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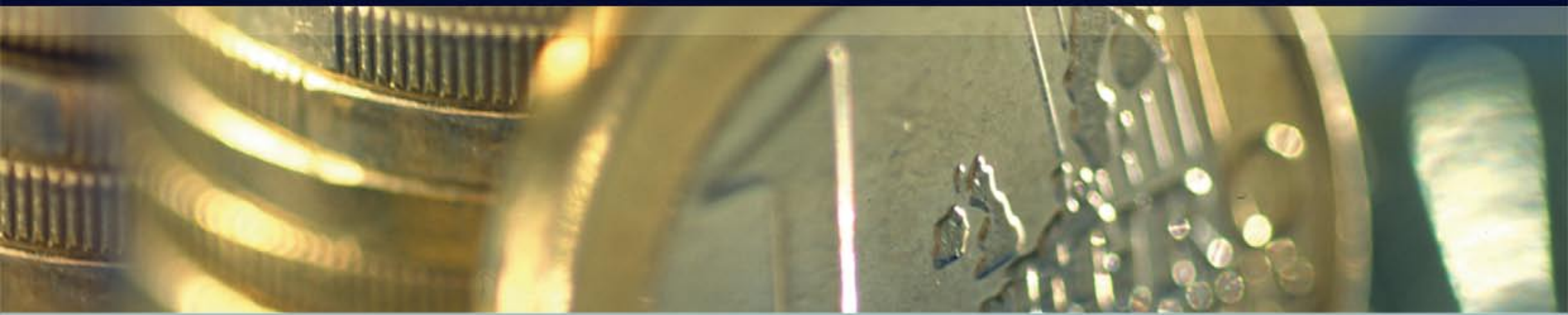

The so-called "Sovereign Wealth Funds": regulatory issues, financial stability and prudential supervision

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THE SO-CALLED "SOVEREIGN WEALTH FUNDS": REGULATORY ISSUES, FINANCIAL STABILITY, AND PRUDENTIAL SUPERVISION

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Abstract

This paper aims to contribute to the debate on the regulatory and economic issues raised by the recent gain in prominence of the so-called "Sovereign Wealth Funds" (SWFs), by first trying to better identify the actual legal and economic nature of such "special purpose" government investment vehicles. SWFs are generally deemed to bring significant benefits to global capital markets. Nevertheless, significant concerns have been expressed due to SWFs limited disclosure and transparency, their multiple investment objectives and notably as – being sovereign entities' instruments – SWFs may take investment decisions driven by political and/or strategic objectives and considerations or in a fashion entailing national security concerns. Although the debate on SWFs has mostly revolved around such issues, this paper aims at also pointing out that SWFs sharp growth is one of the by-products of the large and persistent global imbalances in trade (which may threat global financial and economic stability) and that the increasing transfer of "excess reserves" from monetary authorities to SWFs is expected to result in significant rebalancing of capital flows in global financial markets. On the other side, while the risk of a political/strategic bias should not be underestimated, this paper argues that at present a specific regulation of SWFs may not be needed, as their assets actual management is already constrained by SWFs own features and objectives as well as by many regulatory, economic and political factors (e.g. WTO and OECD rules, as well as the *acquis communautaire* already provide for legal waivers and exception to the free movement of capital and goods whereby "legitimate national interests" are at stake). With specific reference to legal aspects, this paper proposes that a balanced and proportionate regulatory approach to SWFs issues may just require, for the time being, to complement "soft law" instruments – e.g. the so-called "Santiago Principles" or GAPP and the OECD guidelines for SWFs investments (expected to be finalised in 2009) – with a "light" and "indirect" regulatory and supervisory framework for SWFs equity investments consistent, *inter alia*, with the recommendations endorsed in the European Parliament Resolution of 23 September 2008 on transparency of institutional investors and essentially based on legal principles and provisions already in force in most EU Member States. In particular, reference could be made, primarily, to principles and rules providing for shareholding notification requirements and disclosure of information on voting rights attached to shares, and whereby necessary to those imposing possible limits to shareholdings and/or to the exercise of voting rights by EU companies' shareholders.

JEL classifications: K2, K21, K22, K23, K33.

Keywords: Sovereign Wealth Funds, Official Reserves, International Imbalances, Free Movement of Capital, Financial Regulation, Competition Policy, Soft Law, Voting Rights, Market Economy Private Investor Test.

The views expressed are the author's alone and do not necessarily correspond to those of the European Commission.

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1. Introduction to the Sovereign Wealth Funds phenomenon

Despite the relatively recent interest in the political, legal and financial issues posed by the increasing prominence of Sovereign Wealth Funds (SWFs) phenomenon, SWFs are actually not new players in the global economy and financial markets; indeed they have been around for more than 25 years, mainly and traditionally established by countries rich in natural resources (e.g. oil).

According to available data, more than half of the largest SWFs were established before the year 2000 (SWFs first generation), but it is since the year 2000 that the "SWF phenomenon" has gained new momentum, leading to an increase in both size and number of SWFs (**Picture 1** and **Chart 1**).

The rapid changes recently occurred in SWFs characteristics (both at individual and aggregate level) and in the economic environment in which they operate make them emerge as among the most important players in global financial markets, thus attracting substantial attention by policy makers, market participants and the international community.

In particular, SWFs rapid development mainly reflects the significant shift of emerging economies from world's debtors to world's creditors. Indeed for nearly all the second half of the twentieth century, emerging economies ran current account deficits and imported foreign capital; nevertheless, as pointed out, "in 1999, the emerging world as a whole began to run a current account surplus and export capital to the rest of the world"[1].

That surplus rapidly increased, reaching an estimated 685 billion USD in 2006 (1.3% of world GDP), the "Asian economies are the exemplars of the trend. But it is not just Asia, as oil exporters and developing countries in Latin America have also racked up increasing surpluses. The exceptions are the emerging Eastern European economies, Turkey, South Africa, and India – countries that still have significant current account deficits"[2].

As a result, developed countries as a group started to run progressively larger current account deficit. Moreover, the scale of differences also grew "with more countries running surpluses or deficit of over 5% of GDP"[3].

Emerging countries also started accumulating foreign assets. When the level of such assets outstripped the level of reserves needed for stabilisation purposes, it became reasonable to try to increase returns on reserves by

[1] Toloui R., (2007), When Capital Flows Uphill: Emerging Markets as Creditors, PIMCO, Capital Perspective, June 2007.

[2] *Ibidem*.

[3] Bank of England, Sovereign wealth funds and global imbalances, Quarterly Bulletin, 2008 Q2, p. 197.

diversifying investments from traditional government debt securities, also through establishment of SWFs (FX reserves held by emerging countries' central banks as a whole are estimated to be approx. 60% – nearly 3 trillion USD – higher than what actually needed to cover short-term external debt[4]).

2. Possible definitions of SWFs: what, exactly, is a SWF?

Although it proves to be a key question, unfortunately there is no common, generally accepted or off-the-shelf definition of what a SWF actually is. Indeed numerous definitions have been proposed.

For instance, the US Under Secretary for International Affairs (Clay Lowery) referred to a SWF as[5]: *i)* a government investment vehicle; *ii)* which is funded by foreign exchange assets and; *iii)* which manages those assets separately from official reserves.

In the view of the International Monetary Fund (IMF), SWFs can generally be defined as[6]: *i)* special investment funds; *ii)* created or owned by governments; *iii)* to hold foreign assets for long-term purposes.

According to the Organisation for Economic Cooperation and Development (OECD - November 2007) SWFs are essentially: *i)* government-owned investment vehicles; *ii)* funded by foreign exchange assets.

All the definitions reported above focus their attention either on how SWFs are funded (by foreign exchange assets), the type of assets they hold (foreign assets) or how SWFs assets are managed (separately from sponsor countries' official reserves).

As they "capture" just some SWFs "typical" features they appear to some extent underinclusive[7], in particular not wide enough to capture within their scope entities usually included in the "SWF club", such as: *i)* the Korea Investment Corporation (KIC) and the Hong Kong Monetary Authority (HKMA) (i.e. they do not fully manage official reserve separately from other portfolios); *ii)* Temasek, Khazanah of Malaysia and SASCA of China (usually they are either not funded by foreign assets or their assets are invested mainly internally).

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[4] *Ibidem*.

[5] Remarks by Acting Under Secretary for International Affairs Clay Lowery on Sovereign Wealth Funds and the International Financial System, San Francisco, June 21, 2007, hp-471.

[6] International Monetary Fund (IMF), Global Financial Stability Report, October 2007.

[7] State Street, Sovereign Wealth Funds, Assessing the Impact, Vision, Vol. III, Issue 2, 2008.

A slightly wider definition was proposed by a recent European Central Bank Occasional Paper[8], whose authors broadly define SWFs as: *i)* public investment agencies; *ii)* which manage part of the (foreign) assets of national states.

Another fairly wide definition of SWF has been put forth by the IMF which, for the purpose of drafting the forthcoming 6th version of its Balance of Payment Manual, acknowledges (Par. 6.93 of the Draft Text) that some governments create: *i)* "special purpose government funds", usually called Sovereign Wealth Funds; *ii)* to hold assets of the economy for long-term objectives; *iii)* the funds to be invested commonly arise from commodity sales, privatisation proceeds, and/or accumulation of foreign financial assets by authorities.

As long as it is not clear whether the assets held in such "special purpose government funds" could or should be included in a country's reserve assets, the IMF is essentially willing to provide appropriate guidance to prevent the risk that establishment of SWFs could undermine reliability of the "soft law" instruments specifically developed by the very IMF to achieve (although on a merely voluntary basis) proper degree of transparency on the global amount, value and composition of official reserves[9] – namely: *i)* the "Currency Composition of Official Foreign Exchange Reserves" data base (COFER); *ii)* the "Data Template on International Reserves and Foreign Currency Liquidity", which is part of the Special Data Dissemination Standard (SDDS)[10].

According to the IMF, "a key determination is whether there is some legal or administrative guidance that results in the assets being encumbered in a way that precludes their ready availability to the monetary authorities"[11].

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[8] European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by R. Beck and M. Fidora, Occasional Paper, n. 91/2008.

[9] As reported, "according to IMF staff, the countries themselves determine whether to include the value of their SWF assets in their reserve assets or separately as external assets. In some cases, countries do not report any information, about their SWF. […] Analyzing a selection of 21 countries with SWFs, IMF staff found that only 11 included the value of their SWFs' assets in either their balance of payments or international investment position data. IMF staff noted that members are not required to report the value of the SWF holdings as a separate line item and no member currently does so", U.S. Government Accountability Office, (2008), SOVEREIGN WEALTH FUNDS Publicly Available Data on Sizes and Investments for Some Funds Are Limited, Report to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, GAO-08-946, September 2008, p. 15.

[10] In this respect the EU Commission noted that "since SWFs are managed independently from a country's foreign exchange reserves, they are excluded from transparency mechanisms such as the IMF maintains for foreign exchange reserves […]. The extension of specific transparency standards to SWFs should be considered. Existing IMF and OECD guidelines already contain such standards, and some SWFs, such as those of Norway and Singapore are governed by principles which could be seen as a reference. However, SWFs should not be expected to follow transparency practices going beyond those developed by the IMF and the OECD and already applicable to similar state-owned investors", European Commission (2008), Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "A common European approach to Sovereign Wealth Funds", COM (2008) 115 final, 27.2.2008, par. 4.3.

[11] See par. 6.94 of the draft text of the International Monetary Fund (IMF) 6th Balance of Payment Manual.

In other words, whereby the external assets of a country are held in a special purpose government fund and the relevant monetary authorities are legally entitled to exercise control over such fund, "legal" assumption exists "that the assets are reserve assets (provided all other criteria for being a reserve asset are met). On the other hand, if the funds are held in a long-term fund separately incorporated, the presumption is that they should not be included in reserve assets, not least because the ready availability criterion is less likely to be met".

As a result, any final determination depends upon circumstances but, as pointed out by the IMF, generally speaking "in the absence of legal or administrative impediments, and given the fungibility of assets, even assets that had been earmarked as part of a special purpose government fund but could be used to meet balance of payments financing needs and other related purposes are reserve assets (subject to the other criteria being met including, importantly, the control of the monetary authorities over the disposition of the funds)"[12].

In other cases, "where special purpose government funds' foreign assets do not meet the criteria to be classified as reserve assets, they should be classified in the financial account and International Investment Position[13] under the appropriate instrument and functional category".

Finally, in the opinion of the IMF, "if special purpose government funds own direct investment equity and debt securities that could be classified in either direct investment or reserves assets, as general guidance, in the hierarchy of the balance of payments and IIP between direct investment and reserve assets,

- the equity securities should be classified as direct investment ahead of reserve assets, and

- debt securities should be classified as reserve assets ahead of direct investment"[14].

For comprehensiveness, the EU Commission referred to SWFs as: *i)* state-owned investment vehicles; *ii)* which manage a diversified portfolio of domestic and international financial assets[15].

Moreover, the Commission acknowledges that SFWs are typically (but not necessarily): *i)* funded from accumulated foreign-exchange reserves in their

[12] *Ibidem*, par. 6.97.

[13] As specified, "the international investment position (IIP) is a statistical statement that shows at a point in time the value and composition of: (a) financial assets of residents of an economy that are claims on nonresidents and gold bullion held as reserve assets; and (b) liabilities of residents of an economy to nonresidents. The difference between an economy's external financial assets and liabilities is the economy's net IIP, which may be positive or negative", *ibidem*, par. 7.1.

[14] *Ibidem*, par. 6.98.

[15] European Commission (2008), Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "A common European approach to Sovereign Wealth Funds", COM (2008) 115 final, 27.2.2008, par. 2.1.

sponsor countries; *ii)* managed separately from official reserves (i.e. with higher risk acceptance in search of higher returns).

Based upon the different definitions proposed, a common key feature distinguishing a SWF from other investment vehicles and institutional investors lies in its "property regime". As a result, a SWF proves to be typically:

- state-funded, and
- managed (directly or indirectly) in the interest of its sponsor country.

That said, in order to better discriminate between SWFs and other public investment vehicles – e.g. to clearly define the scope of possible regulatory measures of SWF investments – a more "solid" definition of SWFs proves necessary.

In this respect, a practical way to identify SWFs could be to define them by exclusion – a useful reference is the fairly comprehensive and inclusive definition of SWFs proposed by "State Street"[16], according to which SWFs are essentially:

- sovereign-owned asset pools,
- which are neither traditional public pension funds nor traditional reserves assets supporting national currencies.

According to such definition, certain sovereign-owned assets are likely to be regarded as sovereign wealth (regardless of their other characteristics) as long as they[17]:

- are managed (directly or indirectly) to pursue public interests other than those related to monetary/exchange rate policies and public pension systems/schemes, and
- do not represent prudential monetary reserves (i.e. they are not even assets maintained for prudential purposes by central banks and monetary authorities in excess of what they judged adequate for their policy purposes);

[16] State Street, Sovereign Wealth Funds, Assessing the Impact, Vision, Vol. III, Issue 2, pp. 3-6.

[17] For instance, regardless of "whether they are domestic or foreign, equity-like or debt-financed, earmarked for current or future generations, highly liquid and broadly diversified or relatively illiquid and concentrated", *Ibidem*.

A similar approach (i.e. defining SWFs by exclusion) has been followed also by the International Working Group of SWFs (IWG-SWF) – comprising 26 IMF member countries with SWFs[18] – for the purpose of drafting the SWFs "Generally Accepted Principles and Practices" (GAPP) or "Santiago Principles", a voluntary set of principles and practices that IWG members support and either have implemented or aspire to implement in order to "identify a framework of generally accepted principles and practices that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis". As specified by the IWG-SWF, GAPP also "aims at supporting the institutional framework, governance, and investment operations of SWFs […]. Publication of the GAPP should help improve understanding of SWFs as economically and financially oriented entities in both the home and recipient countries. This understanding aims to contribute to the stability of the global financial system, reduce protectionist pressures, and help maintain an open and stable investment climate"[19].

Within GAPP meaning, 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. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports"[20].

