

Legal risks in financing “One Belt and One Road”: China’s dilemma

*Dongsheng Zang**

SUMMARY	I. Introduction
	II. How to finance OBOR: Changing patterns
	III. Legal risks in capital markets
	IV. Conclusion: China’s dilemma
	V. References

I. INTRODUCTION

In May 2017, the “One Belt One Road” (“OBOR”) international summit in Beijing drew leaders from more than 30 countries, the United Nations, the World Bank, and the International Monetary Fund (Rmrb, 2017a). The *New York Times* editorial in May 2017 commented: “While Mr. Trump pushes an America First agenda of isolationism and protectionism and embroils himself in controversies that raise doubts about his competence, President Xi Jinping of China exudes purpose and confidence as he tries to remake the global economic and political order and lure nations into Beijing’s orbit” (NYT, 2017a).

While its concerns of President Trump’s policy are well justified, the *New York Times* nevertheless expresses a perspective in the United States that is closer to that of an empire looking at its emerging rival with fear and envy, but little sense of history. If OBOR is China’s strategy to build an empire with itself at the center on the one hand, and Eurasia, Africa, Latin America, and Southeast Asia on the other, as the periphery (Tom Miller, 2017), China will face the same problems that past empires had faced. However powerful and ambitious they may be, empires ultimately have to face the constraint of resources they could allocate (Paul

* Associate Professor of Law, University of Washington School of Law, Seattle, Washington, U.S.A. The author wishes to thank Dr. Arturo Oropeza Garcia for his invitation to the book project and editorial guidance. Special thanks to Mr. Cesar Jose Hernandez Bonezzi, a J.D. candidate at UW School of Law, for his research assistance.

Zang

Kennedy, 1988). In other words, empires are inescapably caught in the dilemma where they have to choose between discipline and ambition.

This chapter aims to examine such a dilemma that China is currently locked in, as a consequence of the tension between its global ambition and the financial constraints imposed by market forces. The starting question raised here is a practical one: how does China finance the enormous OBOR projects that will cost trillions of dollars? To answer this question, the chapter first examines changing patterns of financing in OBOR's recent history in Section II. Here I argue that China's policymakers are trying to shift the financing via banks (indirect financing), to financing via capital market (direct financing). This is necessary because Chinese investors in OBOR projects need to (a) control their exposure to financial risks from overdependence on commercial banks, and (b) access to more capital in order to meet their insatiable demand. Legally, this is a significant change because the latter requires China to step out of its comfort zone and increasingly out of its border. If China decides to raise funding for its OBOR projects through capital markets, because it will face different regulatory frameworks that can be translated into legal risks. Such legal risks are the focus of Section III. Here the question becomes: what happens if China uses sovereign wealth funds (SWFs) as the vehicle to raise money in capital markets in world's major financial centers such as Hong Kong, London, New York. For this purpose, this Section will look into the sovereign immunity laws in China, Hong Kong, United Kingdom and the United States, in order to explain their differences and as a consequence, the legal risks for China's SWFs. Section IV summarizes the findings and concludes with a general statement of China's dilemma.

II. HOW TO FINANCE OBOR: CHANGING PATTERNS

The official narrative of OBOR in China is that it all started with President Xi Jinping's speeches in 2013. The first speech was in September 7, 2013, in Astana, Kazakhstan, when President Xi spoke at Nazarbayev University. It was here that President Xi referred to the ancient "silk road" and talked about the "silk-road economic belt" for the new era. The second speech was in Jakarta, Indonesia, on October 3, 2013, when President Xi spoke at the Indonesian Parliament, proposing "the Twentieth-first-Century Maritime Silk Road." In less than two years, in March 2015, the ideas of reviving the "silk road" became a national strategy when the National Development and Reform Commission (NDRC), Ministry of Foreign Affairs, and Ministry of Commerce jointly issued a joint statement titled "Vision and Actions on Jointly Building Silk Road Economic Belt and 21st-Century Maritime Silk Road" (NDRC, 2015).

Legal risks in financing “One Belt and One Road”...

The official narrative, which gives exclusive credit to President Xi Jinping for OBOR, clearly suggests that President Xi himself has invested “great personal capital” in OBOR, as Nadège Rolland has noted (Rolland, 2017: 43). The narrative, however, obscures the policy continuity with his predecessors (Rolland, 2017: Chapter 2). More importantly, the official narrative also obscures a significant change that President Xi brought to OBOR between 2013 and 2015, and the more consequential changes afterwards. One such change is in financing patterns of OBOR projects. As will be shown, many of the projects in OBOR have been started before Xi’s OBOR announcement, but they were financed by Chinese investors and Chinese state-owned banks, which was characterized as “indirect financing” by Chinese policymakers. Between 2013 and 2015, Xi made the first change to this financing pattern by setting up development banks in China and in the international arena. Between 2015 and 2017, there was a clear move by Chinese policymakers that China needed to go further in the direction of direct financing, i.e., financing of OBOR projects via capital market.

A. INDIRECT FINANCING VIA BANKS

It is interesting to note that on the same day he gave the speech in Astana, September 7, 2013, President Xi and Kazakhstan President Nazarbayev attended a ceremony marking the official completion of a natural gas pipeline connecting Kazakhstan and China, known as the South line. This was part of a much bigger Central Asia-China Gas Pipeline that aimed to bring Turkmenistan natural gas to China via Uzbekistan and Kazakhstan. The Pipeline consists of parallel lines. The ceremony that President Xi attended was for line C, the construction of which has been started in September 2012. Lines A and B, each measuring 1,833 km in length, had been completed in December 2009 and October 2010, respectively. A fourth line, Line D, was announced in March 2014, but was cancelled in March 2017. Another project, the Kazakhstan–China Oil Pipeline aimed at bringing crude oil from Kazakhstan’s Atyrau on the Caspian Sea to China. In November 2005, the 962-km Atasu-Alashankou section was completed. Thus, by the time President Xi Jinping delivered the OBOR speech at Nazarbayev University, China’s ambitious plans and strategies to secure energy supply from Kazakhstan as well as the Central Asian area have been laid out and many parts had been completed.

