states traditionally prefer to reserve the sovereign right to grant admission to and establishment of foreign investments, to preserve sufficient discretion, and to better pursue their own development needs.[50] However, this trend is changing gradually. For instance, as early as 1994, the Asia-Pacific Economic Cooperation has published non-binding investment principles granting pre-establishment NT and MFN.[51] In 2013, China agreed to negotiate a BIT with the United States which included a right to pre-establishment NT,[52] and the negotiations had been basically completed in 2015.[53] Moreover, the final version of the Trans-Pacific Partnership Agreement (TPPA),[54] concluded by eleven states, including Asian developing countries,[55] also includes pre-establishment NT and MFN.[56] These changes indicate that some developing countries are becoming more open to the idea of higher standards of liberalisation. As FDI remains a key driving force of their development, while FDI inflows in developing Asia have actually decreased in the past two years,[57] states are perhaps more inclined to accept the provision of pre-establishment rights.

However, carve-outs to investment treatment are equally essential, as they enable host states to make the rights of foreign investors compatible with national development objectives, and reserve certain flexibility for economic and social concerns. Sectoral carve-outs can be shaped in the form of either a positive or a negative list. Commonly, the former tends to limit the coverage of investment protection to a larger extent and thus suits host states that only plan to liberalise

49 See UNCTAD, 'World Investment Report 2017' (n 9).
50 UNCTAD, 'National Treatment' (1999) <http://unctad.org/en/Docs/psiteiitd11v4.en.pdf> accessed 5 February 2018.
51 The APEC Non-Binding Investment Principles (endorsed 1994, revised 2011).
52 China Daily, 'China to open a wider door to foreign investment' (2017) <http://www.chinadaily.com.cn/opinion/2017-01/04/content_27857988.htm> accessed 7 February 2018.
53 Xinhua Net, 'China, U.S. basically complete text negotiation on BIT' (2015) <http://www.xinhuanet.com/english/2015-03/07/c_134046188.htm> accessed 7 February 2018.
54 Comprehensive and Progressive Agreement for Trans-Pacific Partnership (hereinafter "TPPA") (adopted 8 March 2018, not yet entered into force) <https://ustr.gov/trade-agreements/free-trade-agreements/trans-pacific-partnership/tpp-full-text> accessed 9 February 2018.
55 Maclean's, 'Canada, TPP members agree to revised deal without the U.S.' (2018) <http://www.macleans.ca/politics/ottawa/canada-tpp-members-agree-to-revised-deal-without-the-u-s/> accessed 9 February 2018.
56 TPPA (n 54) arts 9.4 and 9.5.
57 UNCTAD, 'World Investment Report 2017' (n 17).

their market gradually. Conversely, the latter potentially narrows the discretion of host states significantly, and thus fits countries that wish to benefit from readily increased openness and a more competitive market environment.[58] But this distinction does not always hold true. The degree of openness depends primarily on the actual contents of the lists, and the adoption of a negative list does not necessarily imply a more open market if the list is a very comprehensive one.[59] Compared to the positive approach, a negative list does offer a higher degree of regulatory transparency, because of the comprehensive inventory of non-conforming measures provided.[60] Accordingly, this negative approach requires states to sort out carefully domestic legislation before composing the list.[61] Such a requirement can impose difficulties on states with a complex or chaotic legal system. Considering that countries participating in the OBOR investment treaty are in different stages of their development, it might be necessary to adopt a more flexible stance—allowing states to choose their approach themselves. This could be a positive, negative, or hybrid one, containing both a positive and a negative list.[62]

Furthermore, it is necessary to introduce mechanisms in the treaty to regulate state parties' future changes to their lists. This could be achieved through either 'standstill' or 'ratchet' clauses. The former requires countries not to adopt more restrictive non-conforming measures than those in the list and to decrease the degree of market openness after the conclusion of the treaty. Conversely, the latter prevents parties from taking any backward steps after they unilaterally decide to further open the market.[63] Jointly, these two clauses can ensure progressive and continuous liberalisation of international trade.