Accordingly, the following entities would be, in principle, excluded from the SWF definition proposed by the IWG: *i)* foreign currency reserves held by Monetary Authorities for traditional Balance of Payments/Monetary Policy purposes and needs; *ii)* operations of traditional State-Owned Enterprises (SOEs) in the traditional sense; *iii)* national pension funds with contractual liabilities disallowing their use for general macroeconomic purposes; *iv)* assets managed for the benefit of individuals; *v)* government lending funds (i.e. mainly domestic funds); *vi)* government owned banks (e.g. national development banks) operating as intermediaries rather than for general economic purposes.

In other words, on top of being state-owned – certainly a peculiar but not exclusive feature of SWFs – SWFs assets are:

- operationally and legally ring-fenced from other state's assets and source of wealth (primarily official reserve),

[18] Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, and the United States. Permanent observers of the IWG are: Oman, Saudi Arabia, Vietnam, OECD, and the World Bank.

[19] International Working Group of Sovereign Wealth Funds (2008), Sovereign Wealth Funds, Generally Accepted Principles and Practices. "Santiago Principles", October 2008, p. 4.

[20] *Ibidem*, p. 27.

- in order to serve public objectives and interests, defined by political bodies, other than those directly related to the conduct of monetary and exchange rate policies (therefore they are not part of monetary/exchange policies instruments),

- against liabilities just broadly defined (SWFs may include reserve assets, but not all reserve assets are to be regarded as SWFs).

It implies that SWFs assets are *inter alia* subject to legal or administrative provisions that preclude sponsor countries' Monetary Authorities from being clearly entitled to legally exercise a right to call upon them to pursue their own typical functions (e.g. related to balance of payments needs). As a result, SWFs assets are usually not as highly liquid and promptly marketable as official reserves.

Furthermore, a distinguishing element of SWFs is that (as stressed in the mentioned ECB Occasional Paper) "they have no or only very limited liabilities" (or liabilities with a long maturity) allowing for (or at least favouring) pursuit of heterogeneous macroeconomic objectives also through:

- a wide range of investment strategies with a medium- to long-term timescale,

- higher risk taking behaviour,

- foreign investments.

Such characteristic significantly differentiates SWFs from Sovereign/National Pension Funds (and SOEs), which instead have defined or contingent explicit liabilities, implying continuous or regular stream of payments. For instance, having SWFs typically "no immediate, well-defined payables, […would make, *inter alia*,…] the consequences of a decline in the valuation of their assets in case of a market downturn less severe than in the case of most other institutional investors"[21].

To conclude, consistently with all the above definitions, a SWF could be regarded as:

- a public owned pool of (domestic and foreign) assets;

- legally, financially and operationally ring-fenced from other public assets and liabilities;

- made available to political bodies (i.e. not the Monetary Authorities) to achieve a variety of public objectives (typically to "insulate the budget

[21] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 13.

and the economy from excess volatility in revenues, help monetary authorities sterilize unwanted liquidity, build up savings for future generations, or use the money for economic and social development”[22]);

- other than those directly related to the conduct of monetary and exchange rate policies and management of public pension schemes.

In this respect, effective ring-fencing regime can be achieved through "Physical Separation", "Organisational Separation" and "Behavioural Separation" measures, such as: *i)* requirements for separate legal entities or separate ownership structures (which may impose unnecessary costs and reduce operating efficiency though); *ii)* financial and accounting ring-fencing arrangements; *iii)* a system of internal “Chinese” walls.

3. SWFs legal nature and forms between "investment funds" and "investment firms"

With reference to the actual legal nature and form of SWFs, it is worth noting that, according to the generally accepted definitions used for Balance of Payment purposes and under the EU financial regulation provisions, a SWF may not necessarily be regarded as a "fund" or better an "investment fund".

Indeed, as also pointed out by the IMF, "investment funds are collective investment schemes that raise funds by issuing shares or units to the public […]. Investment funds may be constituted: (i) under the law of contract (as common funds managed by management companies), or (ii) under trust law (as unit trusts), or (iii) under a statute (as investment companies), or (iv) otherwise with similar effect"[23].

As a result, “special purpose government funds, usually called sovereign wealth funds, are more likely to be classified as captive financial institutions than as investment funds, given the nature of their liabilities, if classified as a financial corporation”[24].

[22] Razanov A., (2005), Who holds the wealth of nations, Central Banking Journal, Vol. XV, No. 4, 2005.

[23] See par. 4.69-4.69 of the draft text of the International Monetary Fund (IMF) 6th Balance of Payment Manual.

[24] *Ibidem*, par. 4.70.

For the same reasons, under the *acquis communautaire* a SWF is not to be regarded in principle as subject to legal provisions regulating "undertakings for collective investment in transferable securities" (UCITS)[25]. It rather appears to be more similar to one (third country) "Investment Firm" (see Art. 4 - MIFID Directive) performing, in the exclusive interest of its sponsor state, one or more investment services and activities, in particular: portfolio management.

Indeed under MiFID, "Investment Firm" stands for any legal person whose regular occupation or business is the provision of one or more of the following investment services to third parties and/or the performance of one or more of the following investment activities on a professional basis: (1) Reception and transmission of orders in relation to one or more financial instruments; (2) Execution of orders on behalf of clients; (3) Dealing on own account; (4) Portfolio Management; (5) Investment Advice; (6) Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis; (7) Placing of financial instruments without a firm commitment basis.

In line with such considerations, it has been pointed out that “the information available on the world’s largest SWFs suggests that, with respect to investment style, these differ substantially from traditional foreign exchange reserves and are instead comparable to private asset managers”[26].

In this respect, the first-ever survey of “SWFs institutional and operational practices” (undertaken as a voluntary exercise by 20 members of the International Working Group of Sovereign Wealth Funds (IWG-SWF) as background information and input in the preparation of a set of “Generally Accepted Practices and Principles” (GAPP), revealed that: “the legal basis and form in which SWFs are established vary from country to country”, nevertheless 50% of the respondents (most respondents have SWFs funded out of mineral royalties, mainly oil) “indicate that they are established as legal entities separate from the state or the central bank, whereas the rest are not separate legal entities (pool of assets). SWFs falling under the former category either have a legal personality established under a specific constitutive law, or are a private corporation established under company law. SWFs falling within the latter category are usually controlled by the Ministry of Finance and operationally managed by the central bank or a statutory management agency. While many of these SWFs are also established by specific constitutive laws, some are established by general

[25] Defined as "undertakings the sole object of which is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk-spreading, and the units of which are, at the request of holders, re-purchased or redeemed, directly or indirectly, out of those undertakings' assets", see art.1 of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).

[26] European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by Beck R. and Fidora M., Occasional Paper, n. 91/2008, p. 12.

fiscal (budget or fiscal responsibility) laws, and one is established under the central bank law”[27] (**Chart 2**).

As suggested above, a practical method to identify SWFs is by exclusion: SWFs are Sovereign Wealth Management Arrangement other than Central Banks, Monetary Authorities, SOEs and National Pension Funds (the latter are, *inter alia*, not directly financed by foreign exchange assets generated by commodity exports).

Having said that, it is easy to observe that SWF is an acronym covering a heterogeneous range of governments' special purpose investment arrangements, as not all of SWFs are equally established or managed, they actually lie along a spectrum of different sovereign investment institutions/arrangements delimited by Central Banks/Monetary Authorities, on one end, and State-Owned Enterprises, on the other end (**Chart 3**).

Along this spectrum, SWFs “differ in size, age, structure, funding sources, governance, policy objectives, risk return profiles, investment horizons, eligible assets classes and instruments”[28].

In the aim to better sort out and rearrange such variety, SWFs could be usefully grouped by <u>source of wealth</u> and <u>policy objectives</u> (i.e. wealth intended use).

In this respect, a main preliminary distinction could be drawn between:

- <u>Commodity Funds</u> (e.g. Norway Government Pension Funds and Middle Eastern SWFs) essentially financed by sale of commodities (i.e. oil). They represent net national savings by their sponsor governments and are usually established for budget stabilisation and wealth sharing across generations;

- <u>Non Commodity Funds</u> (typically established by Asian countries – e.g. GIC, KIC, HKMA Exchange Fund) funded via transfer of (excess) assets from national foreign exchange reserves portfolios held and managed by national Central Banks or Monetary Authorities.

With reference to their objectives and investment policies, according to IMF taxonomy, SWFs can be broadly grouped in the following categories:

- <u>Stabilisation Funds</u>: set up by countries rich in natural resources to insulate the budget and economy from volatile commodity prices (usually oil). Funds build up assets over the years of ample fiscal revenues in order to prepare for leaner years.

[27] IWG, Sovereign Wealth Funds, Current Institutional and Operational Practices, Prepared by the IWG Secretariat in Collaboration with the Members of the IWG, September 15, 2008.

[28] State Street, Sovereign Wealth Funds, Assessing the Impact, Vision, Vol. III, Issue 2, p. 15.

While newer oil funds predominantly focus on stabilisation objectives, the recent increase in oil prices has allowed them a more flexible management of their assets, adding further emphasis to savings objectives.

- Savings Funds: mainly intended to share wealth across generations by transferring non-renewable assets into a diversified portfolio of (international) financial assets, to provide for future generations[29] or other long-term objectives (e.g. to prevent/mitigate the so-called "Dutch disease", namely a syndrome likely to occur where a large inflow of foreign currency – e.g. due to a sharp surge in prices of commodities exported, foreign assistance and foreign direct investment – is converted into local currency and spent on domestic non-traded goods, inducing a real exchange rate appreciation that weakens the competitiveness of the country's exports (spending effect), and a shift of capital and labour into sectors experiencing an increase in domestic demand (resource movement effect)[30];

- Reserve Investment Corporations: vehicles established as a separate legal entity either to reduce the negative cost-of-carry of holding reserves or to pursue investment policies with higher returns. Often, the assets in such arrangements are still counted as reserves;

- Development Funds: allocating resources for funding socio-economic projects (e.g. infrastructure);

- Pension Reserve Funds: having identified pension and/or contingent-type unspecified liabilities on government's balance sheet.

Another, partially overlapping, useful frame of reference in the analysis of SWFs nature and structure is provided by the "liability approach" to SWFs proposed by State Street, as different structures in the liability side of SWFs balance sheet result in different restrictions and constraints on SWFs assets management (i.e. on their investment policies and decisions).

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[29] As noted, especially in Asian economies and oil-exporting countries, "there is a growing sense that turning "resources in the ground" into financial assets is an important channel for transferring wealth across generations", International Monetary Fund (IMF), 2008, Financial Stress, Downturns, and Recoveries, World Economic Outlook, October 2008, p. 204.

[30] The expression "Dutch disease" broadly refers to the harmful consequences for the Netherlands' economy of the vast increase in its wealth experienced after discovering, in 1960, of large natural gas deposits in the North Sea. Unexpectedly, this positive development had serious repercussions on important segments of the country's economy, as the Dutch guilder became stronger, making (*inter alia*) Dutch non-oil exports less competitive, see: Corden W. M. and Neary J. P., (1982), Booming Sector and De-Industrialization in a Small Open Economy, The Economic Journal, 92, December, 1982; Ebrahim-Zadeh C., (2003), Back to Basics, Dutch Disease: Too much wealth managed unwisely, International Monetary Fund (IMF), Finance & Development, March 2003, Vol. 40, No 1.

Under the proposed approach, the following types of SWFs could be identified[31]:

- Contingent Liability Funds: primarily set up for macroeconomic stabilisation purposes by countries whose budgets are highly dependent on natural resources, "to smooth out budget revenues and expenditures; sterilize excess liquidity, protect economy from overheating, "Dutch disease" and boom-bust cycle".

  Pure "Stabilization Funds" are generally considered "a class of their own and stand out compared to" other SWFs (e.g. savings or heritage funds), as their investment objectives are not very different from central banks reserves' (i.e. safety and liquidity). Indeed, their liabilities being erratic, their primary objective is risk management and not long-term return and/or wealth maximisation, as all other SWFs[32]. However, the distinction between "pure stabilisation funds" and other SWFs is not always clear and, in practice, most funds have mixed nature/objectives[33].

- Fixed liability funds: established to meet a fixed future (long-term) sovereign liability mainly represented by the projected shortfall in public pension systems. As a result, such funds are similar to a large pension scheme with very few current retirees, implying high flexibility in managing their assets although more constrained as they mature (e.g. French pension reserve, Ireland's National Pension Reserve Fund, Australian Future Funds and New Zealand Superannuation Fund);

- Mixed Liability Funds: having a fixed obligation to make regular payments into the sponsor country's budget (according to a fiscal/spending rule) but, at the same time, without targeted terminal value. They have a relatively high degree of freedom on the asset side, lower than a newly lunched fixed liability fund but higher that a mature one (e.g. future generation fund, as in Norway and Russia);

- Open-Ended Liability Funds: essentially "investment authorities/corporations" not having explicit or contractual defined obligations against third parties. Accordingly, they can have longest investment horizon, greatest risk taking attitude and broadest assets diversification.

[31] State Street, Sovereign Wealth Funds, Assessing the Impact, Vision, Vol. III, Issue 2, 2008.

[32] Razanov A., (2007), Sovereign Wealth Funds: Defining Liabilities, State Street Global Advisors; European Central Bank, (2007), Financial Stability Review, December, 2007.

[33] Truman E. M., (2007), Sovereign Wealth Funds: The Need for Greater Transparency and Accountability, Peterson Institute for International Economics Policy Brief, 2007.

Furthermore it is worth noting that – as with private investors – liability profiles are not static, they may change over time mainly according to fund growth dynamic, shifting funds' risk/return profile and asset allocation. Stabilisation funds typically evolve towards savings and future generation funds.

In this respect the policy guideline, aiming to impose SWFs "to clearly define and publicly disclose their policy and investment purpose", does not appear particularly effective in terms of transparency. Indeed, as reported, "Norway's fund may have proclaimed that it has a "100-year investment horizon", but it has put all of its assets into highly liquid instruments and has explicitly avoided any illiquid investments"[34].

4. Who are SWFs and how big are they?

Retrieving reliable figures on SWFs size and characteristics is not easy as the level of disclosure and transparency differs significantly across SWFs, and transparency varies even within funds established by the same state (e.g. GIC and Temasek).

The lack of periodic and reliable information (with the significant exception of Norway Government Pension Funds, widely considered the "gold standard" in this respect) is a main source of concerns; indeed it hampers proper assessment of SWFs developments and identification of potential sources of risks.

Nevertheless, based upon various sources, **Table 1** and **Chart 4** in the Appendix provide a list of the largest SWFs and illustrate how big they are versus related sponsor countries' GDP (as data are likely not to fully reflect the effects of the global financial crisis and economic downturn, figures may turn out to be overstated in the current market and economic context).

As shown, there has been a sharp increase in the estimated SWFs AUM since 2000, mainly driven "by continuing high incomes from commodity sales and reserve accumulation for existing funds as well as the establishment of new entities"[35].

[34] State Street, Sovereign Wealth Funds, Assessing the Impact, Vision, Vol. III, Issue 2, 2008.

[35] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 2.

As a result, main SWFs are generally deemed to have accumulated 3.0-3.5 trillion USD of AUM[36].

According to the above figures, the top 9 SWFs manage more that 100 billion USD each and account for 81% of the total AUM by SWFs taken into consideration. ADIA (the largest SWF) holds more than a quarter of the total. Such high concentration in SWFs AUM, especially if compared to other institutional investors (e.g. private asset managers), implies (*inter alia*) that “the largest sovereign wealth funds could have an impact on some markets especially smaller ones such as other EMEs”[37].

So as to contextualise such figures, it is worth considering that the AUM of main SWFs almost doubled the AUM of the global Hedge Funds Industry (collectively, assets managed by SWFs roughly equal the value of Hedge Funds and Private Equity funds assets). When comparing AUM of SWFs and AUM of other private asset managers (e.g. Hedge Funds) it must be taken into account that SWFs are typically not leveraged (**Chart 5**).

The assets estimated to be under the management of main SWFs roughly account for 14% of Investment Funds AUM, 7% of Pension Funds AUM, 50% of global official reserves and 2% of the total size of equity and bond markets globally.

