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Sovereign Wealth Funds: The *Good Guy* Investment Actors?

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ABSTRACT

Sovereign wealth funds (SWFs) have been portrayed in some quarters as potential bad guys in global financial markets due to their supposed political as opposed to commercial intentions and influence. However, two key international developments during and since the 2008/2009 Global Financial Crisis have prompted some abatement in the hostility and mistrust displayed towards SWFs. First, SWFs provide substantial and growing sources of much-needed liquidity in global capital markets. Secondly, the Generally Agreed Principles and Practices – GAPP (The Santiago Principles) were created in 2008, which are a multilateral initiative to directly address governance issues associated with SWFs. Thus, SWFs have become a more accepted element of global financial markets and more is now known about how they operate and where their investment priorities tend to lie. However, there is still much to learn about the important roles that SWFs are likely to play in global markets, particularly how they may contribute to the public good. Accordingly, this article considers the good guy potential of SWFs by elucidating how SWFs may not only be a facilitative economic mechanism but also an important tool for societal benefit. In so doing, this article focuses on the role that they might play in domestic investment in order to stimulate the growth of social capital and nation building in their home country, as well as progress made by SWFs themselves to improving their standards and processes of governance.

1. INTRODUCTION

Sovereign wealth funds (SWFs) are increasing in number, scale and effects on the world's capital markets. In the past there has been a degree of political tension in some countries that are recipients of investment capital from SWFs about their governance arrangements and the intentions of the foreign governments controlling them. Thus SWFs were portrayed in some quarters as potential *bad guys* in global financial markets due to their supposed political (not commercial) intentions and influence. The 2008/2009 Global Financial Crisis (GFC) and its repercussions prompted some abatement in the hostility and mistrust, given that the sector provided substantial and much-needed liquidity in global capital markets. Allied with these developments, the establishment in 2008 of the Generally Agreed Principles and Practices – GAPP (The Santiago Principles), which are overseen by the International Forum of Sovereign Wealth Funds, has soothed some of the international concerns about the governance of these funds. Thus SWFs have become a more accepted element of global financial markets and more is now known about how they operate and where their investment priorities tend to lie. However, there is still much to learn about the important roles that sovereign wealth funds are likely to play in global markets.

The purpose of this article is to consider the *good guy* potential of SWFs. The first part discusses the increasing investment influence of SWFs in the global economy while noting concomitant challenges in measuring their impact. The article then focuses on the role that SWFs might play in stimulating the growth of domestic social capital and nation building, and the progress that SWFs have made at the multilateral level to achieve improved standards and processes of governance. Finally, we conclude by considering implications for the likely increasing synergy between national economic well-being and the health and vitality of international finance. This in turn, highlights the potential importance of SWFs as a smoothing intervening variable in macro-economic stability and global inter-dependence.

2. THE RISE AND RISE OF SWFs

It may only be in recent times that SWFs as a grouping have attracted a prominent public profile as a major global financial actor,¹ but they have been in existence for many decades. For example, as long ago as 1953 the Kuwait Investment Office (KIO) was established in London to be an asset manager for Kuwait's Foreign Ministry. However, the label SWF itself seems to have been introduced by Andrew Rozanov only in 2005 despite the fact that in the intervening five decades since the KIO many organisations that might be termed SWFs had been established.² Some SWFs are legal entities such as the Abu Dhabi Investment Authority (ADIA), others are corporations like the Investment Corporation of Dubai (ICD), some are joint-stock companies such as Kazakhstan's Samruk-Kazyna or public limited companies such as Malaysia's Khazanah, and others are not legal persons such as Norway's Government Pension Fund Global (GPF). Indeed, it is difficult to categorise SWFs in a uniform way.³ Categorisation of SWFs might be based on their organisational structures, capital ownership, objectives, funding sources, capacity for independent investment activity, asset portfolio composition or any mix of these. A comprehensive definition remains elusive, largely due to attendant difficulties of data access, discussed in detail below.

Categorising a SWF is further problematic because numerous types of actor have been collapsed into popular understandings of the term. They might be seen as a 'separate pool of government-owned or government-controlled financial assets' or a 'government investment vehicle' funded by foreign exchange assets.⁴ Their investment targets include the acquisition of listed foreign companies that are 'operating in sectors considered strategic by their countries of incorporation';⁵ and their investment objectives may range from insulating the home economy from the effects of commodity (usually oil) price swings, to amassing savings funds for future generations or contingent pension reserve funds for an aging population.⁶

Since creation of the Santiago Principles in 2008, the definition of a SWF has been somewhat settled although investment objectives remain malleable. During 2008 an initial 25 SWFs from a

¹ For example, in February 2014 Price Waterhouse Cooper (pwc) estimated that globally SWFs held US\$5.2 trillion in assets under management and projected that total to rise to US\$8.9 trillion by the end of 2020. See pwc, *Asset Management 2020: A Brave New World*, 12 (2014) (available at <http://www.pwc.com/us/am2020>)

² Andrew Rozanov, *Who Holds the Wealth of Nations?* XV Central Banking Journal 52 (2005).