The second trend in investment protection standards, that is, the use of greater details and exceptions, is most obvious in MFN and FET clauses. As outlined above, this development may be considered a response to tribunal interpretations

[58] UNCTAD, 'International investment agreements: Flexibility for development' (2000) <http://unctad.org/en/Docs/psiteiitd18.en.pdf> accessed 10 February 2018.

[59] China was widely criticised for not truly opening its market after adopting the national negative list for foreign investments in domestic law for the first time, as the negative list is too board and too restrictive. Paul Edelberg, 'Is China Really Opening Its Doors to Foreign Investment?' (2017) <https://www.chinabusinessreview.com/is-china-really-opening-its-doors-to-foreign-investment/> accessed 11 February 2018.

[60] UNCTAD, 'Investment Policy Framework for Sustainable Development' (2015) <http://investmentpolicyhub.unctad.org/Upload/Documents/INVESTMENT%20POLICY%20FRAMEWORK%202015%20WEB_VERSION.pdf> accessed 28 May 2018.

[61] European Commission, 'Services and investment in EU trade deals: Using "positive" and "negative" lists' (2016) <http://trade.ec.europa.eu/doclib/docs/2016/april/tradoc_154427.pdf> accessed 11 February 2018.

[62] Such a flexible approach has been successfully used in some IIAs, including the China – Australia FTA (entered into force 20 December 2015) Annex III.

[63] European Commission (n 61).

and evidences the influence of case law on treaty design.[64] After MFN clauses were successfully invoked by some investors to benefit from better dispute settlement clauses inserted in other treaties of the host state,[65] recently concluded treaties explicitly bar such interpretations to dispel any doubts.[66] This trend can similarly be followed by the OBOR investment treaty.

In turn, the drafting of FET is more complicated. With their vague wording, FET clauses are invoked by investors practically in every investment arbitration case, often successfully.[67] The precise interpretation of the FET standard is unclear, due to certain inconsistencies in the practices of investment tribunals. On the following aspects, in particular, there seems to be no consensus: (a) the relationship between FET clauses and customary international law;[68] (b) the relationship between FET and other treaty obligations;[69] and (c) generally the substantive content of the FET standard.[70] Accordingly, IIAs are limiting the interpretative discretion of tribunals and enhancing the predictability of arbitral awards.

As most OBOR states are developing countries that may need to intervene in their economy more frequently or with more incisive action, explicit clarifications on the FET clause should be provided to preserve enough latitude for states to regulate several matters in the public interest. These clarifications include (a) a clear linkage of FET to the international minimum standard of treatment, which tends to establish a relatively high liability threshold and outlaws only gross violations; (b) a stipulation that breach of any other treaty norm will not constitute a breach of the FET standard;[71] and (c) identification of the content of FET. As the substantive content of the international minimum standard of treatment is rather unclear and

[64] Kinnear (n 37).

[65] For example, *Maffezini v Spain*, ICSID Case No ARB/97/7, Decision of the Tribunal on Objections to Jurisdiction, 25 January 2000 [56].

[66] For example, China – Uzbekistan BIT (entered into force 1 September 2011) art 4(3).

[67] UNCTAD, 'Fair and Equitable Treatment' (2012) <http://unctad.org/en/Docs/unctaddiaeia2011d5_en.pdf> accessed 12 February 2018.

[68] Some tribunals considered FET equal to international minimum standards of treatment. For example *Genin v Estonia*, ICSID Case No. ARB/99/2, Award, 25 June 2001 [367]; while some others interpreted FET based on the plain meaning of the terms. For example, *Enron v Argentina*, ICSID Case No. ARB/01/3, Award, 22 May 2007 [258], [259].

[69] Some tribunals held that violation of any other treaty obligations constitutes a violation of FET. For example, *SD Myers v Canada*, UNCITRAL, Partial Award, 13 November 2000 [266].