Apart from their actual size, SWFs AUM are expected to grow further and, according to recent IMF projections, “to surpass the stock of global foreign exchange reserves in the not-so-distant future and to top $7 to $11 trillion by 2013. Thus it is clear that SWFs will play an increasingly prominent role in global finance”[38]. According to other projections, "SWFs could potentially grow to US$17.5 trillion in the next 10 years, compared to a figure of around US$10 trillion for official reserves. During this time, total global financial assets could roughly double. By about 2020, the share of SWFs in global wealth is almost four times higher, growing from around 2.5% of global financial assets to over 9%"[39].

Charts 6 and 7 in the Appendix illustrate the relative size of overall SWFs AUM compared to other institutional investors and asset classes as well as the relative size of the largest SWFs compared to other large global investors.

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[36] As reported by the U.S. GAO “by analyzing the information reported by individual SWFs, IMF data, and private researchers’ estimates, we found the total assets held by the 48 SWFs we identified are estimated to be from $2.7 trillion to $3.2 trillion […].Many of these estimates were published in the last year prior to the significant rise in oil prices in the first half of 2008”, U.S. Government Accountability Office, (2008), SOVEREIGN WEALTH FUNDS Publicly Available Data on Sizes and Investments for Some Funds Are Limited, Report to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, GAO-08-946, September 2008, p. 18.

[37] Bank of England, Sovereign wealth funds and global imbalances, Quarterly Bulletin, 2008 Q2, p. 199.

[38] International Monetary Fund (IMF), 2008, Financial Stress, Downturns, and Recoveries, World Economic Outlook, October 2008, p. 204.

[39] Morgan Stanley, Sovereign Wealth Funds and Bond and Equity Prices, June 01, 2007.

With specific reference to the expectation that the overall size of SWFs AUM could exceed the size of global FX reserves within a few years, recent projection (taking into account the adverse impact on SWFs exerted by global financial crisis and fall in equity and oil prices) revised down the expected growth rate of SWFs AUM. As a result "this 'cross-over' date may be delayed by three years and that, by 2015, instead of US$11.9 trillion, total AUM of SWFs of US$9.7 trillion now looks like a more realistic target"[40].

Nevertheless, available data indicate that some SWFs are already bigger than the FX Reserves in the relative sponsor country, somehow confirming that SWFs have complemented, or even replaced, the "traditional" accumulation and management policies of FX Reserves, as these institutions aim at better diversifying risks and generating higher returns than traditional official reserves, typically invested in low-yielding government securities.

On the other hand, **Chart 8** in the Appendix clearly shows that with reference to China and Russia, even if the respective SWFs were subject to a strict statutory transparency and disclosure regime or other regulatory measures, such measures could however capture within their scope only a small amount of the wealth and "monetary power" of the same countries.

Such statement of fact raises another relevant issue: even assuming a commonly generally accepted definition of which specific investment vehicles should be regarded as SWFs existed, who would then decide when a government investment vehicle is to be actually considered a SWF and thus abide by certain rules or disclosure regime?

For instance, it could be disputed whether the Chinese State Administration of Foreign Exchange (SAFE) is to be regarded as a SWF or not. In other words, the key issue here is that sovereign states always retain the power to modify their internal legal framework and legal arrangement in order to move/modify boundaries between their public bodies and organisations and private entities, and/or between SWFs (however defined) and other investment vehicles – e.g. in order to opt in or out possible statutory or self-regulatory regime devised for SWFs.

At the end of the day, devising a sound legal definition of SWFs may not be sufficient to avoid possible strategic behaviour or regulatory arbitrage by sovereign investment vehicles. Thus it would also be necessary to identify a subject, independent from SWFs sponsor countries and other stakeholders, entitled to decide whether or not a government investment vehicle is to be treated as a SWF.

[40] Jen S. and Andreopoulos S., (2008), SWFs: Growth Tempered – US$10 Trillion by 2015, Morgan Stanley, Global Economic Forum, November 10, 2008.

5. What lies behind SWFs rapid growth?

The (partial and vague) data available indicate that in recent years SWFs have exponentially grown in size, number and prominence (assets estimated to be under the management of principal SWFs increased 18% in 2007 and 14% in 2008). Consequently the total value of assets managed (directly or indirectly) by SWFs is to be considered "already large enough to be systemically important, and their growth clearly has implications for the international financial system"[41] and the global economy[42].

The main triggers of SWFs sudden and rapid growth can be essentially identified in:

- the exceptional and rapid increase in oil price (which results in high revenues to oil exporters – e.g. Middle Eastern Countries, Russia, and Norway);

- the large balance of payment surpluses posted by several emerging economies (mainly by Asian exporting countries) and the relative unparalleled sustained accumulation of FX Reserves by the same countries (esteemed in the range of 3.1 trillion USD by end 2006)[43]. According to certain estimates, the increase in FX Reserves was particularly sharp in China, deemed to hold more than 1 trillion USD of foreign assets[44] (**Table 2 and Chart 9**).

Such accumulation of FX Reserves was fostered (*inter alia*) by the significant balance of payment deficit run by Western Countries (not only the US but also Australia, New Zealand, the United Kingdom, Spain, Greece and Portugal) and in certain cases also by the exchange rate management policies adopted by some Asian countries (firstly China) in order to preserve their exports'

[41] Statement by Deputy Assistant Secretary Robert Dohner before the U.S.-China Economic and Security Review Commission, February 7, 2008 (HP-873).

[42] In this respect, as reported, "IMF officials have stated that collecting additional data on SWFs is important because of the fiscal, monetary, and economic policy impacts that the funds could have for IMF member countries and for the global economy, given their increasing prevalence and growth", U.S. Government Accountability Office, (2008), SOVEREIGN WEALTH FUNDS Publicly Available Data on Sizes and Investments for Some Funds Are Limited, Report to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, GAO-08-946, September 2008, p. 16.

[43] Mohanty M. S. and Turner P., (2006), Foreign exchange reserve accumulation in emerging markets: what are the domestic implications?, BIS Quarterly Review, September 2006, pp. 39-52; European Central Bank, Annual Report, 2007, p. 178; McKinsey Global Institute, (2007), The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets, October 2007.

[44] European Central Bank, Annual Report, 2007, p. 17.

competitiveness, all compounded with integration and liberalisation of international flow of capital.

In such a scenario, the sustained growth of SWFs size and number is likely to continue over the coming years due to the expected trend in their typical source of funding – i.e. excess reserves accumulated from balance of payment surpluses and fiscal surpluses from the export of natural resources (primarily oil and gas).

Indeed, as reported: *i*) official reserves have exhibited an "annual average growth rates of 11% over the past 20 years, 15% over the past ten years and even 22% in the last five years" and "there are no material indicators that strong growth of official reserves will not continue to prevail in the short and medium term"; *ii*) current account surpluses in China, Russia, emerging Asian economies and OPEC countries "can be expected to rise further; *iii*) although possibly influenced by short term factors, oil and gas prices can be expected to remain high due to the steady rise in their consumption"[45].

The general market consensus is that the sustained growth in SWFs size and number is likely to continue over the coming years, as estimates of the SWFs growth rate in the next five years vary, ranging from 5% to 35% (**Chart 10**). However, due to the adverse impact of the recent global financial and economic crisis and the fall in global equities, commodities prices and export growth rates (which may result, *inter alia*, in slower accumulation of foreign exchange reserves in Asian countries) estimates for SWFs growth rate were scaled back from previous forecasts even as recently as mid-2008. With an estimated 3.0-3.5 trillion USD AUM at present, according to the U.S. GAO "SWFs are predicted to continue to grow significantly, to between $5 trillion and $13.4 trillion by 2017"[46], while the IMF expects collective assets at SWFs disposal to grow to 7-11 trillion USD by 2013[47]. According to other recent estimates, although the "18% average annual growth seen over the past three years is likely to slow somewhat in the next few years […] projections are that SWFs are likely to double from their […$3.9 trillion…] current level to around $8 trillion in 2015"[48].

Of course, actual SWFs growth rate will be significantly influenced by several economic factors, such as: trend of oil and other commodities prices; economic growth posted by Asian countries and other emerging/transitioning economies; persistence in trade imbalances; international exchange rate policies;

[45] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 5. In particular the author reported that "by end-2007, global central bank reserves had risen 27% on the previous year, driven by reserves in Asia (31%), the Middle East (35%), and Latin America (47%). Reserves in the industrialised world, by comparison, grew by a mere 8% in that period".

[46] U.S. Government Accountability Office, (2008), SOVEREIGN WEALTH FUNDS Publicly Available Data on Sizes and Investments for Some Funds Are Limited, Report to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, GAO-08-946, September 2008, p. 25.

[47] International Monetary Fund (IMF), 2008, Financial Stress, Downturns, and Recoveries, World Economic Outlook, October 2008, p. 204.

[48] IFSL, Sovereign Wealth Funds 2009, p. 1.

FX reserves accumulation trend; the effect of society ageing on public pension systems; political reactions to SWFs investments and broader political issues; financial return on SWFs investments; the effects of the global crisis and economic downturn.

For instance, according to some estimates, if "reserve accumulation returned to more moderate growth rates as witnessed on average over the past 20 years, these figures could turn out lower. SWF assets would then end up at around USD 4.2 tr in 2010 and just over USD 7 tr in 2015. If, on the other hand, reserve accumulation continued at the pace observed in recent years, SWF asset accumulation would accelerate further, bringing the total to over USD 5tr by 2010 and USD 14tr by 2014"[49].

On the other hand, a recent Working Paper presenting a model for estimating the size and likely growth of Sovereign Wealth Funds in the countries of the Arabian Gulf under different assumptions about oil prices, examined "the impact of $25, $50, $75, and $100 oil on the Gulf's foreign asset growth. If oil averages $75 a barrel over the next five years, the portfolio of the […Gulf Cooperation Council[50]…] official sector would rise to $1.7 trillion. If oil averages $100, it will reach $2.1 trillion. Conversely, if oil averages $50 a barrel, most Gulf countries would need to curtail spending and planned investment projects to avoid a sustained drawdown of their foreign assets – continued interest and dividend payments would keep external assets relatively constant with the region's portfolio ending 2012 with $1.4 trillion. At $25 a barrel, the erosion of assets is significant, despite continued returns on existing assets – the Gulf's external position would fall to just over $1 trillion"[51].

Accordingly, only "if oil averages $100 a barrel or more over the next five years, the GCC's assets will resume their rapid expansion and expand to $2.2 trillion by 2012. Even so the region would fall well short of generating the massive sovereign funds implied by those who project that the assets under management by sovereign funds would rise to $10 trillion to $12 trillion in 2012"[52].

However, SWFs are likely to be among the world's fastest-growing groups of institutional investors (**Chart 11**), and "to become more important participants

[49] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 5. In particular the author reported that "by end-2007, global central bank reserves had risen 27% on the previous year, driven by reserves in Asia (31%), the Middle East (35%), and Latin America (47%). Reserves in the industrialised world, by comparison, grew by a mere 8% in that period".

[50] Members of the GCC include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

[51] Setser B. and Ziemba R., (2009), GCC Sovereign Funds, Reversal of Fortune, working paper, Council on Foreign Relations (Center for Geo-economic Studies), January 2009, p. 6.

[52] *Ibidem*, p. 18.

in global financial markets over the coming years as inflows from trade surpluses and commodities exports continue"[53].

In this respect, in addition to the expected increase in the current SWFs size, essentially "fuelled by the continued inflow from government revenues or excess reserves"[54], it has been rumoured that new SWFs might be established by Bolivia, Brazil, Canada, India, Japan[55], Nigeria, Saudi Arabia, Taiwan and Thailand (**Table 3**).

With reference to the distinction between "commodity funds" and "non-commodity funds", "commodity funds" turn out to be currently larger that "non-commodity funds", although the latter are expected to grow faster than the former "capturing an increasing share of global SWFs, and their 36% share at the end of 2007 may increase to 40% by 2010 and around half by 2015"[56].

6. SWFs investments: facts, figures and trends

Besides their growth in size and number, significant changes occurred also in SWFs use of funds and risk appetite, essentially resulting in greater diversification and shifting from sovereign debt to private equity instruments and other assets classes, as well as in increasing activism in the markets, making them emerge as among the most important institutional investors, although of a special "lineage". As a result, approximately two-thirds of all SWFs investments reported between 1995 and 2008 were undertaken as of mid-2007. As noted, "this concentration primarily reflects the large investments in financial institutions in the US and Europe as observed in the wake of the financial crisis"[57].

SWFs essentially aim at better diversifying risks and generating higher returns than traditional official reserves management by Central Banks and Monetary Authorities. As a result, "in searching for greater yield, the diversification of SWF's portfolios from traditional low-risk and highly-liquid assets (for example, government bonds) to other securities and derivatives could increase liquidity in formerly illiquid corners of the markets"[58] and deliver

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[53] IFSL, Sovereign Wealth Funds 2009, p. 1.

[54] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 4.

[55] The establishment of a Japanese SWF is considered particularly likely, as Japan is deemed to hold an amount of reserves greatly exceeding its currency stabilisation needs while experiencing pressure on national budget due to its weak fiscal position and ageing population trend (S.L. Jen, Why Japan Should Have Its Own Sovereign Wealth Fund, Morgan Stanley Research Global, 2007).

[56] IFSL, Sovereign Wealth Funds 2008.

[57] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 7.

[58] Financial Services Authority, Financial Risk Outlook, 2008, p. 54.

benefits usually attached to the presence of large shareholders and institutional investors.

A "malicious observer" could however stress that SWFs may easily invest not (or not only) on the basis of purely financial/commercial grounds but upon biasing strategic/political considerations, thus raising both "corporate governance" and "national interests" concerns in recipient countries.

Leaving the issue aside, for the time being, at first sight the presence (or better the gain in prominence) in the global financial system of investors such as SWFs should be considered as positive development, as they typically are: *i*) large; *ii*) highly liquid (i.e. with very limited constraints in managing their assets); *iii*) long-term investors; *iv*) not significantly leveraged; *v*) with relatively high-risk tolerance; *vi*) less sensitive to market conditions than Hedge Funds, Private Equity and other institutional investors; *vii*) prone to diversification (from traditional low-risk, high-liquid, and low-return assets) in searching for greater yield.

Due to their characteristics (mainly: long-term investment horizon, little concern for liquidity and lack of explicit liabilities) SWFs are generally regarded as possible stabilising forces in the global financial market[59].

Indeed, despite the general lack of a mandatory transparency regime on their investment strategies, assets allocation and portfolio composition, the general opinion is that SWFs (notably savings and heritage funds) do not follow a "hit and run" approach in their investment decisions; instead their long-term investment horizon contributes "to the broadening of the long-term investor base for risky assets, such as equities, corporate bonds, emerging market assets, private equity and real estate. In this regard, such funds could become a more stable investor base for risky assets in certain markets. In addition, provided that the investments of such funds are driven entirely by risk and return considerations, SWFs may contribute to a more efficient allocation and diversification of risk at the global level"[60].

Furthermore, SWFs are well placed to invest in periods of market stress, by supplying liquidity where it may be strongly needed and in illiquid corners of the market – e.g. "when the global equity market fell sharply between 2000 and 2002, the Norwegian Government Pension Fund was a large buyer of global equities"[61].

SWFs ability to act as a stabilising force and a significant source of liquidity in global financial markets was confirmed and highlighted during the current financial markets crisis by the significant (and welcomed) stabilising role

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[59] See Kern S., (2007), Sovereign Wealth Funds – State Investments on the Rise, Deutsche Bank Research, 2007.

[60] European Central Bank, Financial Stability Review, December, 2007.

[61] Bank of England, Sovereign wealth funds and global imbalances, Quarterly Bulletin, 2008 Q2, p. 199.

played by some SWFs in recapitalisation of some of the biggest US/EU commercial and investments banks negatively affected by recent "turbulences" in the financial markets (**Table 4 and 5**).