In fact, China turned its attention to Central Asia shortly after the collapse of the Soviet Union in 1991 (Sheives, 2006). Kazakhstan became independent in December 1991, and shortly after, in January 1992, China and Kazakhstan established diplomatic relations. In August 1992, the two countries entered into a bilateral agreement on investment protection. By early 2000s, China also has started construction of a railway line connecting Kashgar with Kyrgyzstan, Uzbekistan, a

Zang

highway line connecting Kashgar with Bishkek, Kyrgyzstan, and Almaty, Kazakhstan (Garver, 2006: 3-5). Construction of the Karakorum Highway, the highway line connecting China and Pakistan was resumed in 2001 (Garver, 2006: 7). A deep-water port at Gwadar, Pakistan, was announced during Premier Zhu Rongji's visit to Pakistan in May 2001 (Garver, 2006: 7-8). John W. Garver, an American specialist who followed China's policy in the Eurasia region made the observation in 2006 that "[w]e are witnessing a quantum leap in China's western oriented transportation infrastructure." (Garver, 2006: 18)

Prior to 2015, financing of the OBOR projects was largely bilateral. Though the Asian Development Bank (ADB), for example, provided funding for some of the highway, railway projects in Kyrgyzstan and Kazakhstan; the World Bank and European Bank for Reconstruction and Development were involved in funding some parts of the ports, railway and roads related to the European Union's Transport Corridor Europe Caucasus Asia projects (Garver, 2006), their role was more exceptional. In most cases China had to come up with funding for the massive projects. Who were the Chinese investors? The State-owned Asset Supervision and Administration Commission ("SASAC")—a government agency acting on behalf of public assets—reported that state-owned enterprises under the central government ("CSOEs") are the major driving force in OBOR projects (Rmrb 2017a). Xiao Yaqing, Commissioner of SASAC, disclosed in May 2017 that since OBOR became official in 2015, 47 CSOEs were involved in 1,676 projects in OBOR countries. In Kazakhstan, for example, it was CSOEs like China National Petroleum Corporation ("CNPC"), CITIC group and China Guangdong Nuclear Power Co. as the main players on the ground (O'Neill, 2014). The *People's Daily* reported in 2017 that in the past twenty years, CNPC has invested US\$42 billion in Kazakhstan (Rmrb 2017c). These CSOEs worked with policy banks such as Export-Import Bank of China (EXIM Bank China), China Development Bank (CDB), as well as sovereign wealth fund such as China Investment Corporation (CIC) (O'Neill, 2014).

B. DEVELOPMENT BANKS & SOVEREIGN FUNDS

In the official narrative, it was during President Xi Jinping's visit to Indonesia in October 2013 when China first proposed the idea that eventually led to the establishment of the Asian Infrastructure Investment Bank (AIIB). One month later, in November 2013, the first consultation conference was held, with China's promise of holding up the principle of "open and inclusive." About one year later, on October 24, 2014, a memorandum was signed in Beijing by twenty-one Asian countries deciding to set up the AIIB. On December 25, 2015, AIIB was officially established. The BRICS bank, the New Development Bank (NDB), was established in July 2015. However, the official narrative does not tell that the notion of de-

Legal risks in financing “One Belt and One Road”...

velopment bank was an important innovation. Shortly before the OBOR policy, China was undergoing “Going West” (*xibu da kaifa*) campaigns between 2000 and 2012, when Chinese government invested heavily in inner-land and Western underdeveloped areas. The State Council found it desirable to have a “long-term, stable and dedicated financing channel” to support the inner-land areas, like European Union’s Cohesion Fund (State Council, 2013). The notion that China needs to set up “development banks” became clearer in October 2015 at the Party’s Fifth Plenum of the 18th National Congress, when the Party prescribed direction for financial reform as to “improve the division of labor between commercial banks, development banks, and policy banks.” (Party, 2015) Between 2013 and 2015, as the country declared its ambitious OBOR strategy, “development bank” was the underlying theme in reforming China’s financial mechanism for the megaprojects—and AIIB and NDB were only a domestic extension of the underlying theme.

As noted earlier, China has been working with development banks Asian Development Bank (ADB) and the World Bank since its 1978 reform and has developed a strong and successful relationship with them. In 2012, ADB noted that China was its second largest sovereign borrower (ADB, 2012); and China continued that position in 2015 (ADB, 2016: 4). From 1986 to the end of 2015, ADB has provided public sector loans to China totaling US\$31.08 billion, and US\$5.68 billion for non-sovereign projects, and US\$460.0 million in grants for technical assistance projects (ADB, 2016: 3). But ADB clearly could not keep the pace of China’s rapidly increased financing needs. As noted earlier, in the last twenty years, CNPC alone has invested US\$42 billion in Kazakhstan (Rmrb, 2017c). In the year 2017 alone, China new investment in 59 OBOR countries US\$14.36 billion (Rmrb 2018). ADB as a general development bank covers a wide range of areas, and infrastructure is only one of them; not to mention that for ADB, infrastructure is broader than transport and pipelines, “social infrastructure,” for example, means schools and health care, etc. Nor did ADB’s essential task fit China’s needs—ADB looks for “transformative and demonstration projects” and serves as a “catalyst” for bringing other funding sources together, not a substitute as a source of substantive funding. AIIB, with an initial capital contribution of US\$100 billion from 57 members (by the end of 2017, 84 members), two-third the size of ADB and half of the World Bank, but it specializes in infrastructure. Financially, it provides an additional source of funding; politically, it is an alternative international financial institution led by China, so it serves China’s political ambitions well (Wang, 2016). It also gives some leverage to China in the Southeast Asian markets in competition with Japan, who leads the ADB.