³ George Gilligan and Megan Bowman, *State Capital: Global and Australian Perspectives*, 37 Seattle U. L. R. 597 (2014).

⁴ Press Room, US Department of Treasury, hp-471, *Remarks by Acting UnderSecretary for International Affairs Clay Lowery on Sovereign Wealth Funds and the International Financial System* (June 21, 2007) (available at <http://www.ustreas.gov/press/releases/hp471.htm>). See also Commission of the European Communities, *Communication from the Commission to The European Parliament, The Council, The European Economic and Social Committee and The Committee of the Regions*, Brussels, xxx, COM(2008) 115 provisional, 3 (2008) (available at http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf)

⁵ Fabio Bassan, *The Law of Sovereign Wealth Funds*, 32 (Edward Elgar 2011),

⁶ International Monetary Fund, *Sovereign Wealth Funds – A Work Agenda*, 5 (2008) (available at <http://www.imf.org/external/np/pp/eng/2008/022908.pdf>)

range of jurisdictions formed the International Working Group on Sovereign Wealth Funds (IWGSWF). The IWGSWF provided its own definition of SWFs as part of their Generally Accepted Principles and Practices (GAPP):

SWFs are defined as special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets.⁷

So a shorthand working definition of SWFs is that they are state-controlled investment funds comprised of financial assets that fulfil macroeconomic objectives.

Jurisdictions have been motivated to establish SWFs by a range of factors including: diversification away from non-renewable commodities (most commonly oil and/or gas); investing currently unneeded liquidity (most commonly away from US dollars or gold); increasing the return on national savings; implementing domestic economic development objectives; and enhancing the value and capability of national assets.⁸ Whether motivated by commodity price booms (e.g. Abu Dhabi) or trade generated fiscal surpluses (e.g. China), a key factor common has been the need by governments to manage cyclical trends: global trade imbalances lead to savings gluts and SWFs are a useful mechanism to help manage these gluts. Despite the uncertainty permeating the discussion of how SWFs might be defined and classified, there is little doubt that as a grouping they have become an influential investment force in global capital markets. In February 2014 the Sovereign Wealth Funds Institute (SWFI) ranked the seventy four largest SWFs by assets under management, estimating their total combined holdings at US\$6,282.8 billion, with oil and gas-related SWFs managing US\$ 3,784.4 billion (approximately 59 per cent). Yet the jurisdictions that operate SWFs are politically and economically diverse. Nearly half of the estimated geographical distribution of total SWF funds (in terms of controlling interests) resides in Asia (40 per cent). Indeed, the economic rise of China in the global economy is reflected in the increasing size and complexity of its SWFs, and it now has four of the world's eleven biggest funds on size of assets held.⁹ The second largest SWF ownership jurisdiction is the Middle East (35 per cent) and Europe is the third largest (17 per cent). The remaining geographic ownership is spread evenly between Africa, Americas and the rest of the world.¹⁰

Of particular relevance to this article is the fact that SWFs are acknowledged as increasingly valuable sources of liquidity in capital markets that have been drained of liquidity in recent years post-GFC, which has helped to augment their 'good guy' image. The longer term investment horizons of SWFs in comparison to many investment actors make them more likely than most investors to absorb short-term pain in order to secure longer-term gain. For example, in November 2007 ADIA invested US\$7.5 billion for a 4.9 per cent share of Citigroup which allowed the latter to immediately make US\$6.8 billion in sub-prime write offs and thus ward off potential bankruptcy. In February 2008, the SWFI estimated that ADIA had a minus 49.2 per cent return in only three months on its US\$700 million investment in Advanced Micro Devices;

⁷ International Working Group of Sovereign Wealth Funds, *Generally Accepted Principles and Practices (GAPP) – The Santiago Principles*, 3 (2008) (available at <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf>). In 2009 the IWGSWF became the International Forum of Sovereign Wealth Funds (IFSWF). See <http://www.ifswf.org/>

⁸ Bruce W. Bean, *Attack of the Sovereign Wealth Funds: Defending the Republic from the Threat of Sovereign Wealth Funds?* (MSU Legal Studies Research Paper No. 08 -01, 2010) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1537323##)

⁹ See Sovereign Wealth Fund Institute, *Global Rankings* (available at <http://www.swfinstitute.org/fund-rankings/>).

¹⁰ Sovereign Wealth Fund Institute, *Sovereign Wealth Fund Rankings February 2014* (2014) (available at <http://www.swfinstitute.org/fund-rankings/>)

and China's CIC suffered a minus 52.1 per cent return in eight months on its US\$3 billion investment in The Blackstone Group and a minus 15 per cent return in only two months on its US\$5 billion investment into the global investment bank Morgan Stanley.¹¹ As American and Asian financial markets have rebounded from the GFC, those investments have taken on a more healthy character.