In fact, it has been assessed that since the spread of the sub-prime crisis in 2007 SWFs have invested between 60 billion USD and 92 billion USD in return of large minority stakes in financial institutions[62] (generally lower that 10%), "over two-thirds of the capital invested in foreign financial institutions in 2007 and early 2008 came from Asian SWFs (13% from China), with Middle Eastern SWFs generating the remainder"[63]. Although SWFs consequently acquired a significantly influential position in such companies (recently "counterbalanced" by the equity investments also undertaken by EU[64] and US governments under their national rescue measures and support schemes for banks and financial intermediaries), they typically avoided taking controlling stakes and mainly behaved as "passive institutional shareholders"[65]. In this respect, even when they became "the largest single shareholders in individual banks – which usually puts an investor in an elevated position – the state funds have so far refrained from claiming board seats and playing a role in either the strategic approach or the day-to-day operations of their investments"[66], probably also to avoid additional regulatory and supervisory burdens.

For instance, the US Foreign Investment and National Security Act of 2007 (FINSA)[67] provides for the Committee on Foreign Investment in the United States (CFIUS) review and investigation of "covered transactions" (to be completed within 30 days) to determine the transactions effect on national security and address national security concerns. In this respect, a "covered transaction" stands for "any transaction proposed or pending after 23August 1988, by or with any foreign person, which could result in <u>control</u> of a U.S. business by a foreign person"[68].

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[62] Banca d'Italia, Economic Bulletin, n. 51/2008; Citi, Sovereign Wealth Funds: A Growing Global Force, 2008; Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 9.

[63] IFSL, Sovereign Wealth Funds 2008, p. 2.

[64] See: Communication from the Commission - The application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis (2008/C 270/02).

[65] A recent analysis on the stock price impact of SWFs investments suggested "that SWF investments have a strong positive effect on stock prices around the announcement date and no substantial effect on operational performance and corporate governance outcomes, consistent with the empirical evidence on the investment behaviour of passive institutional shareholders", Kotter J. and Lel U., (2008), Friends or Foes? The Stock Price Impact of Sovereign Wealth Fund Investments and the Price of Keeping Secrets, November 1, 2008, p. 6 (see also: Karpoff J. (2001) - The impact of shareholder activism on target companies: a survey of empirical findings. Unpublished working paper. University of Washington).

[66] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 12.

[67] Pub. L. 110-49, 121 Stat. 246, which amends section 721 of the Defence Production Act of 1950 ("DPA") (50 U.S.C. App. 2170).

[68] US Department of The Treasury, Guidance Concerning the National Security Review Conducted by CFIUS, billing code: 4810-25, 12/1/2008.

The new final regulations governing CFIUS issued by the U.S. Treasury Department on 14 November 2008 by clarifying, inter alia, the key concept of "Control" confirm that a "functional test" must be followed by CFIUS – i.e. CFIUS shall consider all relevant facts and circumstances rather than applying a bright-line test to determine whether a transaction results in foreign control (e.g. while expanding the illustrative list of "important matters", control is defined as the "power, direct or indirect, whether or not exercised … to determine, direct, or decide important matters affecting an entity"). Moreover, with reference to the exclusion of "passive investment" from CFIUS review, the new regulations clarify that "there is no automatic exclusion for acquisitions of ten percent or less. That rule applies only if the investor is passive, maintains that sole intent, and takes no action to the contrary"[69].

As a result, it is evident that the new regulations intentionally omit "any bright-line rules regarding control, instead requiring CFIUS to consider all relevant facts when determining whether a foreign entity controls a U.S. business. Although practitioners had previously focused on a 10% safe harbour threshold below which CFIUS would not find control, the final regulations explicitly reject the 10% threshold as a safe harbour, except when the investment is solely for the purpose of "passive investment"; therefore, this exception does not apply if the foreign entity plans or intends to gain control over the U.S. business"[70].

While attracting the attention (and sometimes concerns) of the wider public on SWFs potential influence on developed countries' economies, the significant engagement in the US and EU financial sectors is believed to have delivered substantial "reputational benefits" to SWFs. Indeed "following their investments in the financial industry – at a time when some banks were facing serious problems with regard to their capitalisation, and conventional, market-based sources of capital had dried out – SWFs have experienced a more benign reception in the US and Europe, with policymakers and the wider public recognising the helpful role they played in a critical phase of market developments"[71].

The sharp decline in the market value of financial firms hit by the sub-prime crisis (e.g. Citigroup, Merrill Lynch, Morgan Stanley, and UBS) was probably one of the main triggers of recent SWFs remarkable interest in the financial sector and clear sectoral bias of their investments: SWFs investments in financial institutions compared to the value of total SWFs investments increased from 3.8% in 2006 to 93.3% by January 2008 (**Charts 13 and 14**).

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[69] US Department of The Treasury, CFIUS Reform: Final Regulations Issued on November 14, 2008, 11/14/2008.

[70] Hogan J. and Martin T., (2008), Final CFIUS Regulations on Reviewing Foreign Investments in the United States, Torys on Mergers and Acquisitions, M&A 2008-10, November 26, 2008, p. 1.

[71] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 10.

This "could be an indication that some SWFs pursue mean-reverting investment strategies. However, the stabilising market impact of these investments has been short-lived, as stock prices tended to decline further following the SWF acquisitions while CDS spreads narrowed moderately"[72] (**Chart 16**).

In this respect, coeval factors contributing to the recent sharp increase in SWFs acquisition of shareholdings in EU and US financial firms have been identified in[73]: *i)* the abundant liquidity and availability of funds allowing substantial buying power; *ii)* the "*per se*" attractiveness of financial sector as an investment target due to the high "return on equity" for banks ("6.9% in the EU-25 and 12.3% in the US in 2006") and their "substantial growth and profitability potential in the medium and long run"; *iii)* the transitional attractive investment opportunities for long-term investors provided by the sub-prime related financial crisis and relative substantive fall in the share price of banks and other financial institutions (the market value of most major banks is estimated to have fallen to between 60% and 20% since mid-2007); *iv)* the long-run strategic and commercial benefits for SWFs and their sponsor countries' financial and industrial sectors deriving from direct participation in large and well-established banks and financial firms; *v)* the possibility to build trust and increase their reputation as credible and reliable institutional investors by playing a helpful role in recapitalisation of EU and US distressed financial institutions.

That said, it is interesting to note that: *i)* the financial sector proved to be the most alluring to SWFs not only in 2007 and 2008 but even prior to the credit crisis; *ii)* the overall volume and value of deals performed in such sector were proportionally higher than in other relevant sectors, both in the EU (with the UK attracting the largest share of SWFs capital flows, net of investment in the financial sector) and US, as well as in Asia (**Charts 17–20**).

Although recent SWFs large capital injections in distressed financial institutions obviously bias the overall picture, data available indicate that investments in the financial sector have been the dominant SWFs investment pattern in the US, while in the EU and Asia SWFs investments followed a more balanced sectoral distribution.

Such prominent interest in the EU and US financial sector by SWFs is considered to have reached its peak and is thus expected to fade away – at least for a while – due to the compounded effect of different factors. For instance, as a result of the large equity investments in financial institutions performed as of mid-2007, SWFs as a group – and in particular a restricted number of most exposed SWFs – may now be in the need of reducing the concentration risk in their

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[72] European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by Beck R. and Fidora M., Occasional Paper, n. 91/2008, p. 12.

[73] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, pp. 9-10.

portfolio and increasing their diversification by investing their wealth in other sectors.

Moreover, even though SWFs were invested in EU and US banks and financial intermediaries when their market value was very low, “share prices have fallen further. By mid-October 2008, the decline in bank share prices since the date of the respective SWF investment had ranged from 19% up to 66%. Emergency measures, such as recapitalisation and mergers, are set to have substantial implications for sovereign stakeholders that most likely were not part of the original investment rationale”[74].

The significant losses so far incurred by SWFs on their portfolio, the still volatile and uncertain conditions afflicting both global financial markets and the real economy, associated with the uncertainty surrounding the expected political and regulatory response, are likely to induce SWFs to take an extremely cautious approach versus further involvement in the EU/US financial sector in favour of alternative allocation of their wealth, at least for the time being.

7. Main concerns on SWFs investments: what is the fuss all about?

Considering the potential benefits attached to SWFs investments, it is not instinctive to understand why SWFs investments (especially in equity) are so controversial both in the US and EU.

The main sources of concerns can be summarised as follows:

- Blurring boundaries between private and public investors: reintroducing, via the “back door”, public ownership into market economy, counteracting development towards a more market-based financial system;

- Lack of transparency: this may interfere with markets efficiency, harming competition and limiting the positive effects arising from stronger "market discipline". Moreover, the lack of reliable information hampers proper assessment of "SWFs phenomenon" developments and identification of potential sources of systemic risk. For instance, it negatively affects the reliability of IMF instruments aimed at increasing transparency on the level and composition of FX reserves (e.g. "Currency Composition of Official Foreign Exchange Reserves" data base (COFER) and “Data Template on International Reserves and Foreign Currency Liquidity”, which is part of the Special Data Dissemination Standard, SDDS);

[74] *Ibidem*, p. 2.

- Political/strategic purpose of investments: the main concern is that SWFs might take investment decisions not based on purely economic/financial considerations but biased/driven by political and/or strategic objectives;

- Adverse impact on corporate governance efficiency: SWFs may impose additional "agency costs" by forcing a portfolio company to act in their own interest against the interest of other stakeholders;

- Strategic relevance of investments: the acquisition of significant stake in foreign "national champion" or strategic industries/assets could give stance to foreign government intervention to protect national interests and/or national security;

- Geopolitical implications: the significant acquisition of foreign assets in developed countries is *per se* likely to raise political concerns and pressure for protectionism actions;

- Concentration of monetary/financial power (impact on global financial system): the sheer size and scopes of SWFs rise concerns as to the impact of their investment decisions on global financial markets and assets prices (e.g. risk of equity price bubbles and increase in volatility) and the conduct of monetary and exchange policies (e.g. decline in demand for treasury bonds);

- Domestic reactions: taxpayers in SWFs sponsor countries may question the way SWFs invest their (public) resources (e.g. as reported, earlier in 2007, the acquisition of a ten percent stake in Blackstone was very vocally criticised by the Chinese press[75]);

- Target companies' shareholders reaction: UBS faced a backlash from investors thinking they were not offered the opportunity to underwrite new capital on the same terms offered to GIC (FT, 23.1.08).

Having said that, the terms of the debate have been mainly revolving around the risks attached to the lack of transparency on SWFs investment strategies and shareholdings. For instance, it has been argued that the lack of transparency by SWFs (with the significant exception of the Norwegian Pension Fund) may mask "market abuse" and "insider trading" practices, raising the cost of capital and undermining market confidence.

In this respect, however, it has been correctly pointed out (Gilson R. J. and Milhaupt C. J. – 2008) that SWF "lack of transparency cannot itself be the

[75] Fotak V., Bortolotti B., Megginson W., (2008), The financial impact of Sovereign wealth fund investment in listed companies, June 2008.

problem, and as a result of that greater transparency cannot itself be the solution"[76].

Indeed, achieving a fair degree of transparency is to be regarded just as an "intermediate target" aiming to attain other ultimate policy objectives and not as an objective itself.

It is also fair to say that any shareholder/investor is not *per se* transparent (e.g. Hedge Funds and Private Equity Funds) unless required or imposed to do so.

For instance, it is easy to observe that US and EU laws and regulations provide for a considerable comprehensive mandatory disclosure regime (e.g. when major holding in a listed company is acquired or disposed[77]; in case of acquisition and disposal of “qualifying holding” in banks, insurance, financial intermediaries, mutual funds and other regulated subjects[78]; with reference to shareholders' agreements and indirect holdings) where transparency is considered an important tool to achieve certain ultimate objectives (e.g. sound and prudent management of financial intermediaries, stock market integrity; investors protections, etc.). This set of rules and regulation is in principle applicable to SWFs and may serve to achieve the desired degree of transparency on SWFs equity investments without imposing further regulatory burdens.

At the same time, the existence of non-transparent investors is also allowed under EU and international regulatory frameworks (e.g. no significant disclosure rules are usually imposed on “private companies”).

Therefore, when it comes to SWFs the real concern appears to be not exactly or better not only related to their transparency, rather to their likely strategic/political motives in addition to (or instead of) pure commercial/financial motives when investing.

As a result, a fair reading of the current debate should strongly suggest that the real fear or concern is that SWFs may use their influence on portfolio companies:

- to secure technology (an explicit concern in the discussion of the Abu Dhabi Fund’s investment in AMD);

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[76] Gilson R. J. and Milhaupt C. J., (2008), Sovereign Wealth Funds and corporate governance: a minimalist response to the new merchantilism (February 18, 2008), Stanford University Law and Economics Olin Paper No 355, Columbia University Law and Economics Olin Paper No 328 (http://ssrn.com/abstract=1095023), p. 17.

[77] See Articles 85-97 of Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities.

[78] E.g. see Articles 12, 19-21 of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking-up and pursuit of the business of credit institutions.

- to gain access to natural resources, know-how, or confidential information;

- to improve competitive positions for domestic companies;

- to gain competitive advantages;

- or in a fashion entailing national security concerns for portfolio companies' country of incorporation.

Leaving aside, for the time being, concerns related to national security and other national interests, it is evident from a microeconomic perspective that a conflict of interests among shareholders (and stakeholders) may arise, thus harming the position of some shareholders versus others, similarly to what may happen in groups of companies (e.g. between the holding company shareholders and shareholders of other companies in the group subject to control or dominant influence exerted by the holding company), with detrimental effects on corporate governance efficiency.

Indeed, a SWF may not be necessarily interested in maximising the value of its portfolio companies' shares, as it should be, instead, the case for "normal" public companies' shareholders.

In particular, this could happen whereby a SWF manages to extract value from portfolio companies' activities :

- in ways other that the mere holding of shares in that company;

- not accessible to the other shareholders.

In this case, a given SWF could enjoy a (private) incentive to exploit portfolio companies in order to achieve its own private interests. Such private incentives may lead a SWF to impose goals and priorities not necessarily consistent with maximisation of its portfolio companies' value, thus impairing the efficiency of corporate governance mechanisms, leading to increasing agency costs and declining firms/shares value and possibly squeezing out minority shareholders.

Due to its "political nature", a SWF is perceived as being strongly prone to adopt investment strategies based on strategic/political motives in addition to (or instead of) only purely commercial, financial motives — e.g. by transferring know-how, technology or other resources from a portfolio company, despite reducing the value of such portfolio company[79]. Indeed, it will be in the position to suffer

[79] It has been noted that "SWF investments may lead to poor financial performance and inefficiency in target firms, as state-owned enterprises have additional objectives besides return maximization such as achieving political and social goals. A large body of literature suggests that state ownership is associated with poor financial performance inefficiency, and weak managerial incentives", Jason Kotter and Ugur Lel, Friends or

just part of the value loss of its portfolio company, while keeping all the benefits arising from transfer of resources.

In other words, a SWF with private interest can benefit from an improper transfer of wealth versus other shareholders, with negative effects on corporate governance mechanisms, stock price "signalling" value, overall stock market efficiency and firms' performances, thus making possible regulatory or judicial interventions desirable also from an economic point of view.

7.1. SWFs equity investments impact on listed companies

According to corporate governance theories, general consensus is that, in principle, equity investments by large institutional shareholders are likely to exert a positive impact on firms profitability through better corporate governance and, in particular, through the so-called "monitoring effect" – i.e. large institutional shareholders have strong incentives (and are able) to strengthen monitoring on company's managers and firms performance while, on the other hand, small shareholders lack such incentives (Shleifer and Vishny)[80]. For instance, larger shareholders turn out to have increased likelihood of hostile takeover or managers' replacement in case of poor performances, as well as portfolio firms' performance and directors' turnover[81].

At the same time, however, a different strand of research points out that large shareholders are likely to impose "agency costs" on firms as a result of a possible "conflict of interest" with other shareholders and stakeholders – i.e. large shareholders might force a portfolio company to act in their own interest, against the (legitimate) interest of other shareholders, investors, employees, managers, creditors and stakeholders (Jensen and Meckling)[82].