[70] Many tribunals tried to identify specific elements of FET, some of which have been widely accepted, like the protection of investors' legitimate expectations; while others have generated concerns and criticisms regarding transparency. Andrew Newcombe and Lluís Paradell, *Law and Practice of Investment Treaties: Standards of Treatment* (Wolters Kluwer 2009) 278, 291.

[71] This will be more important after the conclusion of the OBOR FTA, as it may protect host states from numerous suits based on FET but triggered by violations outside the coverage of investment arbitration: see UNCTAD, 'Fair and Equitable Treatment' (n 67).

controversial,[72] an exhaustive list of substantive obligations can reduce the risk of an expansive reading by tribunals.

B. Exceptions to substantial investment treaty obligations

General exception clauses allow states to adopt necessary good faith measures that *prima facie* appear to breach treaty norms without violating the treaty as such. In addition to clarifications and carve-outs to investment treatment, general exceptions are important to protect social values and address public concerns, especially when host states have less leeway to control and restrict foreign investment after granting establishment rights.[73] However, very rarely do OBOR states' IIAs contain exception provisions. Although states can raise the necessity defence under customary international law, even when the applicable IIA does not explicitly stipulate any exception as such, the requirements for the defence are strict and difficult to satisfy,[74] while its interpretation is controversial and inconsistent.[75] Therefore, it is advisable to include exception clauses that can be invoked more easily and offer greater certainty. Conversely, certain safeguards are necessary to prevent the abuse of exceptions.

Safeguards can be imposed in various manners, and may adopt both a substantive and a procedural point of view.[76] However, the following two express requirements should be included in any case. One is necessity, the other is non-discrimination. These two requirements can, at least conceptually, restrict the abuse of non-conforming measures by host states and protect foreign investments in exceptional circumstances.

Nevertheless, the arbitral interpretation of necessity varies. Therefore, recent IIAs tend to include a self-judging clause, to prevent tribunals from conducting their assessments on whether the situation of necessity can be established, but rather leave this to be determined by the host state adopting the measures.[77] In such circumstances, tribunals can only review whether the measure has been implemented in good faith.[78] Although some tribunals argue that the standard of good faith review will not differ much from a substantive review under a non-self-judging clause,[79] it is widely accepted that with a self-judging clause in place, tribunals will lower their (more deferential) review standard.[80] As the circumstances of OBOR states vary significantly, a self-judging clause can retain their discretion and thus better suits different needs. However, states may also use self-judging clauses to dilute investor protection. Such risks may be mitigated by asking tribunals to take into account the host state's stage of development when conducting the good faith review.[81]

There are several types of general exceptions, two of which are essential to the OBOR investment treaty. One is the national security exception, which can ensure public order, and thus is particularly needed by a number of states. The other is the protection of health, environment and natural resources. These two sets of exception clauses can contribute to the goals of achieving security and sustainable development while attracting foreign investments, and thus should be mandatory provisions of the treaty. Additionally, there exist exception clauses for other policy objectives, including the preservation of cultural and linguistic diversity and cultural heritage. Here, states can customise general exception provisions according to their needs and development policies.

C. Dispute settlement mechanisms

The issue of dispute settlement is essential to the application and enforcement of IIAs, and thus fundamental to the achievement of treaty goals and the balance of interests between foreign investors and host states. Accordingly, the design of

72 There is controversy regarding the standard of international minimum treatment. Some arbitral tribunals held that it is the same as in the Neer case. For example, *Glamis Gold v the US*, UNCITRAL, Award, 8 June 2009 [616]. Conversely, others highlighted the evolutionary nature of customary international law. For example, *Merrill and Ring v Canada*, ICSID Case No. UNCT/07/1, Award, 31 March 2010.