The longer-term investment horizon of SWFs in comparison to most institutional investors has also contributed to them retaining many of their investments in the finance sector despite the widespread damage to portfolio values by the GFC. Data issued by the SWFI compare direct SWF investments by sector from 2007 to 2013 and demonstrate the sticky nature of the SWF/Finance Sector investment relationship. Financials topped the list of SWF investment targets at US\$206 billion, which is well clear of international real estate in second place with US\$83 billion and the energy sector at US\$70 billion.¹² SWFs also retain a strong investment relationship with international equity markets. For example, the largest SWF in the world is Norway's GPF: it is run by Norges Bank Investment Fund (NBIM) and was valued at approximately US\$840 billion in 2013. Of that total, 61.7 percent was held in equities, 37.3 percent in fixed income and 1 percent in real estate.¹³ GPMG's 61.7 percent equity holding is approximately 1 per cent of the world's listed equities, so it is very much a player on global financial markets.

SWFs are an example of a space where the dual roles of the state as both an investment actor and regulatory actor may become entwined. As such, SWFs may not only be a facilitative economic mechanism but also an important tool for societal benefit. Specifically, SWFs may help to utilise state capital investments to generate social capital, which the World Bank defines as not just the institutions that underpin a society but the glue that holds it together.¹⁴ In this way SWFs can make positive contributions to the public good, as discussed in the next section.

3. THE PUBLIC GOOD POTENTIAL OF SWFs

Before discussing what public good might be produced by the investment activities of SWFs, it is instructive to consider how the concept of 'public good' is framed. Over the years, debates about what constitutes the public good have occurred through a variety of theoretical lenses and from a range of disciplinary perspectives.

For example, from a political economy perspective the public good might be described as the issue of collectives telling individuals 'what is good for them' and labelling this 'the public interest'¹⁵ This 'alchemy of social construction of the public good' emerges in different forms in different societies as a component of the political economy.¹⁶ Conversely, from an economics theory perspective, Samuelson has described a public good as being a good which can be consumed by an individual which does not subtract from how another individual might consume

¹¹ Sovereign Wealth Funds Institute, *Do SWFs Make Smart Equity Purchases?* (February 19, 2008) (available at <http://www.swfinstitute.org/swf-research/do-swfs-make-smart-equity-purchases/>)

¹² Sovereign Wealth Funds Institute, *If Size Matters, Financial Sector Most Attractive for SWFs Between 2007 and 2013* (April 16, 2014) (available at <http://www.swfinstitute.org/swf-article/sovereign-wealth-funds-attractive/>)

¹³ Norges Bank, *A Good Year for the Fund*, Press Release (28 February 28, 2014) (available at <http://www.norges-bank.no/en/about/published/press-releases/2014/press-release-28-february-2014-nbim/>)

¹⁴ The World Bank, *Social Capital* (available at

<http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTSOCIALDEVELOPMENT/EXTSOCIALCAPITAL/0,,contentMDK:20185164~menuPK:418217~pagePK:148956~piPK:216618~theSitePK:401015,00.html>)

¹⁵ Geoffrey R. Underhill, *The Public Good Versus Private Interests in the Global Monetary and Financial System*, 2 Intl. and Comparative Corp. L.J. 335 (2000).

¹⁶ *Id.* at 336.

that good.¹⁷ Public goods are considered to have two core aspects: *nonexcludability*, meaning that it is difficult to exclude people from consuming a public good; and *nonrivalrous consumption* when a person can consume a good without increasing its cost or reducing someone else's consumption of it. Thus examples of public goods might include access to clean air and being able to benefit from lighthouses when out at sea.¹⁸

However, in discussing the concept of the public good as it relates to SWFs, we wish to emphasise notions of public investment and good governance.

A. Public good and private investment

Turning first to the issue of SWFs and public investment, there are different ways of evaluating the effects of SWFs including: impact on recipient countries; impacts on different types of investors; impacts on national policy issues; impacts psychologically on investors and policy makers. Nevertheless it is important to remember that SWFs are long-term investors that can be a true provider of liquidity in times of crisis and have large holding power.¹⁹ The often longer term investment horizons and a lower need to react to market volatility for SWFs in comparison to most other investment actors offer the potential to contribute to nation-building at home and abroad. For example, SWFs can be a source of the investment capital required for local and national infrastructure projects which contribute to the production of social capital. Truman notes that it is a feature of many SWFs that they already have significant domestic investments as part of their investment portfolios.²⁰

Some of the public good and social capital pathways to which SWFs might contribute include: how to achieve better alignment of investment resources to notions of inter-generational equity; how SWF activities might be aligned with the national budget; looking at the need for increasingly sophisticated custodianship relationships and the corporate governance role played by SWFs. For example what criteria should SWFs give to fund managers regarding voting policies, environmental risks or governance systems? In this context another potential public good pathway for SWFs is to integrate into their investment decision-making the concept of social licence. For example, large plants (funded through SWF investment) could buy local products so that there is mutual benefit for local communities and also the foreign investors. This is especially important in less developed economies.