Moreover, it has also been suggested that if large shareholders are not sufficiently diversified they may impose additional costs on firms, being keener to excessively reduce company specific risks (Demsetz and Lehn)[83].

Foes? The Stock Price Impact of Sovereign Wealth Fund Investments and the Price of Keeping Secrets, November 1, 2008 pp. 1-2.

[80] Shleifer A. and Vishny R.W. , (1986), Large Shareholders and Corporate Control, Journal of Political Economy, Volume 94, Issue 4, Pages 461-488; Shleifer A. and Vishny R.W., (1997), A Survey of Corporate Governance, The Journal of Finance, Volume 52, Number 2, pages 737-783.

[81] Shivdasani A., (1993), Board Composition, Ownership structure and hostile takeovers, Journal of Accounting and Economics, Vol. 16, Issue 1-3, pp. 167-198.

[82] Jensen M.C. and Meckling W.H., (1976), Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure, Journal of Financial Economics, Vol. 3, 1976, pp. 303-360.

[83] Demsetz H. and Lehn K., (1985), The Structure of Corporate Ownership: Causes and Consequences, The Journal of Political Economy, Volume 93, Issue 6, pp. 1155-1177.

As a matter of fact, theoretical and empirical studies on the relationship between ownership concentration and firm performances highlighted that a trade-off actually exists between concentrated ownership benefits (higher profitability through better monitoring) and related costs (risk of exploitation and/or "asset stripping")[84].

In particular, it has been observed that initially higher concentration leads to higher profitability (through increased monitoring and reduction of agency costs). Nevertheless, as ownership concentration increases, largest owners gain incentives to take exclusive advantages of their positions, exploiting private benefits not shared by minority shareholders and other stakeholders.

SWFs tend to be large investors, thus capable of improving corporate governance of their portfolio companies through better monitoring effect. At the same time, being state-backed, they appear particularly likely to impose additional "agency costs" on their portfolio firms – e.g. because their assets allocation and management are <u>not always necessarily driven by risk-adjusted profit maximisation motives</u>, and/or <u>simply by virtue of their low transparency breeding uncertainty</u> as to their behaviour as shareholders.

In this respect, a recent empirical research by Fotak, Bortolotti, and Megginson (2008)[85] – sampling 75 investments originated from 16 SWFs and related to 62 companies in 23 countries[86] – on the financial impact and profitability effect of SWFs investments in stocks of listed companies (proxied by abnormal returns of target stocks over 30, 60, 120, 240 and 480 trading days) revealed that: "in the two years (one year) following SWF investment, shares of target firms average <u>an abnormal buy-and-hold return of negative 40.96%</u> (negative 18.17%), which is statistically significant at the 10% (10%) level and clearly economically significant as well", suggesting that equity acquisitions by SWFs are followed by deteriorating target firms' long-term performance.

The research authors were therefore led to conclude that SWFs "have negative impact on firm profitability, perhaps, by imposing additional agency costs" not overweighed by benefits related to better monitoring.

At the same time no evidence of a significant relationship has been found neither between the magnitude of the abnormal return following SWFs investments and the share of equity acquired (i.e. the larger the share of equity acquired the stronger the expected "agency costs" effect), nor between the investing SWF governance and the investing SWF level of transparency. The

[84] Stulz M. R., (1988), Managerial control of voting rights, Journal of financial economics, Vol. 20, pp. 25-54.

[85] Fotak V., Bortolotti B., Megginson W., (2008), The financial impact of Sovereign wealth fund investment in listed companies, June 2008.

[86] The sample was restricted to purchases of shares of equity of publicly traded firms, disregarding direct investments and debt financing.

authors suggest it might be due to the limited sample size and predictors' lack of variability.

Additionally, the authors investigated how the market assesses/anticipates SWFs investment potential impact on target firms. Surprisingly, they found out stocks of targeted corporations exhibiting "significantly positive abnormal returns averaging about 1% on the day on which the SWF investment is announced", showing a short-term welcome/optimistic attitude towards SWFs as shareholders, despite their predicted detrimental long-term impact on portfolio firms' profitability.

The positive market reaction to SWFs capital injection could have been explained as the result of most of the recent SWFs investments occurred in distressed financial institutions, in urgent need of liquidity. Nevertheless, after in-depth examination, the authors of the empirical analysis were "forced to conclude that the positive short-term market reaction is not due to liquidity influxes in distressed companies" and were unable to offer an alternative valid explanation for the positive short-term market reaction.

One possible explanation to such puzzling result may suggest that SWFs investments in distressed financial corporations just mitigated their problems – i.e. in the absence of SWFs capital injection, deterioration in target firms' performances would have proven even worse.

A similar analysis (as to the initial stock price impact of 163 announcements of SWF investments in firms from 28 countries) carried out by Kotter and Lel (2008)[87] on SWFs investments wealth effects on target firms' shareholders and on whether higher SWF transparency alleviates concerns on SWFs documented that "a risk-adjusted abnormal return of about 2 percent on the three-day window surrounding the announcement date. In dollar terms, the mean (median) firm's market value increases by $327 million ($60 million) in the first two days of the SWF investment announcement. The magnitude of the average CAR is similar to the announcement effects of investments by institutional investors on stock returns for a comparable event window (e.g. Wahal, 1996), indicating that SWF investments convey a positive signal to market participants about the future risk-adjusted returns of target firms".

In addition, the analysis revealed that "investors react negatively to the announcements of SWFs exiting the firm" and "that SWF transparency plays a major role in determining investors' reaction to the SWF investment announcement". By using the Truman scoreboard[88] to evaluate the SWFs structure, governance, accountability, transparency and behaviour, the analysis

[87] Kotter J. and Lel U., (2008), Friends or Foes? The Stock Price Impact of Sovereign Wealth Fund Investments and the Price of Keeping Secrets, November 1, 2008.

[88] Truman E. M., (2008), A blueprint for sovereign wealth fund best practices, Peterson Institute for International Economics, Policy Brief No. 08-3, April 2008.

authors suggest that SWFs may pay a price for their lack of transparency – indeed they found that firms experience higher Cumulative Abnormal Returns (CAR) if the investing SWF "ranks higher in terms of its overall disclosure standards". For instance, they document that "the average CAR is more than 3.5 percentage points higher for firms targeted by SWFs that are subject to independent audits or make annual reports publicly available. This finding suggests that investors use voluntary SWF disclosure as a signal of the quality of screening and monitoring by SWFs". Not only target firms' existing shareholders, but also SWFs are deemed to benefit from voluntarily improved transparency.

According to the research authors, the reasons underlying the positive market reaction to SWF investments turn out to be different. For instance, the fact that significantly higher abnormal returns (i.e. highly positive market reactions) are usually positively associated with higher likelihood target firms' financial distress "suggests that SWF investments are particularly valuable for firms in greater need of capital in times of financial difficulty, and serve as a certification of the firm's long term economic viability". Moreover, "the positive market reaction may also emanate from investors' expectation that as strategic investors, SWFs can recapitalize the target firm in case of future financial difficulties". On the contrary, no evidence has been found that positive Cumulative Abnormal Returns "are driven by a temporary liquidity effect generated by block purchases of SWFs".

Finally, finding that – compared to a control sample of firms – "target firms do not experience any robust and statistically significant change in profitability, growth, investment, and corporate governance environment in the three year period following the SWF investment" the authors assumed "that SWFs do not improve firm value in the long run, implying that shareholder activism is not common among SWFs, consistent with the empirical evidence documented for U.S. institutional investors".

According to another (less extensive) provisional assessment of SWF investments impact on the share price of a panel of banks (i.e. Deutsche Bank, Citigroup, UBS, Merrill Lynch, Morgan Stanley, Credit Suisse, Barclays Bank), based on a selection of the most important markets' recent events, the following main conclusions have been drawn by Kern (2008)[89]: *i)* none of the selected SWF investments actually broke the strong downward trend followed by the share prices of the selected banks between mid-2007 and mid-2008, "one interpretation would be that, without SWF investments, individual stocks may have declined even further or faster, but a comparison of stock performances and especially with the benchmark suggests otherwise"; *ii)* "SWF investments have had no strong or lasting impact on bank share prices", *iii)* "even in cases where an event's impact can be identified, the direction of the impact is not homogeneous", both on volatilities and abnormal returns.

[89] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, pp. 13-17.

7.2. SWFs potential impact on global financial markets and international imbalances

SWFs investments stand for a portion of total capital flows between countries and are closely related to global imbalances in trade, indeed they mainly originate from Balance of Payments surplus posted by Asian and oil exporting countries and other emerging economies. As noted, “current account balances are the mirror image of capital flows: countries with current account deficits must import capital to finance these deficits, while countries with current account surpluses export capital to finance the deficits of others”[90].

SWFs recent rapid development reflects that when emerging economies started run current account surpluses also capitals started “flowing uphill” in the global financial markets – i.e. from developing countries (with large “excess reserves”) to rich developed countries (capital is flowing "uphill" mainly because of the US current account deficits and Chinese current account surpluses) – in contrast with the standard economic theory stating that financial capital should, on net, flow from richer developed countries to less wealthy developing and emerging countries.

One of the reasons for such a “paradox” lies in capital flows not being necessarily driven by only basic rate-of-return considerations – e.g. they are strongly biased by liquidity and/or geopolitical considerations.

A recent analysis simulating the impact exerted on global capital flows by an increasing transfer of “excess FX Reserves” to SWFs revealed that under the main assumption that SWFs behave as “CAPM-type investors” and “thus allocate foreign assets according to market capitalisation rather than liquidity considerations, official portfolios reduce their “bias” towards the major reserve currencies. As a result, more capital flows “downhill” from rich to less wealthy economies, in line with standard neoclassical predictions. More specifically, it is found that under the assumption of SWFs investing according to market capitalisation weights, the euro area and the United States could be subject to net capital outflows while Japan and the emerging markets would attract net capital inflows”[91].

The mentioned “paradox” could also be explained by a “global saving glut” due to the significant increase in the global supply of saving over the past

[90] Toloui R., (2007), When Capital Flows Uphill: Emerging Markets as Creditors, PIMCO, Capital Perspective, June 2007.

[91] European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by Beck R. and Fidora M. , Occasional Paper, n. 91/2008, p. 4.

decades. Indeed it has pointed out "a particularly interesting aspect of the global saving glut has been a remarkable reversal in the flows of credit to developing and emerging-market economies, a shift that has transformed those economies from borrowers on international capital markets to large net lenders" (Ben S. Bernanke, 2005)[92]. The impact of the "global saving glut" would also help explain both the increase in the U.S. current account deficit and the currently relatively low level of long-term real interest rates.

In this respect, high domestic savings could also explain the positive correlation highlighted between current account surplus and country's growth rate. In other words, they can explain why foreign capitals do not necessarily flow to fastest growing developing countries. Indeed, it turns out that "one explanation for the positive correlation between the current account surplus and a country's growth rate is that higher growth is associated with – and itself generates – higher domestic savings. In other words, fast-growing countries may need less foreign capital. The problem with this explanation is that, typically, as countries grow (that is, when they experience a positive productivity shock), they should want to consume more (because they are richer) and invest more (because of the investment opportunities). Thus, the correlation should, if anything, be negative. This is where the financial system – especially an underdeveloped one – can play a role. If the financial sector were deep and efficient, a sustained increase in productivity would result not only in more investment (as firms borrow to take advantage of investment opportunities) but also in more consumption as consumers borrow to consume in anticipation of their higher income. Conversely, a weak financial sector could translate a sustained increase in the productivity of certain sectors into weaker investment growth and greater savings growth […]. Another possibility is that weak financial systems may not help in efficiently intermediating foreign capital"[93]. However "the seemingly perverse flows of capital from poor to rich countries today are not necessarily a sign of inefficiencies in global financial markets. Rather, they may indicate financial and other structural impediments that limit a poor country's ability to absorb foreign capital" [94].

Whatever the case, SWFs recent growth is one of the effects of the changing structure of the world's economic output and the large and persistent international imbalances in trade – which may represent a threat to global financial stability.

Indeed, large current account deficit makes, for instance, a country more vulnerable to rapid reversal of capital inflows, and the rapid unwind of external imbalances may produce severe negative impact on the concerned country. As

[92] The Global Saving Glut and the U.S. Current Account Deficit, Remarks by Governor Ben S. Bernanke at the Sandridge Lecture, Virginia Association of Economics, Richmond, Virginia, March 10, 2005.

[93] Prasad E., Rajan R. and Subramanian A., (2007), The Paradox of Capital, International Monetary Fund (IMF), Finance & Development, March 2007, Vol. 44, No1.

[94] *Ibidem*.

reported, "a recent IMF study reviewed 42 episodes of large reductions in current account deficits in developed countries over the past 40 years. In a quarter of the cases, which were mainly countries with limited real exchange rate depreciation, annual GDP growth fell by 3½ percentage points on average"[95]. Also surplus countries are exposed to risks linked to large international imbalances, as foreign exchange inflows require significant sterilisation interventions and may generate higher inflation and asset price bubbles.

That said, SWFs are deemed to play an important role in the (sought) unwinding of global imbalances, which requires domestic demand to be curbed in deficit countries and increased in surplus countries. Demand may be rebalanced through a gradual real exchange depreciation of deficit countries against surplus countries. In this respect, the gain in prominence of SWFs is deemed to be "a sign that surplus countries may be less willing in future to accept such low yielding assets. That should put pressure on exchange rates to adjust and contribute to a reduction in global imbalances" [96].

In line with the consideration expressed above as to causes and effects of the "global saving glut", in order to reduce global imbalances it would also be important to reduce the current large gap between national savings and national investments in Asian and oil-exporting countries.

Apart from the macroeconomic and geopolitical implications of SWFs rapid growth, the increasing transfer of "excess reserves" from central banks and monetary authorities portfolios to SWFs is expected to result in a significant rebalancing of capital flows in the global financial markets, as SWFs are less liquidity-oriented and less risk adverse than monetary authorities in managing the asset side of their balance sheet.

The amount of "excess reserves" of major emerging economies is estimated "to exceed $ 3 trillion or more than half of total official foreign exchange reserves to date"[97] (**Chart 21**).

As SWFs essentially seek to better diversify risks and generate higher returns than traditional reserves management, their investments are likely to lead to an increasing demand for risky assets and declining investments in US treasuries and other government securities. In this respect, 80% of the sovereign

[95] Bank of England, Sovereign wealth funds and global imbalances, Quarterly Bulletin, 2008 Q2, p. 200; International Monetary Fund (IMF), World Economic Outlook (2007), "Exchange rates and the adjustment of external imbalances", April, Chapter 3.

[96] Bank of England, *Ibidem*, p. 201.

[97] The figures result from the following definition of "excess reserves": "foreign exchange reserves in excess of both (i) the difference between actual foreign exchange reserves and the value of three months of imports; and (ii) the difference between actual foreign exchange reserves and total short-term external debt", European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by Beck R. and Fidora M., Occasional Paper, n. 91/2008, p. 14.

investors surveyed reportedly increased their portfolio diversification by adding new assets classes, including equities, corporate bonds and real assets[98].

There is general consensus that the increase in size and number of SWFs "might trigger a diversification not only out of US dollar assets but also out of euro assets, given that official reserves are currently overweight in euro area and US government bonds"[99]. Nevertheless, actual diversification magnitude will be influenced (restrained) by the reserve currency role played by the US dollar and the euro, as well as by restrictions on the currency composition of SWFs investments resulting from their sponsor countries' exchange rate and monetary policy objectives and SWFs own statutory objectives (e.g. stabilisation funds).

Some analyses suggest (Jen and St-Arnaud 2007)[100] that the drop in demand for US Treasuries due to SWFs moving into equity will not be dramatic and very low likelihood exists of US dollar severe depreciation due to divestiture from US markets.

On the other hand, Jen and Miles (2007)[101] noted that "whether national governments and central banks are able to remain committed to riskier portfolios remains to be seen, as their resolve will be tested by periodic draw-downs". However, they estimated that "the emergence of SWFs could, ceteris paribus, push up 'safe' bond yields over the next ten years by 30-40bps and reduce the equity risk premium by 80-110bps". Moreover, possible migration of funds from the US dollar and Euro to emerging market currencies should put upward pressure on the latter (Jen, 2007)[102].