73 UNCTAD, 'Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking' (n 43).

74 There are five requirements for the necessity defence: (a) essential interests of the state are subject to great and imminent peril; (b) the measure adopted is the only way to safeguard these interests; (c) the measure does not impair essential interest of other states or the international community; (d) the obligation has the possibility to invoke necessity; and (e) the state has not contributed to the existence of the emergency situation itself. Draft Articles on Responsibility of States for Internationally Wrongful Acts 2001, art 25.

75 With the same factual background, the tribunals in *CMS v Argentina* and *LG&E v Argentina* draw opposite conclusions on whether Argentina was eligible to evoke the necessity defence under customary international law. See CMS, ICSID Case No. ARB/01/8, Award, 25 September 2007 [319]–[331]; LG&E, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006 [238]–[242], [255]–[257].

76 For substantial limitations, some IIAs only exempt specific parties from certain obligations, like the Germany – Mexico BIT (entered into force 23 February 2001) art 3(1); for procedural limitations, the Japan – Vietnam BIT (entered into force 19 December 2004) art 15 requires the state invoking the exception to notify its contracting party.

77 For example, TPPA (n 54) arts 9.16 and 29.2.

78 State parties are required to perform every treaty in good faith under customary international law. See Vienna Convention on the Law of Treaties 1969 art 26

79 For example, LG&E (n 75) [214].

80 For example, *Continental Casualty v Argentina*, ICSID Case No. ARB/03/09, Award, 5 September 2008 [182].

81 States' level of development has affected the merits of several investment arbitral awards. For example, *Pantechniki v Albania*, ICSID Case No. ARB/07/21, Award, 30 July 2009 [76]–[82].

the dispute settlement mechanism is also important for the success of the OBOR initiative.

Investment arbitration can impose heavy financial burdens on litigating parties. According to an OECD survey, the average legal and arbitration costs in reviewed cases are over $8 million.[82] The amounts of compensation awarded to foreign investors can also be substantial. In an IISD survey, the average sum in eighty-three reviewed awards exceeded $8 billion.[83] Most OBOR states have already faced a number of investment claims.[84] Therefore, it is also desirable to mitigate the costs and legal risks faced by host states in investment dispute settlement. This section addresses the concerns from two points of view. One is the possibility to establish an OBOR investment treaty commission; the other is the drafting of dispute settlement provisions in the treaty itself.

A treaty commission could be established as a permanent institution, composed of official representatives and legal experts from all states. First, it could supervise and support the implementation of the treaty in state parties. Particularly developing countries may require legal advice regarding various issues of implementation, especially when they need to change domestic laws. Moreover, whenever the commission would spot a potential breach, it could inform the country concerned and suggest corrections, to minimise the risk of possible claims. The legal advice provided by such a commission is usually not legally binding, and thus states are free to decide whether they intend to follow it. However, reports of supervision activities are commonly published, and thus reveal states' compliance. Consequently, countries that ignore these reports may face greater risks of disputes and less foreign investment.

Secondly, the commission could also help with dispute settlement. This can be achieved by providing a sound platform for mediation between investors and states. Compared to investor-state arbitration, mediation is speedier and cheaper, and thus could ease the burden for the parties involved. Moreover, mediation is more informal, and hence more likely to achieve a mutually acceptable solution.[85] Alternatively, notes of interpretation could be issued upon the request

[82] OECD, 'Investor-State Dispute Settlement Public Consultation: 16 May – 9 July 2012' (2012) <http://www.oecd.org/investment/internationalinvestmentagreements/50291642.pdf> accessed 10 April 2018.

[83] D. Rosert, 'The Stakes are High: A review of the financial costs of investment treaty arbitration' (2014) <http://www.iisd.org/sites/default/files/publications/stakes-are-high-review-financial-costs-investment-treaty-arbitration.pdf> accessed 10 April 2018.

[84] 57 OBOR states have faced investment claims so far, among which 16 have faced more than 10 claims, while 6 of which than 20 claims. See UNCTAD, 'Investment Dispute Settlement Navigator' <http://investmentpolicyhub.unctad.org/ISDS/FilterByCountry> accessed 11 April 2018.