Assuming that they are successful in their macroeconomic investment strategies, all SWFs are likely to make broad contributions to the public good by growing their assets under management and thus generating wealth for their citizens. What is more difficult to discern is how many, and to what extent, individual SWFs are committed to developing their domestic infrastructures and directly stimulating their domestic economies. Gelb et al. explore World Bank data to identify the significance of domestic investment mandates in directing the activities of SWFs in different countries. They found that a number of jurisdictions have written domestic development into SWF mandates including: Abu Dhabi; Angola; Australia; Bahrain; France; Kazakhstan; Malaysia; Nigeria; Palestine; Russia; South Africa; Taiwan; and the United Arab Emirates (UAE). However, what differentiates the various jurisdictions on this issue of social capital building is

¹⁷ Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 *Rev. Econ. & Statistics*, 387 (1954).

¹⁸ See e.g., Ronald H. Coase, *The Lighthouse in Economics*, 17 *J. of L. & Econ.* 357 (1974)

¹⁹ See e.g., Katharina Pistor, *Sovereign Wealth Funds and Global Finance*, in K.P. Sauvart, L.E. Sachs and W.P.P. Schmit Jongbloed (eds), *Sovereign Investment, Concerns and Policy Reactions* 145 (Oxford U. Press 2012).

²⁰ Edwin M. Truman, *Sovereign Wealth Funds: Is Asia Different?* (Working Paper 11-12, Petersen Institute for International Economics, Washington: D.C., 2011) (available at <http://www.piie.com/publications/interstitial.cfm?ResearchID=1856>).

the degree of mandated domestic obligation to which individual SWFs must adhere. For example: the mandate for France's Strategic Investment Fund (SIF) is to 'make strategic investments in French firms to prevent them from being bought at discounted prices by foreign investors through participation and investment in innovative enterprises with a long-term investment horizon'; Kazakhstan's Samruk-Kazyna (SK) fund is mandated to 'support regional development and implementation of social projects'; Malaysia's Kazanah fund must 'nurture the development of selected strategic industries in Malaysia with the aim of pursuing the nation's long-term economic interests'; and Nigeria's Nigeria Infrastructure Fund (NIG) must 'invest in projects that contribute to the development of essential infrastructure in Nigeria'.²¹

There are clear national development and social capital generation goals evident in these mandates. From the perspective of nation-building, it is justifiable to capitalise on public goods such as oil and gas resources in order to nurture domestic industry and infrastructure by using surplus revenues from commodity trading (e.g. Nigeria's NIG and Kazakhstan's SK). The reason is that it can be seen as a wealth transfer of a commonly held public good such as oil or gas reserves into another commonly held public good such as public infrastructure. However, the mandate on France's SIF to protect French firms from foreign investment at supposedly discounted prices hints at protectionist sentiment and difficulties of measurement. For example, what matrix should be applied to evaluate when a French firm's share price is discounted, especially given the vagaries of currency fluctuations in currency markets?

Nonetheless, there are risks associated with mandatory requirements imposed upon different national SWFs to invest domestically. For example, there is the possibility of reduced market discipline on public spending projects, weaker regulatory oversight, and diminished scrutiny from parliament and other budgetary checks and balances. Similarly, there is the risk that investment resources of a SWF will be diverted away from the profit-maximisation rationale of traditional funds management to lower economic return activities such as building roads, hospitals or energy transmission infrastructure (even though such initiatives have high social returns). The counter argument is that less of the capital required to fund such initiatives would have to come from taxation revenues or foreign loans, and also that public good and social capital may be generated by such transfer. However, measuring and classifying the positive benefits of the latter is an enormous challenge. There may also be challenges in aligning SWF private investment with broader macro-economic policy settings and national budgetary management.

Similarly, if valuable SWF investment capital is diverted into domestic social capital generation it may be vulnerable to corrupt actors in both the public and private spheres, especially in jurisdictions where for example the rule of law, transparency, governmental and business accountability, political stability and an independent media are not well-established. Even a cursory examination of some of the jurisdictions listed above that mandate domestic investment by their SWFs and a comparison with their rankings on perhaps the most well-known international measure of corruption, the Transparency International Corruption Perceptions Index (TICPI), may be enough to ring some alarm bells. The TICPI evaluated 175 jurisdictions on their perceived level of corruption on a scale of 0-100: the lower the score (and thus the lower the ranking) then the more corrupt that country is perceived to be. In the TICPI 2013 survey Angola is ranked at a lowly 153 with a score of 23, Nigeria at 144 with a score of 25 and Kazakhstan at 140 with a score of 26. Countries with SWFs that are ranked highly on the TICPI

²¹ Alan Gelb, Silvana Tordo, Håvard Halland, Noora Arfaa, Gregory Smith, *Sovereign Wealth Funds and Long Term Development Finance Risks and Opportunities*, 6 (World Bank Policy Research Working Paper 6776, 2014) (available at <http://www.mfw4a.org/nc/knowledge-center/resources/documents/documents-details/file/sovereign-wealth-funds-and-long-term-development-finance-risks-and-opportunities.html>)

include New Zealand equal first with a score of 91, Norway and Singapore at equal fifth with a score of 86 and Australia ranked equal ninth with a score of 81.²² The TICPI has widely-acknowledged methodological limitations including reliance on a limited number of surveys and the subjective character of those surveys, but it remains a long-standing and widely quoted measurement indicator on the subject of corruption, an issue that is notoriously resistant to accurate measurement.