In order to asses the potential impact on global assets price exerted by (i) the reduction in SWFs incremental purchase of US Treasuries, (ii) the selling of a portion of their current US Treasuries and (iii) the reallocation of their investments to global equities and global bonds proportionately to the world market weights, a recent study by State Street[103] assumed that over time the collective asset allocation of SWFs will approximately resemble the asset allocation of a typical pension fund: 60% equities, 30% bonds and 10% alternatives.

With reference to global equity values, it emerged that if SWFs were to allocate 60% of their estimated 3 trillion USD AUM to the FTSE Global All Cap Index, they would own approximately 5.2% of each company in the Index, or

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[98] Survey of Central Banks Reserves, Central Banking, 2008.

[99] European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by Beck R. and Fidora M., Occasional Paper, n. 91/2008, p. 4.

[100] Jen S.L. and St-Arnaud C., (2007), Tracking the Tectonic Shift in Foreign Reserves and SWFs, Morgan Stanley Research Global, 2007.

[101] Jen S.L. and Miles D. K., (2007), Sovereign Wealth Funds and Bond and Equity Prices, Morgan Stanley Research Global.

[102] Jen S.L., (2007), Sovereign Wealth Funds - A Game Changer, Working Paper, 2007.

[103] State Street, Sovereign Wealth Funds, Assessing the Impact, Vision, Vol. III, Issue 2, pp. 25-26.

circa 5.5% of each company in the MSCI All Country World Index. Allocating 60% of SWFs assets to equities is expected to likely reduce the global equity risk premium and increase the real bond yield.

So as to estimate the impact on future capital flows of "excess reserves" reallocation into SWFs, Beck and Fidora (2008)[104] assumed that traditional reserve portfolios are allocated across currencies as reported in the IMF's COFER database, while SWFs follow an allocation strategy similar to private asset managers' (i.e. based on a ten-year average of global market capitalisation weights).

Under this and other simplifying assumptions (e.g. not considering the effect on exchange rates of a large shift out of US dollars and liquidity considerations) it emerged that the shift out of capital to more risky markets due to SWFs investments would trigger:

- "net capital outflows out of US assets at an order of magnitude of around USD 500 billion. This net outflow is entirely due to the large reduction in demand for US bonds". In particular, "the outflow out of the US bond market is partly offset by an inflow into US equity markets, given the large size of US equity markets, which currently account for roughly 45% of world stock market capitalisation";
- "net capital outflows out of euro area assets". In particular, "the net inflow into euro area equities of around USD 200 billion would be more than offset by net outflows from euro area bonds of around USD 400 billion. In other words, official reserve assets are currently more overweighed in euro area bonds than underweighted in euro area equities, when taking portfolios based on market capitalisation as a benchmark".

Finally the simulation showed that the expected net capital outflow from developed countries would result in net capital inflow to emerging and developing countries (mainly reflecting the large weight of such countries in global capital markets and their limited role as issuers of reserve currencies), thus proving that the mentioned "Lucas Paradox" (i.e. capital flow "uphill" from developing to developed economies) could be explained by a "reserve portfolio bias", i.e. only developed countries' currencies are widely regarded as proper reserve currencies.

Indeed, as noted by Beck and Fidora (2008) in "a situation in which SWFs behave as CAPM-type investors and thus allocate foreign assets according to risk and return rather than liquidity considerations, official portfolios lose this "bias" towards the major reserve currencies. As a result, more capital flows "downhill". In fact, anecdotal evidence as well as some available data on Singapore's

[104] European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by Beck R. and Fidora M., Occasional Paper, n. 91/2008.

Temasek suggest that many SWFs indeed have an already high exposure to emerging markets" [105].

With reference to the impact on global fixed income values, empirical studies of the US Treasury market suggest that annual net foreign purchases lowered long rates on US 10-years Treasury Yield by 130 basis points[106]. The situation could be to some extent reversed by the increasing transfer of "excess reserve" to SWFs. Therefore, the above "130 basis point" value could be considered as an "upper bound" estimate of the possible rise in the US yields as a result of foreign central banks greater diversification (reducing their purchase of US Treasuries) and SWFs (selling a portion of their existing US Treasuries).

Finally, as SWFs increasingly diversify their portfolio, the expected impact on world currencies of their investments is deemed to put further pressure on the US dollar. Nevertheless, being global FX market trade equal to circa 3 billion USD a day, the general sentiment is that the impact could be small.

8. Is there a solid economic rationale for a (EU) regulatory intervention?

In order to assess whether, in light of the above issues, an economic rationale for a possible (EU) regulatory intervention actually exists, it would be useful to refer to some basic financial regulation principles.

Firstly, markets are permeated by widespread "market failures" or, better, "market imperfections" (e.g. public goods, externalities, incomplete information, incomplete markets, etc.). Nevertheless, the mere lack of first-best private incentives to eliminate market imperfections does not necessarily make a regulatory intervention desirable *per se*.

In other words, market imperfections cannot *per se* justify regulatory interventions. It is instead necessary to verify whether the market response/solution to market imperfection(s) can actually be cost-effectively replaced or improved/enhanced by government.

Indeed, although markets do not necessarily provide first-best incentives to behave as efficiently as possible, (sometimes) they could however provide very

[105] *Ibidem*, p. 16.

[106] Warnock F. and Warnock V., (2008), "International Capital Flows and US Interest Rates" FRB International Discussion Paper, No 840, September 2006; Citi, Sovereign Wealth Funds: a growing global force, 2008; McKinsey Global Institute, (2007), The new power brokers: how oil, Asia, Hedge Funds, and Private Equity are shaping Global Capital Markets, October 2007.

good incentives – at the same time regulators not always have first-best incentives either.

At the end of the day, public regulation appears to make sense whereby incentives for regulators "to do the right thing" outweigh strong private incentives not to behave efficiently (e.g. the real economic and policy problem "with a monopoly is not that the monopolist has slightly less than optimal incentives to charge the efficient price, it is that the monopolist has very strong incentives to charge a higher than efficient price"[107]).

As a result, regulation is less likely to make sense when market players already have strong (though not "first-best") incentives to develop an efficient solution to a market imperfection – e.g. possible critical issues and additional costs posed by general SWFs lack of transparency lead some of the most important SWFs to develop a set of best practices aimed, *inter alia*, at increasing disclosure and building trust in recipient countries (i.e. SWFs "Generally Accepted Principles and Practices" – GAPP).

In this respect, it is worth noting that, from a microeconomic perspective, SWFs equity investments "produce" an important market imperfection (externality) resulting from:

- the uncertainty as to their behaviour as shareholders, and
- the suspicion of political/strategic motive,

both supported and intensified by their general lack of transparency.

In other words, the SWFs veil of secrecy can be used as an excuse to aim or simply give room to the adoption of protectionism policies by SWFs investments recipient countries or defensive measures by target companies, possibly disrupting the interested financial markets or, at least, making their functioning far less efficient (e.g. imposing additional costs on market participants and/or reducing the amount of FDI/financial resources available for investment in the EU/global financial markets).

In order to avoid the negative externality "produced" by their lack of transparency and public ownership SWFs need to build trust**.**

At the same time, as uncertainty and instability impose significant costs not only on SWFs but on all market participants as well, SWFs receive significant incentives to cooperate to devise institutions, rules, and behaviours minimising such costs, as they will gain mutual benefits.

[107] James K. R., (2005), "Efficiency or Stability?: A Market Failure Analysis", Centre for Central Banking Studies, Bank of England, June 2005.

According to the so-called "Coase Theorem"[108], when trade of externalities is possible, there are <u>no transaction costs</u> and all parties are free to bargain, then the market is always able to efficiently accommodate possible imperfections in the most efficient way, leading to an efficient outcome and market allocation, regardless of the initial allocation of property rights and without any regulatory intervention (which, under these assumptions, is likely to produce a "government failure" as deleterious as market failures).

Under the Coase Theorem assumptions, externality is not a problem in itself (e.g. pollution or, in our case, the uncertainty and suspicion related SWFs investment motives); the problem is, *inter alia*, that both parties affected by externality deem their respective position justified.

In this context, <u>the legal system role should be limited to assigning and protecting property rights and letting the market work toward efficient solutions</u> – i.e. with specific reference to issues raised by SWFs investments, "<u>protecting property rights</u>" requires that the threat of protectionist reaction should be credible.

That said, unlike the Coase Theorem textbook assumptions, the real world offers significant positive transaction costs. Therefore efficient allocation of resources might <u>require market forces action to be complemented (but not replaced) with regulatory interventions</u>.

Therefore, for the time being, an efficient regulatory policy response to specific issues raised by SWFs investments should be firstly aimed (and limited) at <u>minimising the transaction costs between SWFs and other stakeholders</u>, thus allowing for cheaper correction by the same market participants of possible <u>misallocation of resources</u> resulting from the <u>suspicions and uncertainty</u> surrounding <u>SWFs strategies and investment motives</u>.

In this respect, the catalyst role played by the EU, IMF and OECD in order to facilitate development of <u>reasonable market solutions</u> (i.e. voluntary codes of conduct for SWFs and recipient countries) appears to be the most appropriate for the time being.

On the other hand, in inefficient markets the prices paid/received for goods and services are far from being optimal – namely while someone is gaining, some others are losing – e.g. SWFs may be taking advantage of privileged information by the government while competing with private undertakings and/or benefit from private interests in portfolio companies via their voting rights or other means.

In this case, any efficiency increase would result in a transfer of wealth from one group of participants to others; the party benefiting from inefficiency

[108] Coase R. H., (1960), The Problem of Social Cost, Journal of Law and Economics 3: 1–44.

(e.g. SWFs) therefore do not have much incentive to change things and, as a result, market forces alone are not likely to lead to efficient outcomes, thus making a (EU harmonised) regulatory intervention more desirable.

9. A possible (proportionate) regulatory framework for SWF investments

As stated above, due to SWFs characteristics, SWFs may potentially exert significant positive effects on the operation of global capital markets; nevertheless if their investments are not entirely driven by genuine risk/return objectives – instead biased by political and strategic purposes – they can produce negative effects on portfolio companies, markets efficiency and stability and other national interests. The acquisition of significant holdings in foreign companies, for instance, could be just aimed at allowing the ultimate beneficial owner (a sovereign state) to influence such companies' management in order to extract "private benefits" from portfolio companies' activities or in a fashion entailing national security concerns for the portfolio company's country of incorporation.

In this regard, in light of the significant geopolitical effect of SWFs investments, it has been suggested that we should prove the "courage to admit that dealing with SWFs may require departures from the conventional liberal orthodoxy concerning global trade and investment flows"[109].

Indeed, concerns over SWFs political goals induced the US and some EU Member States (Greece, Germany, France) to envisage protectionism measures against SWF investments, showing that, in the end, "international cash flows are always political"[110] and to some extent confirming the view Keynes expressed in a famous article highlighting the benefits of national self-sufficiency and economic autarchy.

In particular, Keynes noted that "the policy of an increased national self-sufficiency is to be considered, not as an ideal in itself, but as directed to the creation of an environment in which other ideals can be safely and conveniently pursued"[111]. Indeed, Keynes becomes convinced that the retention of private enterprises structure is compatible with greater material well-being only if the interest rate is reduced towards a vanishing point, "but under a system by which

[109] Garten J., (2007), "We need rules for sovereign funds", in Financial Times, 8 August 2007.

[110] Gilson R. J. and Milhaupt C. J., (2008), Sovereign Wealth Funds and corporate governance: a minimalist response to the new merchantilism (February 18, 2008), Stanford University Law and Economics Olin Paper No 355, Columbia University Law and Economics Olin Paper No 328 (http://ssrn.com/abstract=1095023), p. 1.

[111] Keynes J.M., (1933),"National Self-Sufficiency," The Yale Review, Vol. 22, no. 4 (June 1933), pp. 755-769.

the rate of interest finds a uniform level, after allowing for risk and the like, throughout the world under the operation of normal financial forces, this is most unlikely to occur". Accordingly, Keynes was persuaded that "economic internationalism embracing the free movement of capital and of loanable funds as well as of traded goods may" may result in a "much lower degree of material prosperity than could be attained under a different system", and so pointed out that "there is no prospect for the next generation of a uniformity of economic system throughout the world, such as existed, broadly speaking, during the nineteenth century; that we all need to be as free as possible of interference from economic changes elsewhere, in order to make our own favourite experiments towards the ideal social republic of the future; and that a deliberate movement towards greater national self-sufficiency and economic isolation will make our task easier, in so far as it can be accomplished without excessive economic cost" (the importance of the last assumption is to be underscored).

For example, a recent study on economic growth and capital flows revealed that non-industrial countries "that had high investment ratios *and* lower reliance on foreign capital (lower current account deficits) grew faster – on average, by about 1 percent a year – than countries that had high investment but also a greater degree of reliance on foreign capital"[112].

That said, apart from possible negative effects on EU financial markets and corporate governance efficiency, from a legal point of view under the *acquis communautaire* any protectionist measure against SWFs equity investments is likely to breach the EC Treaty provisions on free competition and, in particular, the general prohibition to "all restrictions on the movement of capital between EU Member States and between EU Member States and third countries" provided by Art. 56 EC Treaty – as emerged with reference to the "golden share" provisions adopted by some EU Member States (Italy, France, Spain, United Kingdom, Netherlands, Belgium and Germany) to protect (i.e. keep under political influence/control) their "national champions" and privatised companies[113].

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[112] Prasad E., Rajan R. and Subramanian A., (2007), The Paradox of Capital, International Monetary Fund (IMF), Finance & Development, March 2007, Vol. 44, No1.

[113] As noted the recent golden share jurisprudence of the European Court of Justice has "substantially supranationalized the rules of member state involvement in formerly state-owned enterprises – whether such involvement was in the form of a formal privileged stake in the enterprise, the product of specifically targeted regulation, or some hybrid arrangement. […] The European Court of Justice's judgments in these cases can be viewed as a simple elaboration of long-standing principles of European law grounded in basic provisions of the Treaties – principally the nondiscrimination and free movement of capital obligations – in the amplification of a harmonized company law. From a choice-of-law perspective the Court's approach represents a greater effort to move choice of law issues up from the member state to the European level, thereby harmonizing and eliminating the horizontal choice-of-law issue", Backer L.C., (2008), The Private Law of Public Law: Public Authorities as Shareholders, Golden Shares, Sovereign Wealth Funds, and the Public Law Element in Private Choice of Law, Tulane Law Review, Vol. 82, No. 1, 2008 (http://ssrn.com/abstract=1135798), p. 7.

According to the consolidated jurisprudence of the Court of Justice[114], "movements of capital" for the purposes of Article 56 include:

- direct investments, in the form of participation in an undertaking through the holding of shares which confers the possibility of effectively participating in its management and control,

- portfolio investments, acquisition of shares on the capital market solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking.

With regard to the above forms of investment, the Court stated "that national measures must be regarded as 'restrictions' within the meaning of Article 56(1) EC if they are likely to prevent or limit the acquisition of shares in the undertakings concerned or to deter investors of other EU Member States from investing in their capital".

In line with the above rules and principles – considering *inter alia* that SWFs have to comply with the very EU and national legislation that any other investors shall respect while investing in the EU – EU institutions have so far supported an approach to SWFs aimed at avoiding the risk of sending the misleading signal "that the EU is stepping back from its commitment to an open investment regime"[115] by urging Member States not to adopt unilateral protectionism measures and ruling out, as far as possible, the adoption of SWF specific regulations or the imposition of limitations to the inward flows of capitals. Such approach favoured harmonised policies aimed at increasing relevant information disclosure, transparency and predictability of SWFs investment decisions and their responsibility (i.e. not to disrupt proper functioning of EU financial markets and/or not to "plumber" target companies) mainly through "soft law" and self-regulatory instruments (guidelines, best practices) and, however, through a market–friendly, tailored, proportionate and transparent regulatory approach (mainly based on existing EU and Member States' legal instruments applicable to cross-border investments in general)[116].