[85] Jeswald W Salacuse, 'Is there a Better Way – Alternative Methods of Treaty-Based, Investor-State Dispute Resolution (2007) 31 Fordham International Law Journal 138.

of parties involved in an arbitration procedure. These are binding upon both the present tribunal and future ones. As long as the interpretation note is clear and understandable, and does not amount an amendment of the treaty, such an approach could increase certainty and predictability.[86] Furthermore, it will ensure that treaty provisions are responsive to the needs of the states involved. Finally, the enforcement of arbitral awards could be facilitated through the commission providing investors with useful information on matters such as asset availability and location. The aforementioned functions could effectively reduce the legal risks faced by host states. Consequently, they may be more willing to accept a higher standard of protection in the treaty.

Some scholars propose to design a dispute settlement centre specifically for OBOR investor-state arbitration.[87] This commendable proposal seeks to accommodate the peculiarities of OBOR states and investors, but may not work as expected. If the treaty offers foreign investors a unilateral choice between listed fora, including the OBOR dispute settlement centre, foreign investors may hesitate to prefer a newly established institution over popular and experienced ones. Thus, the centre may struggle to play a meaningful role. However, the other option is viable neither. It is very rare nowadays to provide only one available forum to foreign investors,[88] as such an approach is considered too restrictive. Additionally, even without establishing a new dispute settlement centre, states can still shape arbitration proceedings according to their specific needs by explicitly defining detailed rules regarding various procedural aspects, such as the qualifications of the arbitrators. Therefore, it is both impractical and unnecessary to establish a dispute settlement centre specifically for the OBOR initiative.

In sum, legal risks and costs are essential concerns of host states when they decide whether to accept a higher standard of investment protection. Therefore, a dispute settlement mechanism that can mitigate the risks and financial burdens of states can, perhaps somewhat counter-intuitively, also benefit foreign investors.

[86] Gabrielle Kaufmann-Kohler, 'Interpretive Powers of the Free Trade Commission and the Rule of Law' in Emmanuel Gaillard (ed) *Fifteen Years of NAFTA Chapter 11 Arbitration* (JURIS, 2011) 175.

[87] For example, Lewis and Moise (n 26).

[88] States have gradually increased the number of fora available to foreign investors. The proportion of treaties offering only one forum has declined since the early 1980s, and since 2009 no such treaty exists. OECD, 'Dispute settlement provisions in international investment agreements: A large sample survey' (2012) <http://www.oecd.org/investment/internationalinvestmentagreements/50291678.pdf> accessed 30 June 2018.

D. Special issues about state-owned enterprises as foreign investors

With the rapidly increasing amount of foreign investments made by SOEs,[89] issues regarding these institutions have attracted much attention and intense debate.[90] There exist various concerns, which can be invoked as strong reasons to bar their activities. For instance, the China-owned Ralls Corporation was ordered by the US to divest a part of its assets for national security reasons.[91] As Chinese and other SOEs play an important role in OBOR investment projects,[92] it is important to consider their protection while safeguarding the interests of host states.

The foremost issue in this regard is the coverage of treaty protections. Very rarely do investment treaties explicitly refer to sovereign investors.[93] Unless an explicit provision to the contrary is present, investment treaties should be interpreted as covering SOEs, as the term 'investor' is broadly defined to include all kinds of legal entities.[94] However, the qualification of SOEs as investors under investment treaties is still debatable without clarification, especially in investment dispute settlement.[95] As SOEs usually operate in highly capital-intensive industries, they are more likely to incur investment disputes.[96] Accordingly, it is important to guarantee SOEs' standing in arbitration through their manifest inclusion in the investor definition. Similarly, state-owned vehicles like sovereign wealth fund and governments themselves can also be included, to cover sovereign investments as broadly as possible.