Despite ongoing concerns about corruption in certain jurisdictions and the relative legitimacy of some political regimes there is not widespread evidence that the investment decisions of SWFs are politically biased. For example, in a study conducted for the OECD, Avendano and Santiso compared the investment decision-making of SWFs with those of commercial mutual funds. They found no significant differences between the investment targets or the underlying investment strategies of SWF wealth managers in comparison to those in mutual funds.²³ However, what seems less clear is whether domestic investment by SWFs will be more or less risky, and more or less effective, than public investment in other forms. Dabla-Norris et al. identify four key phases in evaluating whether public investment is effective: strategic guidance and project appraisal; project selection and budgeting; project implementation; and project audit and evaluation.²⁴ It is likely that as time goes on, and domestic investment by SWF actors increases, SWF investment can be evaluated along similar lines to more conventional public investment through means such as regular reports, an independent board, transparent organisational structures and human resource processes, competitive tendering and external audit by commercial auditors. Similarly, SWFs in the future might be expected to engage in co-operative investment initiatives with not only private but also public sector actors and international development agencies. However, given the investment return expectations overall on SWFs it might be reasonable to expect that in the future even public investment initiatives by SWFs should have a commercial market reality about them, so that financial as well social returns can be expected. Robust methodologies for SWFs to achieve this in practice have yet to be developed but can be expected to emerge over time. For example, Gelb et al. at the World Bank have flagged that the International Finance Corporation (IFC) is currently pilot testing a new financial valuation tool, the Sustainable Program Quality Framework, which attempts to integrate the whole value of sustainability and social programs in investment initiatives.²⁵

It has been recognised at the highest levels of international organisations that SWFs could promote the development of social capital and the public interest. For example, speaking on ways to promote development in Africa in particular, then World Bank President Robert B. Zoellik actively promoted what he called his *one per cent solution*, whereby SWFs ‘invest one percent of their funds in Africa.’²⁶ On 9 December 2008 the Board of the IFC approved the Sovereign Funds Initiative to ‘raise and manage commercial capital from sovereign funds for equity investments in some of the poorest developing countries.’ The initiatives will support the

²² Transparency International, *Corruption Perceptions Index 2013* (available at <http://cpi.transparency.org/cpi2013/results/>)

²³ Rolando Avendaño and Javier Santiso, *Are Sovereign Wealth Fund Investments Politically Biased? A Comparison With Mutual Funds*, 283 (OECD Development Centre Working Paper, 2009) (available at http://www.oecd-ilibrary.org/development/oecd-development-centre-working-papers_18151949)

²⁴ Era Dabla-Norris, Jim Brumby, Annette Kyobe, Zac Mills, and Chris Papageorgiou, *Investing in Public Investment: An Index of Public Investment Efficiency* (IMF Working Paper No 11/37, 2011) (available at <http://www.imf.org/external/pubs/cat/longres.aspx?sk=24651.0>)

²⁵ Alan Gelb, Silvana Tordo and Håvard Halland, *Sovereign Wealth Funds and Domestic Investment in Resource-Rich Countries: Love Me, or Love Me Not*, 4 (World Bank, Economic Premise No.133, January 2014) (available at <http://www.mfw4a.org/nc/knowledge-center/resources/documents/documents-details/file/sovereign-wealth-funds-and-long-term-development-finance-risks-and-opportunities.html>).

²⁶ Steven R. Weisman, *World Bank Calls on Sovereign Funds to Invest in Africa*, The New York Times (April 3, 2008) (available at http://www.nytimes.com/2008/04/03/world/africa/03worldbank.html?_r=0).

private sector, which is critical to employment, recovery, and growth.²⁷ That initiative was followed by a further announcement on 7 May 2009 that the IFC was setting up a subsidiary that:

for the first time will serve as a fund manager of third-party capital. The subsidiary, IFC Asset Management Company, LLC, an asset-management platform, which is wholly owned by IFC, will manage the \$3 billion IFC Recapitalization Fund...It will also manage a new \$1 billion private equity fund that will allow national pension funds, sovereign funds, and other sovereign investors from IFC's shareholder countries to co-invest in IFC transactions in Africa, Latin America, and the Caribbean.²⁸

These have been positive steps by the IFC. However, to date, a new branch of the World Bank dedicated to receiving investments from SWFs to be utilised for private investment purposes has not been established. Ochoa and Keenan had recommended that such an initiative oriented to facilitating smaller private enterprises in Africa be called the Multilateral Sovereign Investment Agency.²⁹ For now it seems that SWFs, perhaps unsurprisingly given their mandatory fund management obligations discussed above, are more likely to pursue public good investment on a case-by-case basis, rather than via bloc contributions to an international development agency. This is so regardless of whether that public good is generated through exclusively private, public, or private-public partnership investment pathways.

B. Public good and governance

It is important to note that many jurisdictions with SWFs such as Australia, Singapore and Norway are not only recipient countries of SWF investment but also receive high levels of foreign investment generally. This scenario is likely to become more common in the future amongst other jurisdictions with SWFs such as China, as they become recipients of investment capital as their financial markets become more liberalised and more open to competition from external actors. Thus the activities of SWFs not only raise issues of the implications of cross-nationalisation of assets and industries for jurisdictions all over the world, but also how SWF activities will impact upon corporate governance contexts both at home and abroad.