The notion of development bank is also the underlying theme in domestic reform between 2013 and 2015. China Development Bank (CDB) was first es-

Zang

established in 1994, but its role as a development bank was not clear. In 2007, for example, CDB was instructed to lend on commercial terms, like other commercial banks (Provaggi, 2013). After the 2008 financial crises, it became more necessary for CDB to undertake the role of a development bank. On March 20, 2015, the State Council officially designated the status (State Council, 2015). As part of the change, CDB received capital injection of US\$38 billion from the Chinese Parasol Tree Investment Platform Co., an investment vehicle of Chinese foreign reserve under the State Administration of Foreign Exchange (SAFE)—China’s government agency in charge of foreign reserves (Wang, 2016). On the same day, the State Council also approved the general reform of the Export-Import Bank of China (EXIM Bank China) towards a policy bank (State Council, 2015); and in December 2014, the State Council just designated the Agricultural Development Bank of China (State Council, 2014).

In the mid of redefining the tasks of the three major development banks, new sovereign wealth funds (SWFs) were set up to support OBOR projects. The most prominent among them is perhaps the Silk Road Fund (*silu jijin*),¹ established in December 29, 2014, with US\$40 billion, with investments from the SAFE (65%), China Investment Corporation (15%), CDB (5%), and EXIM Bank China (15%). At its initial stage, the Silk Road Fund was managed by China’s central bank—People’s Bank of China (PBOC); once it becomes fully operational, it will be independent, according to PBOC Governor Zhou Xiaochun (Zhou 2015a). Another powerful SWF was CIC Capital, established in January 2015, which received US\$100 billion capital infusion from China’s Ministry of Finance through a bond issue (China Daily, 2015). CIC is China Investment Corporation, a sovereign wealth fund company set up on September 29, 2007, with the task to control and manage China’s megabanks such as the Industrial and Commercial Bank of China, the Bank of China, and China Construction Bank (Guo, 2010).

Thus, between 2013 and 2015, China has sought to establish multiple sources of financing for its OBOR projects, and this multiple-source strategy is centered on the notion of development bank, both inside China and outside. While NDB and AIIB both serve China’s political ambitions well (Wang, 2016); they may be a welcome addition to financing need, but clearly neither NDB nor AIIB has enough capital to serve as a substitute for financing by commercial means (D. Dollar, 2015). 2015 saw a significant rise of SWFs as a funding source for the OBOR projects. This not only opens more channels for financing, but also signals a gradual shift to the capital markets.

¹ During an interview on February 16, 2015, Zhou Xiaochuan, Governor of People’s Bank of China, denied that Silk Road Fund was a sovereign wealth fund (Zhou 2015a).

C. DIRECT FINANCING VIA CAPITAL MARKETS

In November 2015, one month after the Party’s Fifth Plenum of the 18th National Congress, PBOC Governor Zhou Xiaochuan published an article on the *People’s Daily* (Zhou, 2015). Zhou highlighted the Party’s policy on division of labor between commercial and development banks. He emphasized the need to further reform policy banks, so that they facilitate growth (Zhou, 2015). So far, he was merely repeating what the Party has decided. But as the key official in charge of China’s financial system, he clearly had concerns and worries about financing OBOR projects and the enormous pressure and risks associated with it.

Part of the pressure came from the state-owned commercial banks. In March 2015, OECD (Organization of Economic Cooperation and Development) has warned that Chinese banks’ “rapid credit growth has raised financial stability concerns.” (OECD 2015: 19) IMF (International Monetary Fund) gave a similar warning one year earlier (IMF, 2014). Credit growth was the result of a stimulus policy in response to the global financial crisis, which is translated to increase lending to SOEs and local governments. Thus, as the top regulator of the Chinese financial market, Governor Zhou was caught in between two competing demands: the insatiable appetite for more financing and the increasing vulnerability of the banks. In his article, Governor Zhou made several suggestions: one specific measure was to open financial service market to private firms; the other specific measure was to allow online financial services. However, his more fundamental policy suggestion was to stress the general direction of financial reform—that is to increase use of capital market as the channel to raise capital—what he called direct financing (Zhou, 2015). He argued that a well-developed financial market is based on both direct financing via the capital market and indirect financing via banks (Zhou, 2015).

Governor Zhou again made a similar suggestion at a high-level conference in March 2016 (Zhou, 2016). The idea gradually gained more support. In September 2017, Fan Gang, Peking University professor, and member of the Currency Policy Committee under the PBOC, expressed concerns of OBOR financing needs: infrastructure are long-term projects, they cannot rely on bank loans, but rather on financing through the capital market, which means bonds (Fan, 2017). On October 26, 2017, China’s Ministry of Finance issued sovereign debt bonds worth of US\$2 billion in Hong Kong; and two months later, on December 20, CDB, China’s policy bank, raised US\$350 million for private equity in a five-year fixed-term OBOR fund (Xinhua, 2017).

Zang

III. LEGAL RISKS IN CAPITAL MARKETS

The rise of sovereign wealth funds (SWFs) became a global phenomenon in the last decade, when countries put their cash earned from once-booming commodity prices and trade surplus together and use the SWFs as a vehicle to invest in financial institutions such as Citigroup, UBS and Morgan Stanley (Gordon & Niles, 2012). China became part of this new phenomenon thanks to its sizable foreign exchange reserves as a consequence of the large amount of foreign investment and trade surplus. However, for its OBOR projects, China also needs its SWFs to raise funds in capital markets. If this is the case, what would be legal risks for China's SWFs?