As a result, considering SWFs "blurred" nature and the cross-jurisdictional features of their transactions (giving room to regulatory arbitrage, possibly weakening the effectiveness of actual and possible statutory regulatory measures), at present a balanced and proportionate approach to SWFs issues may just entail complementing existing EU legal instruments and provisions with specific SWFs "soft law" instruments and guidelines and an "indirect" monitoring and

[114] Joined Cases C-282/04 and C-283/04, Commission of the European Communities v. Kingdom of the Netherlands.

[115] European Commission (2008), Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "A common European approach to Sovereign Wealth Funds", COM (2008) 115 final, 27.2.2008, par. 4.1.

[116] *Ibidem*, par. IV.

supervisory framework[117] of SWFs investments and other financial markets activities.

In particular, in order to devise a proper SWFs regulatory framework, it might be useful to follow a two-layer approach of "self-regulation within a statutory framework", as the one widely adopted in Europe for stock exchanges regulation.

Additionally, considering that – as noted by the EU Commission – SWFs greater transparency "is also important to ensure SWFs are included in global surveillance of financial markets"[118], it appears that public monitoring and supervision on SWFs may be mainly and/or primarily focused on the phase of the "integration" of SWFs financial resources in recipient countries' economy and markets, and aimed at increasing the overall level of transparency as well as strengthening supervision on entities, intermediaries and infrastructure used by SWFs to finalise relevant transactions and manage their assets (e.g. recipient companies, financial intermediaries, regulated markets, payment systems, central depositories, central counterparties (CCPs), and other post-trading firms).

In this respect, it is useful to recall, *inter alia*, the provisions introduced (in 2005) in the Italian Financial Consolidated Act (Legislative Decree n. 58 of 24 February 1998) in order to increase transparency (thus market discipline) on relationships between Italian listed companies and foreign companies having their registered office in a country whose legal system does not ensure transparency as to their establishment, assets and liabilities, and operations. The same provisions also apply to Italian companies with financial instruments widely distributed among the public and affiliated with or controlled by such foreign companies.

Pursuant to Articles 165*ter*–165*septies* of the Italian Financial Consolidated Act, Italian listed companies linked, controlled or under the influence of "foreign non transparent companies" (e.g. SWF) should attach to their Annual Report a Relation, signed by CEO and CFO, illustrating the relationship existing with the "foreign non transparent companies". The Italian Securities Commission is entrusted with significant supervision and on-site inspection powers, while relevant countries are identified in joint decrees issued

[117] For instance, the 2000 Report by the Financial Stability Forum (FSF) did not recommend direct regulation of Hedge Funds' leverage (as for SWFs, the main issue is not the leverage, rather their possible political/strategic investment motive), and instead recommended a set of measures aiming to constrain leverage, largely based on market discipline. The FSF recommendations centred on: *i)* stronger counterparty risk management; *ii)* stronger risk management by hedge funds; *iii)* enhanced regulatory oversight of HLI credit provider; *iv)* greater risk sensitivity in bank capital adequacy regulation; *v)* sustaining industry progress; *vi)* building a firmer market infrastructure; *vii)* enhanced public disclosure by HLIs; *viii)* enhanced public disclosure practices generally; *ix)* enhanced national surveillance of financial market activity; *x)* good practice guidelines for foreign exchange trading.

[118] European Commission (2008), Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "A common European approach to Sovereign Wealth Funds", COM (2008) 115 final, 27.2.2008, par. 2.3.

by the Minister of Justice and the Minister of the Economy and Finance (against criteria listed in the same Italian Financial Consolidated Act).

Moreover, an "indirect" supervisory and regulatory framework narrowly-tailored on the specific concerns raised by SWFs investments (i.e. fear of non-commercial, strategic or political motives) may be based – as suggested (Keller, 2008) – on the mandatory requirement for a SWF to conduct investments over a certain threshold (or investments of certain kinds) through <u>third-party professional asset managers</u> or alternatively to <u>disclose its shareholder voting records</u> whereby the ownership percentage in a company exceeds a given threshold[119].

In particular, delegating SWFs investments execution to <u>external independent asset managers</u> would help ensure that, at least, their single investments are not influenced or managed by SWFs sponsor countries' political bodies or parties. Indeed, as noted by the U.S. SEC Chairman, "to the extent sovereign investing is conducted through professional management of these funds, this could help to de-politicize the process both in practice and in perception"[120], thus also increasing transparency of sovereign business and investments and contributing to establishment of mutual trust and investor confidence.

The mandatory use of external asset managers may deliver additional advantages for SWFs, without imposing significant compliance costs or disrupting their operations.

Indeed (Keller, 2008) the experience of pension funds (a recent study esteemed that the "fraction of assets managed by external managers" is, on average, 84.2% of pension fund assets and, "more significantly, a substantial number of funds delegate corporate governance responsibility, including voting authority, to their external portfolio managers"[121]) may suggest that external asset management "is likely to produce the best risk-adjusted returns" and "is one means of preventing […internal…] conflicts of interest, as well as insider trading and other potential abuses". Moreover the "delegation of investment functions to third-party managers may result in greater investment passivity. This correlation,

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[119] Keller A. D., (2008), Sovereign Wealth Funds: Trustworthy Investors or Vehicles of Strategic Ambition? (September 11, 2008), Georgetown Journal of Law & Public Policy, Vol. 7, No. 1, 2008 (http://ssrn.com/abstract=1264349), p. 51.

[120] Cox C., (2007), Speech by U.S. Securities and Exchange Commission Chairman: The Rise of Sovereign Business, Gauer Distinguished Lecture in Law & Policy at the American Enterprise Institute Legal (Washington, DC, December 5, 2007).

[121] Choi S. J. and Fisch J. E., (2007), On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance (August 27, 2007), NYU Law and Economics Research Paper No. 07-30, Fordham Law Legal Studies Research Paper No. 1010330 (http://ssrn.com/abstract=1010330), p. 12.

if realised, could allay some of the fear of the influence that SWFs would exert"[122] on their portfolio companies.

Such conclusions appear to be supported by the fact that, although the use of outside asset managers may give room to various problems (e.g. a conflict of interest between the (short-term) interests of the outside investment manager and the long-term interests of the SWF, as well as increase in transaction costs and reduced overall return for smaller SWFs), SWFs are already extensively using and relying on external money managers. For instance, the Abu Dhabi Investment Authority reportedly "outsources between 70% and 80% of its assets, while the Kuwait Investment Authority outsources at least 50%"[123]. According to the survey carried out by the IMF and the IWG-SWF, "only two of the responding SWFs do not use external managers at all, although one of them is actively considering this possibility. In contrast, some SWFs have assigned most or all of their assets to external asset managers. External managers are used in cases where the managing agency does not have sufficient expertise in managing specific assets, or where it is not cost-effective to manage them in-house due to the external mangers' economies of scale and extensive research capabilities"[124].

The results of the survey also showed that the appointment/removal of external managers (typically approved by the SWF Board) is essentially based on delivered performances, although "some SWFs indicate that the organization, the personnel team, and the investment philosophy of the external managers are also considered important factors. Fees could be flat, performance-based, or a combination of both […(**Chart 22**)…]. Consultants are not commonly used to assist in the selection process, except by some smaller SWFs or for specific advice in specialized areas".

With reference to the disclosure of SWF shareholder voting policies and voting records, it has been argued (Lowery C. – 2008)[125] that "in looking at both a large sovereign wealth fund (Norway's Government Pension Fund-Global) and a large U.S. state pension fund (CalPERS) which exercise their voting rights, two things stand out. One is the utility of laying out in advance the broad policies that guide how the fund votes, in order to avoid undue, unwelcome surprises. Another is the utility of disclosing the actual votes themselves, so that outside observers

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[122] Keller A. D., (2008), Sovereign Wealth Funds: Trustworthy Investors or Vehicles of Strategic Ambition? (September 11, 2008), Georgetown Journal of Law & Public Policy, Vol. 7, No. 1, 2008 (http://ssrn.com/abstract=1264349), p. 55.

[123] At the same time, "winning business from sovereign funds requires more work than for typical institutional clients. Training and educating the fund's staff often is expected to come with managing the assets. The funds also expect more disclosure about the money manager's own business". J. Cooper, (2008), Sovereign wealth fund hires no cinch, Potential treasure trove of business awaits, but getting to it won't be a walk in the park, Pensions&Investments, March 17, 2008 (www.pionline.com).

[124] IWG Secretariat in collaboration with the Members of the IWG, Sovereign Wealth Funds, Current Institutional and Operational Practices, September 15, 2008, p. 17.

[125] Remarks by Treasury Assistant Secretary for International Affairs Clay Lowery at Barclays Capital's 12th Annual Global Inflation-Linked Conference, (hp-836), February 25, 2008.

can assess whether the fund is following its stated broad policies". In particular, such a disclosure regime could assumingly "alleviate the risk of political interference by the SWFs government-owners in the business decisions of the companies in which they invest, and would alert the market of troublesome voting patterns, reducing the danger of capital misallocation and market inefficiency"[126], without imposing too severe restrictions on SWFs equity investments or significantly impairing their operation, and in particular without denying them the possibility to exercise the legitimate rights and powers attached to their shareholdings.

In this respect, if compared with the idea of suspending the voting rights attached to SWFs shareholdings (Gilson R. J. and Milhaupt C. J. – 2008)[127] or other further incisive protectionist measures, a (mandatory) disclosure regime of voting policies and voting records (for SWFs that decided to exercise their voting rights) appears to have less unwanted or detrimental "side effects"[128] and to be a much more proportionate and flexible solution to issues and concerns raised by SWFs equity investments.

In order to develop a mandatory disclosure regime for SWFs voting policies and voting records, it is useful to refer, *inter alia*, to the provisions introduced in 2003 by the U.S. Securities and Exchange Commission (SEC) requiring management investment companies (mutual funds) registered under the Investment Company Act of 1940 to: (*i*) disclose in their registration statement (and, for closed-end funds, in the Form N-CSR) "the policies and procedures that they use to determine how to vote proxies relating to portfolio securities"; (*ii*) file with the SEC "and to make available to shareholders the specific proxy votes that they cast in shareholder meetings of issuers of portfolio securities"[129].

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[126] Keller A. D., (2008), Sovereign Wealth Funds: Trustworthy Investors or Vehicles of Strategic Ambition? (September 11, 2008), Georgetown Journal of Law & Public Policy, Vol. 7, No. 1, 2008 (http://ssrn.com/abstract=1264349), p. 57.

[127] Gilson R. J. and Milhaupt C. J., (2008), Sovereign Wealth Funds and corporate governance: a minimalist response to the new merchantilism (February 18, 2008), Stanford University Law and Economics Olin Paper No 355, Columbia University Law and Economics Olin Paper No 328 (http://ssrn.com/abstract=1095023), p. 21.

[128] For instance, any restrictions imposed on SWFs voting rights could: *i*) result in undue constraint to investors' formal mechanism of corporate governance, *ii*) reduce shareholders control over the Board for decisions it makes on behalf of the corporation, *iii*) encourage "bad behaviour" and "incentivise using informal means to get their voices heard in the shadows of the corporation", *iv*) reduce relevant markets attractiveness, *v*) induce retaliatory response by SWFs sponsor countries with a consequent backwards step toward reciprocal open markets, Keller A. D., (2008), Sovereign Wealth Funds: Trustworthy Investors or Vehicles of Strategic Ambition? (September 11, 2008), Georgetown Journal of Law & Public Policy, Vol. 7, No. 1, 2008 (http://ssrn.com/abstract=1264349), pp. 61-64.

[129] See: Securities and Exchange Commission, Final Rule: Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, 17 CFR Parts 239, 249, 270, and 274, Release Nos. 33-8188, 34-47304, IC-25922; File No. S7-36-02, RIN 3235-AI64; Remarks by Treasury Assistant Secretary for International Affairs Clay Lowery at Barclays Capital's 12th Annual Global Inflation-Linked Conference, (hp-836), February 25, 2008; Clarke K.K and Miller P. M., (2003), Complying with the SEC's new proxy voting rules, Journal of Investment Compliance, 2003, vol. 4, issue 1, pp. 22-25; Watt K., (2003), Proxy Voting Trends: Funds Managers in the United States of America and Australia, Bond Law Review, Special Issue: Comparative Corporate Governance, Vol. 15, Issue 1, 2003, Article 3, pp. 12-46.

At European level, reference could be made to the "Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward" Action Plan adopted in 2003 in response to the Recommendations issued by the High Level Group of Company Law Experts (presented in 2002), where the European Commission included in the list of proposed medium-term (2006-2008) actions for the adoption of (legislative) measures aimed at "enhancing disclosure by institutional investors of their investment and voting policies".

In particular, the European Commission recommended that institutional investors – esteemed to "hold significant proportions of the share capital of companies in many Member States (reaching up to 50% of all ordinary shares listed in the UK as on 31.12.2004)"[130] – "should be obliged: a) to disclose their investment policy and their policy with respect to the exercise of voting rights in companies in which they invest; b) to disclose to their beneficial holders at their request how these rights have been used in a particular case"[131]. In the Commission's opinion "such requirements would not only improve the internal governance of institutional investors themselves, but would also enhance participation by institutional investors in the affairs of the companies in which they invest"; so indirectly recognising that the important role that institutional investors (SWFs included) could play in the governance of companies in which they invest should not be frustrated by limiting their ability to vote their shares but should instead be fostered through a properly designed disclosure regime.

With specific reference to SWFs equity investments, also the U.S. Treasury Assistant Secretary for International Affairs recently stated that the right of SWFs to vote their shares should not be questioned, because the right of the owner of certain classes of equity securities "to vote on major matters of corporate policy and the board of directors […] is one of the most fundamental rights of ownership in U.S. corporations. It is integral to the vitality and attractiveness of our capital markets"[132].

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[130] See: European Commission, (2005), Directorate General for internal market and services, Consultation on future priorities for the action plan on modernising company law and enhancing corporate governance in the European Union, p. 7.

[131] Communication from the Commission to the Council and the European Parliament, "Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward", Brussels, 21.5.2003, COM (2003) 284 final, p. 13.

[132] See: Remarks by Treasury Assistant Secretary for International Affairs Clay Lowery at Barclays Capital's 12th Annual Global Inflation-Linked Conference, (hp-836), February 25, 2008.

As to effective adoption of a EU mandatory voting disclosure regime for institutional investors, it has been argued that – despite stakeholders' opposition during the public consultation lunched by the European Commission in 2005 on future priorities for the Action Plan presented in 2003[133] – "the examination of the U.S. experience with a similar rule provided valuable insights and arguments to overcome the concerns of the sceptics. Similar to the U.S. situation prior to the implementation of mandatory disclosure rules, the success of voluntary solutions as well as the reliance on market forces are not adequate substitutes for a mandatory rule in order to achieve disclosure to the extent intended by the proposal. There are also good reasons not to leave the adoption of a disclosure rule to the member states, but to realize the proposed EC legislation"[134].

The results of the consultation launched in 2005 show, *inter alia*, clear support to widest application of "Better Regulation" principles to the field of company law and corporate governance. In particular, according to the European Commissioner for Internal Market and Services (Charlie McCREEVY) "it means only legislating at EU level when that is the best level at which to act and where legislation is the only answer. We need to opt for instruments that put the least burden on companies and leave them as much flexibility as possible. Therefore, we will prefer a recommendation to a directive where a recommendation is suited to achieve the aim pursued. We will look at the measures originally proposed to see if they are still appropriate. For example, whether a directive is really needed on disclosure for institutional investors or whether the market is already moving in the right direction"[135].

In this respect, over recent years market-led solutions seem to have been encouraging institutional investors to disclose their voting policies to the public and the records of the execution of their votes to actual beneficial owners, thus making an EU legislative intervention less necessary or not always desirable.