The most significant international manifestation of commitment by SWFs to improving standards of governance came at a meeting in Santiago Chile in October 2008 via the Santiago Principles.³⁰ IWG members committed to operate by the GAPP, which comprise 24 voluntary principles emphasising good governance, accountability, transparency and a commitment to financially motivated investment strategies. At the media conference formally announcing the Santiago Principles, the IWG drafting Chair Mr David Murray (then-Chairman of Australia's Future Fund) stated that the key task was to establish trust in recipient nations of SWF investment based on notions of openness and legitimacy.³¹ The IWG evolved into the

²⁷ International Finance Corporation, *IFC Board Approves Initiatives for Financial Crisis Response and Sovereign Funds to Support Private Sector in Emerging Markets* (December 18, 2008) (available at <https://ifcndd.ifc.org/ifcext/pressroom/ifcpressroom.nsf/0/E915A6E933FD599E85257523007974CD?OpenDocument>).

²⁸ International Finance Corporation, *In a Historic Step, IFC Launches Subsidiary to Manage Third-Party Capital for Development: Gavin Wilson Is Appointed First CEO of IFC Asset Management Company*, May 7, 2009) (available at <https://ifcndd.ifc.org/ifcext/pressroom/ifcpressroom.nsf/0/FD0A212B06FCC317852575AF00646966?OpenDocument>).

²⁹ Christiana Ochoa and Patrick Keenan, *The Human Rights Potential of Sovereign Wealth Funds*, 40 Geo. J. Intl. L. 1151 (2009)

³⁰ International Working Group of Sovereign Wealth Funds, *Generally Accepted Principles and Practices (GAPP) – The Santiago Principles* (2008) (available at <http://www.iwg-swf.org/pubs/gapplist.htm>)

³¹ International Working Group of Sovereign Wealth Funds, *Press Conference Working Call: International Working Group of Sovereign Wealth Funds*, September 2, 2008) (available at <http://www.iwg-swf.org/tr/swftr0801.htm>)

International Forum of Sovereign Wealth Funds (IFSFW), which states its purpose as ‘a voluntary group of Sovereign Wealth Funds (SWFs), which will meet, exchange views on issues of common interest, and facilitate an understanding of the Santiago Principles and SWF activities’.³²

Thus the Santiago Principles are at the core of the IFSWF. The issue of governance itself, and more particularly good governance, revolves around those goals stated by Mr Murray - trust, openness and legitimacy. The IFSWF produces limited published material; however, in July 2011 it did publish a report about IFSWF Members’ Investment and Operational Practices with a particular emphasis on the GAPP.³³ The report revealed that: 76 percent of Members participated in the IFSWF surveys; their investment activities were commercially motivated; there were differing levels of compliance with the GAPP amongst Members; and, in the view of the IFSWF, it was not reasonable or possible to expect uniform compliance with the GAPP from all IFSWF Members. Given the substantial variance in cultural, political and developmental differences between the jurisdictions that comprise the IFSWF, it is not surprising that aspiration rather than full compliance should feature significantly. SWFs must function in the space where international trade pressures and national self-interest intersect and sometimes clash.

In October 2013 at its fifth meeting in Oslo Norway, the IFSWF released a further report summarising the views of its membership regarding application of the Santiago Principles.. The key findings of that report were that: the response rate had risen from 76 per cent in 2011 to 84 per cent (i.e. twenty one of the twenty five members) in 2013; in 2011 ten members had fully implemented all 24 GAPPs, but in 2013 that had risen to thirteen members, although on average 86 percent of the 24 GAPPs had been fully implemented (unchanged from 2011). In particular the GAPPs which had significant increased levels of observance compared to 2011 were: GAPP 12 – financial statements meeting international standards (+6); GAPP 13 – having professional and ethical standards in place (+7); GAPP 19 – disclosure regarding maximisation of risk-adjusted financial returns (+5); GAPP 20 – non-usage of privileged information or inappropriate influence (+5); and GAPP 21 – exercise of ownership rights (+7).³⁴

It is re-assuring to note an upward curve in reported adherence to the GAPPs. However, it must be emphasised that it is a self-reporting exercise and not all commentators are convinced that all SWFs are significantly improving their standards of governance. For example, Truman is a long-established analyst of SWFs and he has constructed a 33 element SWF Scoreboard on 49 SWFs which includes members of the IFSWF. For the common group of 32 funds whom Truman analysed in both 2007 and 2012 there was a significant improvement of 40 percent from 42 in 2007 rising to 59 in 2012. However, Truman found that the improvement was not uniform across all funds and that the IFSWF and the Santiago Principles had limited influence on a number of individual funds.³⁵ Truman’s SWF Scoreboard is based on publicly available information and he argues that it is more granular than the IFSWF compilation of SWF self-reporting. Whilst congratulating the IFSWF on its continuing efforts to raise standards of accountability, governance and transparency amongst its membership, Truman states that his