For legal analysis purposes, we will use a hypothetical case and then analyze the laws in mainland China, Hong Kong Special Administrative Region, United Kingdom, and the United States, the laws that govern the financial centers in Hong Kong, London and New York. The following facts of the hypothetical case are derived from a 2016 decision by the United States Court of Appeals for the Second Circuit:²

Defendant is a sovereign wealth fund (the "SWF"), majority shareholder of a bank incorporated under Kazakhstan law ("Kazakh Bank"). In 2010, Kazakh Bank issued debt securities on the Kazakh and Luxembourg Stock Exchanges in connection with restructuring of Kazakh Bank's debt. Plaintiffs include domestic ("Forum Country") investors as well as institutional investors registered in foreign country (Panama). They brought action in domestic court, seeking to hold Defendant liable for alleged misrepresentations under domestic securities law. Though the securities in question were only listed on foreign (Kazakh and Luxembourg) stock exchanges, Plaintiffs alleged that the Defendant marketed the securities extensively in Forum Country. In particular, Plaintiffs alleged and Defendant did not dispute that the Defendant sent representatives to the Forum Country to meet with investors and assured them of the health of the Kazakh Bank's balance sheet in the wake of the 2010 debt restructuring. Defendant argues in court that the court has no subject-matter jurisdiction because as a sovereign wealth fund wholly owned by Kazakh government, it is entitled to sovereign immunity under the Forum Country's Foreign Sovereign Immunity Act. The key question for the court to decide: is Defendant entitled to such immunity?

² *Atlantica Holdings v. Sovereign Wealth Fund*, 813 F.3d 98 (2d Cir. 2016).

Legal risks in financing “One Belt and One Road”...

Around the world, it is recognized that foreign sovereign state is immune from the jurisdiction of domestic courts. In England, since *Blad v. Bamfield* (1674),³ and in the United States, since *Schooner Exchange* (1812),⁴ sovereign immunity has been considered absolute or complete, i.e., no exception was recognized. Gradually, a distinction between *acta jure imperii* (public act), and *acta jure gestionis* (commercial act) was made and different treatment was urged.⁵ Since the 1970s, statutes in the Commonwealth Countries and the United States started to recognize the distinction by adopting a more limited sovereign immunity doctrine known as the “restrictive theory.” The restrictive theory treats a sovereign state just as a private entity when the latter is engaged in commercial transactions. Thus, Kazakh SWF’s exposure to legal risk depends on forum country’s choice absolute or restrictive theory of immunity.

A. CHINA

Since this chapter’s main interest is to explore to legal risks for Chinese SWFs when they try to raise funds in international capital markets, the purpose of the following discussion is to provide some foundation for comparison. An additional reason is that China’s position on foreign sovereign immunity may be a good indicator of its position on sovereign immunity in domestic context, which may be of direct interests for investors inside China.

With some ambiguities to be explained below, it is most likely that the SWF (if it is a foreign SWF) enjoys sovereign immunity in Chinese court because China—the Forum Country—adopts absolute theory of sovereign immunity. That means the SWF faces little exposure to the legal risks, while Chinese investors may have to deal with the legal risks. However, in a competitive capital market, investors have their choice of tools. They may either choose not to buy securities from the SWF, which undermines the SWF’s ability to raise funds; or, they may have enough bargaining power to request a waiver of sovereign immunity by contract—which neutralizes the protection from absolute sovereign immunity.

There is no general statute on sovereign immunity in China as of today. China does have a specific statute, passed on October 25, 2005, “Law on Judicial Immunity from Compulsory Measures Concerning the Property of Foreign Central Banks.” China’s Ministry of Foreign Affairs considers the statute as “China’s first statute on immunity of state assets.” (MFA, 2006) The statute provides absolute immunity to the property of a sovereign nation’s central bank, though central banks

³ *Blad v. Bamfield*, 3 Swans. 604, 36 Eng. Rep. 992 (1674).

⁴ *The Schooner Exchange v. McFaddon*, 7 Cranch 116 (1812).

⁵ *The Charkieh*, [L.R.] 4 A. & E. 59 (1873) (High Court of Admiralty).

Zang

only enjoy restrictive sovereign immunity in Europe and the United States (Zhu, 2007).⁶ On September 14, 2005, about two weeks before the above statute was passed, China signed an international treaty entitled the “United Nations Convention on Jurisdictional Immunities of States and Their Property” (U.N., 2004)⁷ The U.N. Convention is commonly understood as an international treaty that adopts “restrictive theory” of immunity (e.g., Qi, 2008). David P. Stewart of the United States Department of State who participated the negotiations, made the observation that the U.N. Convention shows that restrictive theory “has gained worldwide acceptance.” (Stewart, 2005) Shortly after signing of the UN Convention, the *Legal Daily*, a newspaper owned by the Communist Party’s Central Committee on Law and Political Affairs, published an article praising the UN Convention as a “milestone” and regarded it as an international law in which China has material interests (Fazhi Ribao, 2005). After explaining that the Convention was based on sovereign equality, it reported that the Convention also contained certain restrictions of immunity. As if to comfort its readers, it quickly added that “those restrictions also set limits on continued expansion of restrictions.” For example, the article reasoned, the Convention would recognize and protect a state’s sovereign immunity even if state-owned enterprises of that state are involved in civil suits. The article also explained that signing the Convention was only a “preliminary consent” given by a country; still, ratification would be required for it to take effect. It suggested that “before the Convention is ratified, we need further reviews, so as to make the final decision whether to accept it as binding on us.” The article concluded by a forward-looking statement that signing of the Convention meant that China had had a much “clear” position on the issue now, thus it urged domestic legislation be followed as a priority.