Manifest inclusion of SOEs in the investor definition is the starting point for equal treatment of private and sovereign investors, which needs to be further guaranteed through non-discrimination provisions included in the treaty. As relative standards, their specific contents depend on the treatment accorded to comparable investors. Therefore, the criteria to select comparable investors are crucial. Inclusion of a qualification such as "in like circumstances" can provide guidance to the selection of comparable investors.[97] However, it is possible to treat ownership structure as a difference in circumstances, and thus accord sovereign and private investors different treatments.[98] Therefore, further clarifications are necessary to assure an overall examination and avoid limiting the analysis to only one factor.[99]

In my view, it is impractical and unnecessary to distinct investments made by SOEs from private investments. First, the main concerns of host states regarding SOEs, like national security and competitive neutrality can be mostly addressed by exception clauses.[100] Secondly, except ownership structure, home states have various approaches to assert influence or control over foreign investments. This blurs the distinction between investors and their home states,[101] as private investors can also act as sovereign investors under such circumstances, and so a distinction would be arbitrary. Thirdly, assumptions regarding the different goals of SOEs and private enterprises are not necessarily valid. One is that private enterprises operate for purely shareholder value maximisation motives; the other is that SOEs behave differently from private enterprises. Both can be easily rejected by counter-examples.[102] Although investments made by SOEs, on average, tend to pose higher risks to host states, their sovereign's ownership is not a determinative factor.[103] Accordingly, the risks triggered by private investments should not be overlooked,

89 There were about 650 state-owned multinational enterprises with around 8,500 foreign affiliates in 2010, while in 2017 the numbers have grown to 1,500 and 86,000 respectively. UNCTAD, World Investment Report 2011 <http://unctad.org/en/PublicationsLibrary/wir2011_en.pdf> accessed 29 May 2018; UNCTAD, 'World Investment Report 2017' (n 9).

90 ibid. See also the contribution of Bian elsewhere in this Special Issue.

91 The White House, 'Order Signed by the President regarding the Acquisition of Four U.S. Wind Farm Project Companies by Ralls Corporation' (2012) <https://obamawhitehouse.archives.gov/the-press-office/2012/09/28/order-signed-president-regarding-acquisition-four-us-wind-farm-project-c> accessed 29 May 2018.

92 Wu Gang, 'SOEs Lead Infrastructure Push in 1,700 "Belt and Road" Projects' (*Caixin Global*, 9 May 2017) <https://www.caixinglobal.com/2017-05-10/101088332.html> accessed 30 May 2018.

93 Yuri Shima, 'The Policy Landscape for International Investment by Government-controlled Investors: A fact finding survey' (2015) *OECD Working Papers on International Investment* 2015/01 (OECD Publishing 2015).

94 UNCTAD, 'The protection of national security in IIAs' (2009) <http://unctad.org/en/docs/diaeia20085_en.pdf> accessed 30 May 2018.

95 For circumstances under which the definition of "investor" should not include SOEs, see Paul Blyschak, 'State-Owned Enterprises and International Investment Treaties: When are State-Owned Entities and their Investments Protected?' (2011) 6(2) Journal of International Law and International Relations 1.

96 Lauge N Skovgaard Poulsen, 'States as Foreign Investors: Diplomatic Disputes and Legal Fictions' (2016) 31(1) ICSID Review 12.

97 UNCTAD, 'Bilateral Investment Treaties 1995–2006: Trends in Investment Rulemaking' (n 43).

98 Lu Wang, 'Non-Discrimination Treatment of State-Owned Enterprises in the Context of International Investment Agreements?' (2016) 31(1) ICSID Review 45.

99 A sample provision can be Article 4 of the Croatia – Azerbaijan BIT (adopted 2 October 2007, entered into force 30 May 2008).

100 Wang (n 98).

101 Poulsen (n 96).

102 Larry C Backer, 'Sovereign Wealth Funds as Regulatory Chameleons: The Norwegian Sovereign Wealth Funds and Public Global Governance Through Private Global Investment' (2009) 41(2) Georgetown Journal of International Law 101.