³² See <http://www.ifswf.org/index.htm>

³³ International Forum of Sovereign Wealth Funds, *IFSFW Members’ Experiences in the Application of the Santiago Principles*, (July 7, 2011) (available at www.ifswf.org/pst/stp070711.pdf)

³⁴ International Forum of Sovereign Wealth Funds, *2013 Report on the International Forum of Sovereign Wealth Funds (IFSFW) Members’ Experiences in the Application of the Santiago Principles* (October 2, 2013) (available at <http://www.ifswf.org/pst/oslo2013.htm>)

³⁵ Edwin M. Truman, *Implementation of the Santiago Principles for Sovereign Wealth Funds: A Progress Report* (Peterson Institute for International Economics, Policy Brief, December 2013) (available at <http://www.iie.com/publications/interstitial.cfm?ResearchID=2454>)

own research contradicts the claim of the IFSWF 2013 Report that all Member Funds have implemented each of the Santiago Principles at least partially.³⁶

Thus, unsurprisingly, especially from the perspective of improved governance contributing to the public good, there would appear to be a significant aspirational character to the performance of a number of SWFs. Regarding the issue of SWFs and governance, it is instructive to consider Norway which is often referred to as the gold standard in terms of how a SWF might be operated and regulated.³⁷ Of particular interest when considering how a SWF might contribute to the public good and the production of social capital is the role of the Council of Ethics for the Fund (CEF). The CEF monitors the GPFG's portfolio and can make recommendations to the Ministry of Finance about whether companies should be excluded. The GPFG is mandated to avoid investments that would constitute an unacceptable risk of seriously breaching its norms and grounds for the exclusion of a company from the GPFG portfolio include not only activities such as: serious or systematic human rights violations; severe environmental damage and gross corruption, but also products such as: anti-personnel mines; cluster weapons and nuclear weapons. Guidance for decision-making about unacceptable levels of risk, practices and products are detailed in the GPFG's Ethical Guidelines.³⁸ There are four key criteria for the decision-making activities of the CEF being human rights law, the law of armed conflict, corruption, and environmental issues.

There are more than 8,000 companies in the GPFG's investment portfolio and the first company excluded based on a CEF recommendation was Singapore Engineering Technologies in 2002. In the twelve years since then, an additional 60 companies from around the world have been excluded, including all companies linked to tobacco production and some huge international corporations such as Boeing, Freeport, Lockheed Martin, Rio Tinto and Wal-Mart. In some instances the CEF publishes details of the processes leading to its decision on an individual company.³⁹ On average the CEF would work with about 80 companies whose identity is kept secret and only the excluded companies are named (about four or five in an average year). The CEF is appointed by the Norwegian Government and not the Ministry of Finance, so in theory there may be less chance of regulatory capture; and the Ministry has to publicise the CEF's advice even if it disagrees with it. The value of the CEF lies in its capacity to leverage on reputational risk. The exclusion capacities of the CEF give leverage via the NBIM to the Norges Bank to influence the governance of companies in which it invests and so there is an important synergy between the CEF and Norway's central bank.

It will be interesting to see in the future whether other jurisdictions equip their SWFs with this institutionalised ethical leverage in the way that Norway has done.⁴⁰ If this does occur it may further leverage the capacity of SWFs to contribute to the public good by stimulating improved standards of governance amongst commercial business actors who desire investment capital

³⁶ Allie E. Bagnall & Edwin M. Truman, *Progress on Sovereign Wealth Fund Transparency and Accountability: An Updated SWF Scoreboard* (Peterson Institute for International Economics, Policy Brief, August 2013) (available at <http://www.iie.com/publications/interstitial.cfm?ResearchID=2454>)

³⁷ See e.g., Madelaine Drohan, *Learn From Alberta's Mistake*, Canadian Business (March 18, 2013) (available at <http://www.canadianbusiness.com/economy/learn-from-albertas-mistake/>)

³⁸ See Council on Ethics, *Guidelines for the Observation and Exclusion of Companies from the Government Pension Fund Global's Investment Universe* (available at http://www.regjeringen.no/en/sub/styret-rad-utvalg/ethics_council/ethical-guidelines.html?id=425277)

³⁹ See Council of Ethics, *List of Excluded Companies* (available at http://www.regjeringen.no/nb/dep/fin/tema/statens_pensjonsfond/ansvarlige-investeringer/selskaper-som-er-utelukket-fra-fondets-i.html?id=447122)

⁴⁰ See Simon Chesterman, *The Turn to Ethics: Disinvestment From Multinational Corporations for Human Rights Violations – The Case of Norway's Sovereign Wealth Fund*, 23 Am. U. Intl. L. R. 577 (2008).

from deep liquid capital pools such as the GPF and thus adjust their operational practices in order to be attractive to such sources of capital. However not all commentators are totally sanguine about the structure and approach of the GPF. Backer believes that the GPF model which may be public in a formal sense but functions in practice as a private investor, does not work as an idealized private investor.⁴¹

4. CONCLUSION

There are inescapable political dimensions to SWFs and other forms of state capital. Increasingly, regulatory demands and expectations are integrated into the maelstrom of international politics and trade. This has been seen recently in the Australian political context, where the current national government has been finalising bilateral trade deals with Japan and South Korea. One of the bargaining chips used by the Australian Government to secure these trade pacts has been to relax investment thresholds for Japanese and South Korean inward investment to Australia. Similarly strenuous efforts are being made to deliver a bilateral trade deal with China. There have been persistent articles in the Australian media in recent times that the Australian Government may be prepared to relax its strict controls over inward investment to Australia from Chinese SWFs and other state-owned investment actors if such investment is channelled into northern parts of Australia where to date there has been insufficient investment by Australian capital interests.⁴² It remains to be seen whether pressure may also be brought to bear on Australia's own SWF, the Future Fund, for it to contribute to nation building and social capital generation by investing in northern Australia.