If the *Legal Daily* newspaper article explains China’s concerns of the UN Convention, it nevertheless reflects the general direction at the time. However, more than ten years after the signing of UN Convention, no ratification has happened; nor any legislation on state immunity has been made. The China Society of Private International Law (CSPIL), an association of China’s scholars, judges and practitioners, had suggested state immunity legislation in 2002 at its annual meeting (Liu, 2003). Despite the fact that some of its academic members were in favor of

⁶ *AIG Capital v. Kazakhstan*, [2005] EWHC 2239 (Comm) (High Court, Queen’s Bench); *Trendtex Trading Corporation v. Central Bank of Nigeria*, [1977] 1 QB 529, [1976] 3 All ER 437, [1976] 1 W.L.R. 868 (). In the United States, *Verlinden B.V. v. Central Bank of Nigeria*, 461 U.S. 480 (1983); *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992).

⁷ As of January 31, 2018, there are 35 states that have signed the Convention, 21 of them have ratified it, https://treaties.un.org/Pages/ShowMTDSGDetails.aspx?src=UNTSOnline&tabid=2&mtdsg_no=III-13&chapter=3&lang=en (last retrieved on January 31, 2018).

Legal risks in financing “One Belt and One Road”...

a gradual transition to restrictive theory of immunity and continued writing about the issue, the topic has disappeared from CSPIL’s agenda in its annual meetings from 2006. In fact China is stepping back from its position of 2005 and returning to its absolute theory of immunity. An unofficial hint of this position lies in a draft document titled “Principles of Foreign-related Civil Procedure” proposed by CSPIL in 2015 (He, 2016). The first principle on its list is “sovereignty principle,” which requires that plaintiffs obtain consent in a civil suit against a foreign state, unless statutes or international treaties or conventions that China has entered into provide otherwise. The authors of the proposal explained that they have “taken into consideration of the absolute immunity position adopted by the foreign affairs authorities and the judiciary.”

B. HONG KONG

In the hypothetical case, if the Forum Country is Hong Kong, it is most likely that the SWF enjoys sovereign immunity in court because Hong Kong recently adopted absolute theory of sovereign immunity. The current law of Hong Kong on sovereign immunity is reflected in a decision by the Hong Kong Court of Final Appeal (CFA) in *Congo v. FG Hemisphere* (2011).⁸ By a majority of 3:2, the Court ruled that absolute sovereign immunity applies in Hong Kong, with no exception for commercial transactions. Hong Kong has no general statute on sovereign immunity; the only statute on sovereign immunity is “Law on Judicial Immunity from Compulsory Measures Concerning the Property of Foreign Central Banks,” the Chinese statute passed on October 25, 2005. The NPC Standing Committee, the Chinese lawmaker, has decided to add this statute in Annex III under the Basic Law of the Hong Kong Special Administrative Region.

The CFA majority opinion in *Congo v. FG Hemisphere* (2011) represents a radical departure from the Hong Kong law prior to the 1997 handover from the Great Britain. When Hong Kong was under British rule, there were a body of case law as well as the State Immunity Act of 1978 (“SIA”),⁹ that provided Hong Kong courts clear and solid foundation to adopt a restrictive theory of sovereign immunity. SIA represents a movement towards restrictive theory along with the United States, Australia, the United States (Delaume, 1979). Hong Kong was part of that

⁸ *Democratic Republic of the Congo v. FG Hemisphere*, [2011] 4 HKC 151 (Court of Final Appeal, CFA) (June 8, 2011).

⁹ The State Immunity Act of 1978 (1978 c. 33).

Zang

movement. In 1975, the Privy Council's decision in *Philippine Admiral v. Wallem Shipping (Hong Kong) Ltd.* (1975),¹⁰ was appealed from Hong Kong. In that case, the vessel Philippine Admiral, operated by a private company, was ordered to be sold in order to pay damages to contractors, even though it was later found that the vessel was owned by the government of the Republic of Philippines. The Privy Council held that sovereign immunity cannot be claimed when the vessel was engaged in ordinary commercial transactions. This was followed by the Court of Appeal's decision in *Trendtex* (1976),¹¹ and the House of Lords' decision in *Playa Larga* (1981).¹²

While the CFA majority may agree with the minority view on the history of Hong Kong law,¹³ they were more caught by the question of consistency with China's views.¹⁴ During the adjudication process, the Office of the Commissioner of the Ministry of Foreign Affairs of China sent three letters to the government of Hong Kong: the first letter, dated November 20, 2008, stated as follows:

The consistent and principled position of China is that a state and its property shall, in foreign courts, enjoy absolute immunity, including absolute immunity from jurisdiction and from execution, and has never applied the so-called principle or theory of "restrictive immunity."

The second letter, dated May 21, 2009, stated as follows:

China signed the Convention on 14 September 2005, to express China's support of the above coordination efforts made by the international community. However, until now China has not yet ratified the Convention, and the Convention itself has not yet entered into force. Therefore, the Convention has no binding force on China, and moreover it cannot be the basis of assessing China's principled position on relevant issues.

¹⁰ *Philippine Admiral v. Wallem Shipping (Hong Kong) Ltd.*, [1977] A.C. 3873 (Privy Council, PC), [1976] 1 All E.R. 78; [1976] HKLR 512 (November 1975).

¹¹ *Trendtex Trading Corporation v. Central Bank of Nigeria*, [1977] 1 QB 529, [1976] 3 All ER 437, [1976] 1 W.L.R. 868.

¹² *Playa Larga v. I Congreso del Partido*, [1983] 1 A.C. 244 (House of Lords).

¹³ *Congo v. FG Hemisphere* (2011), *supra* note 8, paras.217-22.