103 James E Mendenhall, 'Assessing Security Risks Posed by State-Owned Enterprises in the Context of International Investment Agreements' (2016) 31(1) ICSID Review 36.

and the approach to assess SOEs should be largely the same as the one for private investments.

As sovereign investors tend to be large and resourceful, they are typically able to enter industries with large upfront costs like natural resources and infrastructure,[104] in which most private investments find it difficult to operate. As these sectors are key to the common development of the OBOR states, it is important to grant sufficient protection to SOEs, to ensure their operation in an investment-friendly environment.

Although building a multilateral OBOR investment treaty is an ambitious and difficult task, once concluded, it can contribute significantly to the making of an even wider-ranging international instrument in two ways. First, the OBOR treaty can open itself up to other states, and thus has the potential of becoming a global mechanism. Secondly, if it would be necessary to design a new international investment treaty, the OBOR treaty can be a great point of reference, a successful response to the need of both home and host states in various stages of development.

[104] Poulsen (n 96).

Proposed essential treaty contents

Section	Treaty provisions	Proposed contents
Standards of investment treatment		Application to the pre-entry phrase
		Sectoral carve-outs and limitation of changes after conclusion of the treaty
		Qualification of "in like circumstance"
	Most-favoured nation treatment	Application to pre-entry phrase
		Sectoral carve-outs and limitation of changes after conclusion of the treaty
		Qualification of "in like circumstances"
		Explicit exclusion of its application to dispute settlement clauses
	Fair and equitable treatment	Linkage to the international minimum standard of treatment
		Disconnection with the breach of other treaty norms
		Identification of substantive contents
Exceptions to substantial investment treaty obligations	Requirements of their invoking	Self-judging necessity
		Non-discrimination
	Mandatory exception clauses	National security exceptions
		Exceptions for the protection of health, environment and natural resources
	Optional exception clauses	Customisation according to states' needs and development policy
Dispute settlement mechanisms	Treaty commission	Supervision and support the implementation of the treaty
		Assistance with investment dispute settlements
	Dispute settlement clauses	Coverage of essential substantive treaty obligations
		Exclusion of certain treaty provisions opted for by the states
State-owned enterprises	Definition of "investor"	Inclusion of state-owned enterprises

Table I. Proposed essential treaty contents

VI. Conclusion

Despite the significant amount of foreign investments in OBOR states and the high risks these investments face, existing legal protection is insufficient at both the domestic and the international level. Compared to negotiating or upgrading bilateral IIAs between different OBOR states, a comprehensive multilateral OBOR treaty can be a more efficient and beneficial solution to the problem. The making of this treaty can be conducted under China's leading role and with the active participation of other OBOR states. The content and the structure of the treaty can be made based on existing international instruments concluded between OBOR states and practice gained during the promotion of the initiative, which can make the treaty more acceptable and easier to be concluded.

As the OBOR initiative aims at promoting sustainable development and common security of the states involved, a balanced approach should be adopted, which can lure more foreign investments while effectively protect the interests of host states. Essential treaty contents relating to the goals of the initiative include standards of investment treatment and their exceptions, as well as a dispute settlement mechanism. Besides better investment treatments, greater details are also necessary. Moreover, considering the leading role played by SOEs, it is important to extend the protection of the treaty to these enterprises.

The construction of a multilateral OBOR investment treaty is no less ambitious and difficult than the initiative itself, as the states involved vary significantly. This may be the reason for China to begin building the legal framework with signing BITs.[105] However, its conclusion will be of great significance to both the development of states involved and the global investment legal regime.

[105] Until 2016, China has signed BITs with 56 OBOR states. MOFCOM, 'China has signed investment agreements with 56 States along the belt and road' (2016) <http://www.mofcom.gov.cn/article/difang/201606/20160601331178.shtml> accessed 31 May 2018.