We should not be surprised by such developments because the discourse surrounding SWFs is permeated by contrasting historical and cultural perspectives. It seems inevitable that there will be a continuing geo-political security element to reporting about SWFs and that there will be some level of anxiety in the West about the rising influence of SWFs, especially those from China. A significant factor of tension about SWFs is that many of the largest ones are in the most protectionist countries. This concern compounds the lack of transparency around SWFs, as indeed do issues of regional harmonisation. For example the European Commission has stated in the past that it 'cannot allow non-European funds to be run in an opaque manner or used as an implement of geo-political strategy' and it has reserved the right to introduce specific European legislation if increased transparency from SWFs is not achieved through voluntary means.⁴³ However, the reality is that most countries are capital dependent and so a market evolutionary approach is more likely to improve overall governance standards across all SWFs rather than a concerted regulatory push from Brussels or Washington DC.⁴⁴

SWFs have become more integrated into international financial markets since the GFC. The seemingly inexorable growth in the number and scale of SWF portfolios make it extremely likely that SWFs will become increasingly important vehicles for the recycling of global finance, namely, channelling capital from surplus (balance of payments) generating countries, to deficit

⁴¹ Larry C. Backer, *Sovereign Wealth Funds as Regulatory Chameleons: The Norwegian Sovereign Wealth Funds and Public Global Governance Through Private Global Investment*, 41Geo. J. Int'l L. 425 (2010).

⁴² See for example: Peter Coorey, *Abbott Seals Japan Trade Deal*, The Australian Financial Review, 1 (April 8, 2014); Peter Coorey and Lisa Murray, *Door Ajar for China State Enterprises*, The Australian Financial Review, 5 (April 11, 2014).

⁴³ Jose M. Barroso, *Statement by Jose Manuel Barroso President of the European Commission on Sovereign Wealth Funds* (2008) (available at http://ec.europa.eu/commission_barroso/president/press/releases/index_en.htm)

⁴⁴ This pragmatic stance reflects economic and political realities. For a discussion of this issue with a particular emphasis on the rising importance of China as a state investor see Larry C. Backer, *Sovereign Investing in Times of Crisis: Global Regulation of Sovereign Wealth Funds, State Owned Enterprises and the Chinese Experience*, 19 Transnatl. L. & Contemp. Probs. 3 (2010) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1444190)

countries. Real and nominal rates of return on benchmark sovereign assets in the major advanced economies will influence SWF portfolio shifts. It makes sense both economically and in other areas such as social development and geo-political stability that excess capital does not fuel a liquidity boom promoting excessive risk-taking, as was seen in the oil crisis of the 1970s, or the ‘irrational exuberance’⁴⁵ of the dot-com bubble of the 1990s. The increasing investment influence of SWFs and their potential for contributing to the public good can be a positive factor in such developments. There are implications for the likely increasing synergy between national economic well-being, the health and vitality of international finance, and the importance of SWFs as a smoothing intervening variable in macro-economic stability and global inter-dependence. These dilemmas are of course not uncommon in contemporary financial regulation where numerous New Governance strategies are emerging to cater to the inter-connected needs of jurisdictions with both public and private actors.⁴⁶

What is not yet clear is how willing and indeed how capable SWFs will be to play a more active role in domestic private investment. It is quite likely that considerably more SWFs will be pushed in this direction by their national governments. For example, Gelb et al. note that Colombia, Morocco, Mozambique, Sierra Leone, Tanzania and Uganda are considering imposing domestic investment mandates upon their SWFs.⁴⁷ If this trend continues then the public good dimension of SWFs as good guy investment actors will not only become more prominent but will be inevitably shaped by political factors, both domestic and international.

⁴⁵ See The Federal Reserve Board, *The Challenge of Central Banking in a Democratic Society* (speech given by former US Federal Reserve Chairman Mr Alan Greenspan to The American Enterprise Institute for Public Policy Research, Washington DC, December 5, 1996) (available at <http://www.federalreserve.gov/boarddocs/speeches/1996/19961205.htm>)

⁴⁶ See e.g., Chris Brummer, *MINIMALISM - How Trade Alliances, Soft Law and Financial Engineering are Redefining Economic Statecraft* (Cambridge U. Press 2014); and Christie L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation*, 45 Bus L.J.1, 5 (2008).

⁴⁷ Gelb et al., *supra* n. 25 at 5.