¹⁴ According to the majority, "The fundamental question which falls to be determined in the present appeal is whether, after China's resumption of the exercise of sovereignty on 1st July 1997, it is open to the courts of the HKSAR to adopt a legal doctrine of state immunity which recognizes a commercial exception to absolute immunity and therefore a doctrine on state immunity which is different from the principled policy practiced by the PRC." *Congo v. FG Hemisphere* (2011), *supra* note 8, para. 225.

Legal risks in financing “One Belt and One Road”...

The CFA majority decided to adopt the “one voice principle,”¹⁵ and decided to refer the question to China’s National People’s Congress (NPC) Standing Committee.¹⁶ On August 26, 2011, China’s NPC Standing Committee issued its interpretation.

At the time, the decision was questioned in the mid of concerns of Hong Kong’s autonomy, particularly its judicial independence being encroached (Chan, 2012). After the “One Belt One Road” policy declared in 2013, the Hong Kong Bar Association started portraying itself as an ideal partner in China’s ambitious plans. Hong Kong’s common law tradition makes it an ideal choice of site for international commercial disputes; second, Hong Kong as an international financial center. However, *Congo v. FG Hemisphere* (2011) deprives investors of their civil remedy in court.

C. LONDON

In the hypothetical case, if the Forum Country is United Kingdom, it is most likely that the SWF is not entitled to sovereign immunity in court because UK embraces restrictive theory of sovereign immunity. The State Immunity Act of 1978 (“SIA”) codified the legal doctrines established by cases such as *Philippine Admiral* (1975), along with the European Convention on State Immunity (1972), the United States (1976), Singapore (1979), Canada (1982), Australia (1985), South Africa (1981), and Pakistan (1981).¹⁷ Writing in 1989, Georges R. Delaume noted that these countries include those in which most transnational loans are made and are to be repaid, the developments “appear encouraging” to international lenders (Delaume, 1989).

In the early history of English doctrine of restrictive sovereign immunity, London as the world’s financial center in its background. In *Gladstone v. Musurus Bey* (1862) and *Gladstone v. Ottoman Bank* (1863) by the Court of Chancery.¹⁸ In 1858, plaintiffs submitted proposals to the Turkish Government to form a business to be called Bank of Turkey, which would be granted the exclusive privilege of issuing bank notes to be a legal tender at Constantinople. The Sultan gave his assent, a firman (royal mandate in the Ottoman Empire) was delivered, granting Plaintiffs the privilege of forming the bank. The firman also stipulated that

¹⁵ *Congo v. FG Hemisphere* (2011), *supra* note 8, para. 269.

¹⁶ *Congo v. FG Hemisphere* (2011), *supra* note 8, para. 407.

¹⁷ Pakistan Supreme Court decision in *Qureshi v. Union of Soviet Socialist Republics* (July 8, 1981), reproduced in 20 *International Legal Materials* 1060 (Sep. 1981, No.5).

¹⁸ *Gladstone v. Musurus Bey*, 1 H. & M. 495, 71 Eng. Rep. 216 (1862); *Gladstone v. Ottoman Bank*, 1 H. & M. 505, 71 Eng. Rep. 221 (1863).

Zang

Plaintiffs pay as security for performance of the contract £20,000 to the Turkish Ambassador in London to be deposited in Bank of England. Plaintiffs deposited £20,000 in Ottoman bonds in Bank of England, and proceeded to form the bank. However, the contract was halted when the Sultan refused to withdraw the existing paper money, Plaintiffs declined to commence banking business. They filed two lawsuits. The first was filed against the Turkish Ambassador in London when he threatened to withdraw the deposited bonds on the ground of breach of contract. The Court of Chancery recognized the general principle of sovereign immunity: "If the bonds were the absolute unqualified property of the Sultan—that is to say, of the Turkish Government—there might be some difficulty in attempting to enforce any claim against the Sultan by attaching this fund".¹⁹ The Court, however, found the condition is not met because "this property in the eye of the Court is not the property of the Sultan, that it is a fund *in medio*, which is in one contingent event to become the Sultan's property, and in another contingency to become the Plaintiffs'..."²⁰ For this reason, the Court issued an interim injunction to the third party—the Bank of England—to restrain it from delivering the bonds to any person pending further hearings of the case.

Gladstone's second suit was against the Turkish Government and another bank, the Ottoman Bank, when Plaintiffs learned that the latter concerted a scheme for replacing the Bank of Turkey. The Court of Chancery dismissed the suit: "The right of ascertaining what shall be the current coin of the kingdom is vested in the sovereign of the country, but that right, like every other right which he holds *qua* sovereign, is presumed to be exercised for the benefit of the community upon public grounds. This is nota contract for the private benefit of the sovereign, of which this Court might take cognizance, but simply a grant of the sole right of issuing notes as part of the current coin of his realm, made by the Sultan in his public capacity as the sovereign of the country".²¹

The *Gladstone* cases demonstrate that Victorian English courts tried to balance its competing interests as a financial center of the world. Based in part on the *Gladstone* cases, in 1871, Sir Robert Phillimore summarized the jurisprudence of sovereign immunity of the time this way: "[w]hen the ambassador becomes a trader or a merchant in the country to which he is sent, the property embarked by him, or accruing to him, in this capacity, is liable to seizure and condemnation, at the instance of creditors, in the same manner as the property of any other trader or merchant" (Phillimore, 1871: §181). Ten years after the *Gladstone* cases, Sir

¹⁹ *Gladstone v. Musurus Bey*, 1 H. & M. 495, 500; 71 Eng. Rep. 216, 219 (1862).

²⁰ *Gladstone v. Musurus Bey*, 1 H. & M. 495, 500; 71 Eng. Rep. 216, 219 (1862).

²¹ *Gladstone v. Ottoman Bank*, 1 H. & M. 505, 511; 71 Eng. Rep. 221, 223-24 (1863).

Legal risks in financing “One Belt and One Road”...

Robert Phillimore was the judge in *The Charkieh* (1873) case,²² which was an even clearer and bolder statement of the restrictive theory. Soon the English courts reversed the direction, in *The Parlement Belge* (1880),²³ *The Porto Alexandre* (1919),²⁴ and *The Cristina* (1938),²⁵ where an absolute theory of immunity was adopted. English courts had to wait for the Privy Council’s decision in *Philippine Admiral* (1975), discussed earlier, to re-introduce restrictive doctrine of sovereign immunity to UK. Today there is not ambiguity that the United Kingdom adopts restrictive theory.

The question that the Hong Kong CFA struggled with in *Congo v. FG Hemisphere* (2011) would be answered differently in Great Britain. The case by the U.K. Court of Appeal in *Svenska v. Lithuania* (2006).²⁶ Lithuania government entered into an agreement with Svenska Petroleum Exploration AB, a Swedish company in the business of oil exploration and extraction, where Lithuania explicitly waived its sovereign immunity. When a dispute arose, Svenska obtained an arbitral award in Denmark and then sought enforcement of the arbitral award in Great Britain. The Court of Appeal, referring to SIA Article 9(1),²⁷ affirmed the lower court’s decision that Lithuania cannot claim immunity.²⁸ Similarly, in *NML Capital v. Argentina* (2011),²⁹ the Supreme Court ruled in favor of enforcing a summary judgement from a federal court in the United States, regarding Argentina. Lord, “Whether a state is immune from such a claim should, under the restrictive doctrine of state immunity, depend upon the nature of the underlying transaction that has given rise to the claim, not upon the nature of the process by which the claimant is seeking to enforce the claim”.³⁰

The fact pattern in *NML Capital v. Argentina* (2011) contains some similar elements in the hypothetical case stated earlier.³¹ Argentina as a sovereign state

²² *The Charkieh*, L.R. 4 Admiralty and Ecclesiastical Courts 59 (1873).

²³ *The Parlement Belge*, L.R. 5 Probate Division 197 (1880).

²⁴ *The Porto Alexandre*, [1920] P. 30; 14 Am. J. Int’l L. 273 (1920) (Court of Appeal).

²⁵ *The Cristina*, [1938] AC 485; 32 Am. J. Int’l L. 824 (1938) (House of Lords).

²⁶ *Svenska Petroleum Exploration AB v. Lithuania*, [2006] EWCA Civ 1529; [2007] Q.B. 886; [2007] 1 All ER (Comm) 909; [2007] 2 W.L.R. 876 (November 13, 2006).

²⁷ Section 9(1) of the State Immunity Act 1978 provides as follows:

“Where a State has agreed in writing to submit a dispute which has arisen, or may arise, to arbitration, the State is not immune as respects proceedings in the courts of the United Kingdom which relate to the arbitration.”

²⁸ *Svenska v. Lithuania* (2006), *supra* note 26, para.123.

²⁹ *NML Capital Ltd. v. Argentina*, [2011] UKSC 31 (July 6, 2011).

³⁰ *NML Capital Ltd. v. Argentina* (2011), *id.*, para.26.

³¹ *NML Capital Ltd. v. Argentina* (2011), *id.*; more facts are stated by the Court of Appeal in *Republic of Argentina v. NML Capital Ltd.*, [2010] EWCA Civ 41, [2010] 3 WLR 874, [2010] 2 All ER (Comm) 1206, [2011] Q.B. 8 (February 4, 2010).

Zang

issued bonds to raise money to finance government expenditure. Its agreement with Bankers Trust Co. contained an immunity waiver clause, and its choice of law was New York law. When Argentina defaulted in 2003, it was found liable for damages by the federal court in New York.

D. NEW YORK

In the hypothetical case, if the Forum Country is the United States, it is most likely that the SWF is not entitled to sovereign immunity in court because America embraces restrictive theory of sovereign immunity, through the Foreign Sovereign Immunity Act.³² In U.S. law, the issue in *NML Capital v. Argentina* (2011) is not new. In *Argentina v. Weltover* (1992),³³ the United States Supreme Court ruled in a similar case that arose from Argentina's default in 1986 on its obligations under bonds known as "Bonods," when Argentina's central bank unilaterally extended the time for payment bondholders.

The question for the Court was whether Argentina's default as part of the plan to stabilize its currency was an act taken "in connection with a commercial activity" that had a "direct effect in the United States" under Section 1605(a)(2) of the Foreign Sovereign Immunity Act (FSIA) of 1976.³⁴ The Court translated the "direct-effect clause" in Section 1605(a)(2) into three elements:³⁵ (1) "based upon an act outside the territory of the United States;" (2) that was taken "in connection with a commercial activity" of [the foreign state] outside this country; and (3) that "cause[d] a direct effect in the United States." Since there was no dispute that the default occurred outside the United States, the second element became the key: how to distinguish a state exercising its sovereign power or acting as a private party in commercial transaction. The Court concluded, "... when a foreign government acts, not as regulator of a market, but in the manner of a private player within it, the

³² The making of FSIA is thoroughly discussed in *Verlinden B.V. v. Central Bank of Nigeria*, 461 U.S. 480 (1983).

³³ *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607 (1992).

³⁴ 28 U.S.C. 1605(a) provides:

- (a) A foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case--
- (2) in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States . . .

³⁵ *Argentina v. Weltover*, 504 U.S. 607, 611.

Legal risks in financing “One Belt and One Road”...

foreign sovereign’s actions are ‘commercial’ within the meaning of the FSIA³⁶ The Court highlighted that Section 1603(d) provides that the commercial character of an act is to be determined by its “nature” rather than its “purpose”,³⁷ thus, the Court stated, “. . . the question is not whether the foreign government is acting with a profit motive or instead with the aim of fulfilling uniquely sovereign objectives”.³⁸ Again, “. . . it is irrelevant *why* Argentina participated in the bond market in the manner of a private actor; it matters only that it did so”.³⁹

The three prongs in *Weltover* provide the framework for the Second Circuit’s decision in *Atlantica v. Sovereign Wealth Fund* (2016).⁴⁰ The SWF in the case, Sovereign Wealth Fund Samruk–Kazyna JSC (“SK Fund”), was wholly owned by the government of the Republic of Kazakhstan. SK Fund issued bonds on the stock exchanges in both Kazakhstan and Luxembourg, not on any stock exchange in the United States. Some of the Plaintiffs are U.S. citizens who purchased the bonds on the secondary markets, basing their claims on the Securities Exchange Act of 1934.⁴¹ The key part of *Atlantica* is the third prong, i.e., “direct effect” in the United States. Applying *Weltover*, “we have no difficulty concluding that Plaintiffs’ loss ‘follow[ed] as an immediate consequence’ of SK Fund’s alleged misrepresentations concerning securities that were marketed in the United States and directed toward United States persons”.⁴² Therefore, the Second Circuit came to the conclusion that the sovereign wealth fund cannot claim immunity in the U.S. federal court.

³⁶ *Argentina v. Weltover*, 504 U.S. 607, 614.

³⁷ 28 U.S.C. 1603(d) provides:

(d) A “commercial activity” means either a regular course of commercial conduct or a particular commercial transaction or act. The commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose.

³⁸ *Argentina v. Weltover*, 504 U.S. 607, 614.

³⁹ *Argentina v. Weltover*, 504 U.S. 607, 617 (emphasis original).

⁴⁰ *Atlantica Holdings v. Sovereign Wealth Fund*, 813 F.3d 98 (2d Cir. 2016).

⁴¹ Securities Exchange Act of 1934, 15 U.S.C. §§ 78j, 78u. The Supreme Court has ruled in *Morrison v. National Australian Bank Ltd.* (2010) that “. . . in our view only transactions in securities listed on domestic exchanges, and domestic transactions in other securities, to which § 10(b) [of the Exchange Act] applies.” *Morrison v. National Australian Bank Ltd.*, 561 U.S. 247, 130 S.Ct. 2869, 2884, 177 L.E.2d 535 (2010). For application and interpretation of the *Morrison* doctrine in the Second Circuit, see, *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60 (2nd Cir. 2012); *In re Petrobras Securities*, 862 F.3d 250 (2nd Cir. 2017). The trial court in *Atlantica* ruled that *Morrison* doctrine does not bar the claims, *Atlantica Holdings v. Sovereign Wealth Fund*, 2 F.Supp.3d 550, 559-61 (S.D.N.Y. 2014). The Second Circuit denied leave to appeal the *Morrison* issue, 813 F.3d 98, 106 (2d Cir. 2016).

⁴² 813 F.3d 98, 110-11.

Zang

The *Alantica* decision sends a strong signal that even if bonds are not issued on U.S. stock exchange directly, the SWF would still not be able to claim immunity in U.S. courts if “direct effect” test is satisfied. One can imagine this could easily be applied in a scenario that resemble the *Alantica* factual pattern: a Chinese SWF issues bonds on the Hong Kong Stock Exchange, for OBOR projects in Kazakhstan, targeting primarily Hong Kong investors. If the court finds “direct effect,” the Chinese SWF cannot claim immunity in the U.S. court. One additional point in *Alantica* decision is that two of the key plaintiffs, Alantica and Baltica, are foreign (Panamanian) investment funds. The Second Court: “the FSIA requires only that SK Fund’s alleged misrepresentations had a direct effect *in* the United States. In other words, had all of the Plaintiffs been foreigners, they could have successfully premised FSIA jurisdiction on the effect that SK Fund’s alleged misrepresentations had on non-party United States investors, provided that Plaintiffs could adequately establish the existence of United States investors so affected”.⁴³

IV. CONCLUSION: CHINA’S DILEMMA

From the analysis, it is clear that if the SWF is a Chinese entity, it enjoys sovereign immunity in Hong Kong, but not in London or New York. Continental European financial centers such as Zurich or Frankfurt are governed by laws similar to that in UK and the United States. In 2015, even the Russian Federation adopted restrictive theory of sovereign immunity in its new law, “Law on the Jurisdictional Immunity of Foreign States and the Property of Foreign States” (November 3, 2015, No.297-FZ).

If the analysis in this essay is correct, China faces an inescapable dilemma in its OBOR strategy. Such dilemma can be understood from different dimensions. The first dimension is the dilemma in the financial markets. Even if it has enough of its own capital for the OBOR investments, China cannot afford to do it alone because it would be exposed to all the risks that may undermine its own financial stability and liquidity. If China does not have enough of its own capital, thus it has to raise funds in financial centers outside China (and Hong Kong), they will have to face the sovereign immunity laws in all other major financial centers in the United States and Continental Europe that are based on restrictive theory. China has to choose either to stay within its own border, thus to give up financial resources outside, or to choose to accept the disciplines of the financial markets in Europe and America. It is a very difficult choice. Second, related to the constraints in the financial markets, China also has to face the tension between its financial interests and its

⁴³ 813 F.3d 98, 111 (emphasis original).

Legal risks in financing “One Belt and One Road”...

political interests—in particular, its own political commitment to OBOR countries. Not only that OBOR strategy is based on the choice of higher risk countries, but also on the promise that China does not seek to interfere with domestic affairs in hosting countries, that China’s investment has no strings attached. However, if China does not bring more institutional change inside its own market as well as those of OBOR countries, it has no other choice but to live with the legal and financial risks associated with that commitment.

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