[133] In particular, "44 percent of all respondents to the consultation addressed the issue of disclosure of institutional investors' voting policies. […] Respondents who opposed an intervention at EU level did so for a variety of reasons. While certain respondents considered that such matters are to be left to the contractual arrangements between institutional investors and their underlying beneficiaries, others are doubtful of the added-value of disclosure. In their view, either disclosure is of a general nature and therefore of little use, or it is precise and would subject institutional investors to excessive burdens. Other respondents pointed to the initiatives which have been taken both at international level (notably by the OECD and the ICGN) and at national level, including self-regulatory codes of conduct and consider that such mechanisms not only function satisfactorily but also cater for the flexibility which market participants require, so that additional EU intervention would not be necessary or, at any rate, premature at this stage", European Commission, (2005), Directorate General for internal market and services, Consultation and hearing on future priorities for the action plan on modernising company law and enhancing corporate governance in the European Union, Summary report, p. 12.

[134] Schmolke K. U., (2006), Institutional Investors' Mandatory Voting Disclosure – European Plans and U.S. Experience, New York University School of Law, NYU Center For Law And Economics, October 2006, Law&Economics Research Paper Series, Working Paper No. 06-43 (http://ssrn.com/abstract=938116), p. 47.

[135] See: Charlie McCREEVY, (2005), European Commissioner for Internal Market and Services, Company Law Action Plan: Setting Future Priorities, European Corporate Governance Conference, London, 14 November 2005, Speech/05/683.

With specific reference to SWFs, for example, the issue has been addressed in the context of the adoption of the so-called "Santiago principles" (GAPP) – namely, a voluntary set of principles and practices supported and implemented by the IWG members to "identify a framework of generally accepted principles and practices that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis".

Indeed, while clearly stating that "SWFs view shareholder ownership rights as a fundamental element of their equity investments' value"[136], GAAP Principle No 21 also provides that "if an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights".

Within the GAPP framework, disclosure of SWFs policies concerning the exercise of voting rights and other ownership rights is primarily intended as a proportionate measure "to dispel concerns about potential noneconomic or nonfinancial objectives" of SWFs equity investments.

To such end, IWG members deem that both *ex-ante* and *ex-post* disclosure of relevant information is required. In particular, with reference to GAAP Principle No 21, it has been specified that "SWFs should disclose ex ante whether and how they exercise their voting rights. This could include, for example, a public statement that their voting is guided by the objective to protect the financial interests of the SWF. In addition, SWFs should disclose their general approach to board representation". Moreover, "to demonstrate that their voting decisions continue to be based on economic and financial criteria, SWFs could also make appropriate ex post disclosures"[137].

As a result, in line with the renewed European Commission's support to widest application of "Better Regulation" principles (e.g. systematic regulatory impact assessments, legislation only when needed, light touch regulation, etc.) – notably to EU company law and corporate governance regulations – and considering that at international level significant measures are going to be developed or have already been adopted on a voluntary basis to address some of the main issues raised by SWFs management and investments – the efficiency and effectiveness of market-based instruments should be assessed prior to taking any formal EU legislative measure regulating SWFs.

[136] As clarified, the exercise of voting and other ownership rights is seen to be important by some SWFs for their capacity to hold assets on a long term, patient basis and also "as a mechanism for keeping the management of a company accountable to the shareholders, and thus contributing to good corporate governance and a sound allocation of resources", International Working Group of Sovereign Wealth Funds (2008), Sovereign Wealth Funds, Generally Accepted Principles and Practices. "Santiago Principles", October 2008, p. 23.

[137] *Ibidem*.

In particular, reliance on third-party external asset manager already appears to be a common practice among SWFs, while disclosure of SWFs voting policies and records has been already recommended by the "Santiago Principles" adopted, on a voluntary basis, by IWG-SWF members. Consequently, an additional EU formal regulation may be deemed not necessary or, at any rate, premature, at least for the time being.

Accordingly, the proposed "light" and "indirect" regulatory approach appears most appropriate to tackle market failures associated with SWF investments (namely, the fear of non-commercial, strategically or politically-motivated investments) and most consistent with self-regulatory guidelines to be promptly developed by most important SWFs (through the International Working Group of Sovereign Wealth Funds) and the OECD, and does not (significantly) frustrate the EU principle "of an open market economy with free competition" an the commitment to keep EU markets "open for investments".

Moreover the herein proposed "two-layer" and indirect regulatory approach – primarily aimed at increasing transparency and disclosure on SWFs operations through the combined effect of statutory and self-regulatory provisions – appears to be also in line with the spirit of the recommendations to the EU Commission recently endorsed in the European Parliament Resolution of 23 September 2008 on transparency of institutional investors (covering Hedge Funds, Private Equity, and SWFs).

Indeed, the European Parliament Resolution requested the Commission to submit appropriate legislative proposals – pursuant to Articles 44, 47(2) or 95 EC Treaty, depending on the subject matter – guaranteeing a common standard of transparency (e.g. on proportion of voting rights resulting from an acquisition or disposal of shares whereby that proportion reaches, exceeds or falls below specific thresholds; on investment policies and associated risks) and tackling other specific issues covering Hedge Funds and Private Equity[138], as well as to encourage improvements in transparency and governance (e.g. reinforce long-term orientation and discourage financial and other incentives for short-term excessive risk-taking and irresponsible behaviour) by supporting and monitoring the evolution of self-regulation already introduced by managers of Hedge Funds and Private Equity and their counterparts, and to encourage Member States to support such efforts through dialogue and exchange of best practices.

Additionally – as to SWFs non uniform public disclosure standards – the European Parliament did not recommended the adoption of *ad-hoc* statutory legal provisions, but rather called on the Commission to take part in the IMF initiative to establish a working group to draft an international code of conduct for SWFs,

[138] E.g. money laundering, transparency of voting policies, a system of EU-wide shareholder identification, "managers" remuneration systems, unreasonable "plundering" of (or so-called "asset stripping" in) target companies by investors and, in general, any possible misuse of investors' financial power in a way that merely disadvantages the company acquired in the long term, without having any positive impact on the company's future and the interest of its employees, creditors and business partners.

under the assumption that such a code of conduct would somehow demystify SWF activities.

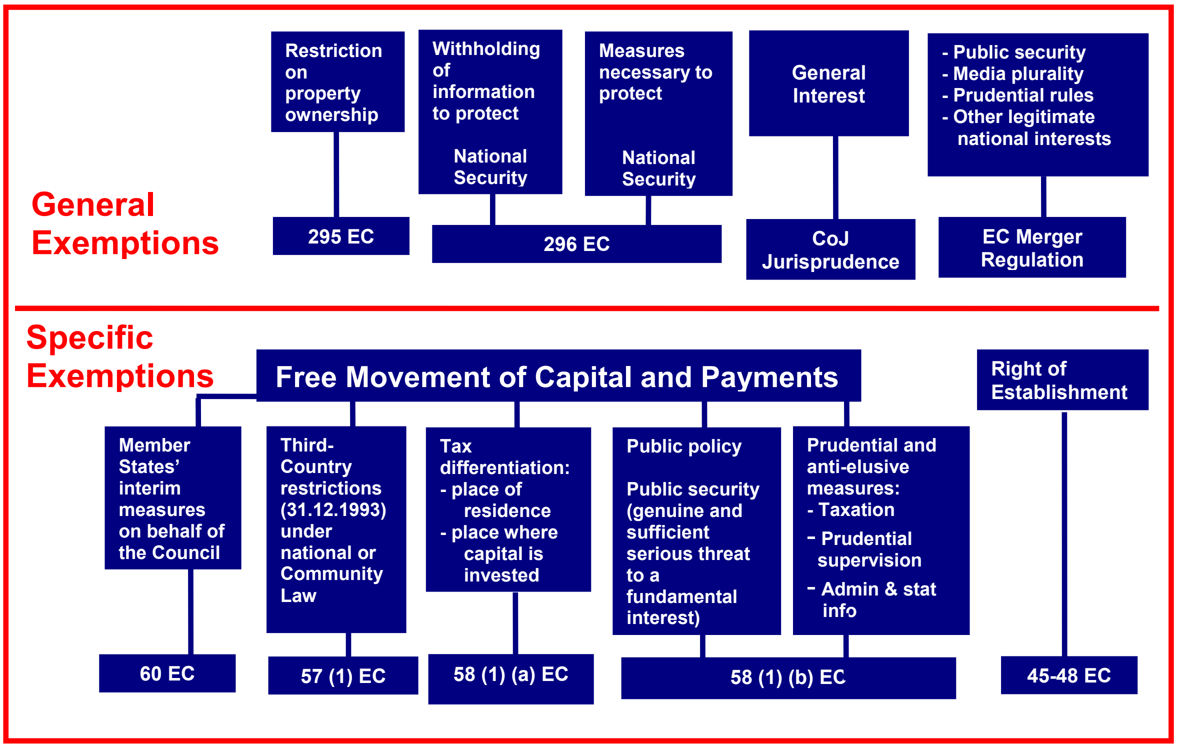
10. Current "hard law" legal instruments to control capital flows originating from SWFs under the *acquis communautaire*

As also suggested by the EU Commission, adoption of SWFs direct and specific statutory regulation is also discouraged by SWFs being not actually operating "in a legal vacuum" in the EU; rather they have "to comply with the same EU and national economic and social legislation that any other investors have to respect"[139]. In addition, WTO and OECD rules as well as the EC Treaty and antitrust legislation already provide for a broad array of waivers and exception to the free movement of capital and goods whereby "public security" and other "legitimate national interests" are at stake.

For instance, the mentioned prohibitions to all restrictions "on the movement of capital between Member States and between Member States and third countries" and "on payments between Member States and between Member States and third countries" provided for by Art. 56 of EC Treaty are not absolute – both specific and general exemptions apply (as summarised in the chart below)[140].

[139] European Commission (2008), Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "A common European approach to Sovereign Wealth Funds", COM (2008) 115 final, 27.2.2008, par. 3.1.

[140] See also: European Commission, Directorate-General for Economic and Financial Affairs, (2003), The EU economy: 2003 review, (Annex: Capital movements in the legal framework of the Community), 2003, No 6, p. 322.



10.1. Third Country restrictions (specific exemptions)

Pursuant to Article 57.1 of the EC Treaty, Article 56 provisions shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Community law adopted in respect of the movement of capital to or from third countries involving direct investment – including in real estate – establishment, the provision of financial services or the admission of securities to capital markets.

Under Art. 57.2 of the EC Treaty, whilst endeavouring to achieve the objective of free movement of capital between EU Member States and third countries to the greatest extent possible and without prejudice to the other chapters of *the* Treaty, the Council may, acting by a qualified majority upon Commission proposal, adopt measures on the movement of capital to or from third countries involving direct investment – also in real estate – establishment, the provision of financial services or the admission of securities to capital markets. Unanimity shall be required for measures under this paragraph, which constitute a step back in Community law with regard to liberalisation of the movement of capital to or from third countries.

In addition, EU Member States are allowed, under certain conditions, to apply restrictions on the movement of capital for the purpose of:

- applying a tax differentiation between taxpayers who are not in the same situation as to their place of residence or with regard to the place where their capital is invested;

- applying all necessary prudential and anti-elusive measures to prevent infringements of national law and regulations, in particular in the field of taxation and prudential supervision of financial institutions;

- laying down procedures for declaration of capital movements for purposes of administrative or statistical information;

- imposing restrictions on the right of establishment of natural persons and corporations, compatible with the EC Treaty (Arts. 45-48);

- taking measures justified on grounds of public policy or public security. However, according to the consolidated Court of Justice jurisprudence "the requirements of public security, as derogation from the fundamental principle of free movement of capital, must be interpreted strictly, so that their scope cannot be determined unilaterally by each Member State without any control by the Community institutions. Thus, public security may be relied on only if there is a genuine and sufficiently serious threat to a fundamental interest of society"[141].

Finally a single Member State may, only for serious political reasons and on grounds of urgency, take unilateral (and temporarily) measures against a third country with regard to capital movements and payments, whereby an action by the Community to interrupt or reduce, partially or totally, economic relations with one or more third countries is provided in accordance with the EC Treaty provisions related to common foreign and security policy, and the Council has not yet taken the necessary urgent measures with regard to the third countries concerned (Art. 60 EC Treaty).

10.2. Third Country restrictions (general exemptions)

Possible restrictions to the free movement of capital, in principle also applicable to SWFs, could legitimately result from:

- national rules governing the system of property ownership (Art. 295 EC Treaty);

[141] Case C-503/99, Judgment of the Court of 4 June 2002, Commission of the European Communities v Kingdom of Belgium.

- the need to protect privileged information, the disclosure of which is considered by a Member State contrary to the essential interests of its security (Art. 296.1 (a) EC Treaty);

- measures that a Member State considers necessary for protection of the essential interests of its security connected with production of or trade in arms, munitions and war materials.

  Such measures shall not adversely affect the conditions of competition in the common market as to products not specifically intended for military purposes (i.e. no spill-over effect).

Apart from the mentioned EC Treaty provisions, while investing in the EU, SWFs are in principle subject to laws and regulations applicable to any other type of investor.

Among the rules most likely to affect SWFs investments, EU and national "antitrust provisions" represent other instruments currently available to tackle issues related to possible political/strategic motives of SWF equity investments.

Indeed, both the EU and Member State "antitrust provisions" acknowledge the possible relevance of "public security", "national defence" and other national interests.

For example, Council Regulation (EC) No 139/2004 of 20 January 2004 on control of “concentrations” between undertakings provides that (Art. 21) EU Member States may take appropriate measures to protect legitimate interests other than those taken into consideration by the same Regulation and compatible with the general principles and other provisions of Community law.

In this respect, public security, media plurality and prudential rules are regarded as legitimate interests *per se*.

Any other public interest must be instead recognised by the Commission (following assessment of its compatibility with the general principles and other provisions of Community law) before the relevant measures may be taken.

A concentration shall be deemed to arise where a change of control on a lasting basis results from:

- the merger of two or more previously independent undertakings or parts of undertakings, or

- the acquisition, by one or more persons already controlling at least one undertaking, or by one or more undertakings, whether by purchase of securities or assets, by contract or by any other means, of direct or indirect control of the whole or parts of one or more other undertakings.

Control is constituted by rights, contracts or any other means which, either separately or in combination and having regard to the considerations of fact or law involved, confer the possibility of exercising decisive influence on an undertaking, in particular by:

- ownership or the right to use all or part of the assets of an undertaking;
- rights or contracts which confer decisive influence on the composition, voting or decisions of the organs of an undertaking.

For instance, not only does the Italian antitrust law entitle the government to exceptionally authorise concentration with anti-competitive effects due to "national economy general interests", but it also provides that whereby non-cooperative or discriminating States are involved, the Prime Minister may prohibit a concentration to occur on the grounds of "national economy" interests.

10.3. Shareholdings' disclosure requirements and provisions affecting the exercise of shareholders' voting rights

Going back to the issues related to SWFs being deemed as not sufficiently transparent and the suspicion that their investments may be not only motivated by profit-seeking[142], possible limitations to general freedom of capital movement and payments are to be regarded as last resort solutions to tackle the concerns expressed in international *fora* as to possible strategic/political motives of SWFs equity investments in EU companies[143].

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[142] For example, according to the authors of a recent study on foreign equity investments by sovereign wealth funds, "SWFs when investing abroad tend to invest in countries that share the same religion and in different industries than those found at home, suggesting that SWFs tend to look for industry-specific diversification but while doing so bias their investments to similar cultures. The latter investment rule clearly is strictly speaking not consistent with pure profit maximizing objectives", Chhaochharia V. and Laeven L., (2008), "Sovereign wealth funds: Their investment strategies and performance", University of Miami and International Monetary Fund, working paper, August 31, 2008, (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1262383), p. 2.

[143] With reference to policy measures intended to address national security concerns that arise in the general context of foreign investments as well as in the specific context of investments from SWFs, participants in the OECD's project on "Freedom of Investment, National Security and 'Strategic Industries'" have recently agreed that, in line with a proportionality principle, "restrictions on investment, or conditions on transaction, should not be greater than needed to protect national security and they should be avoided when other existing measures are adequate and appropriate to address a national security concern", in particular, "restrictive investment measures should be used, if at all, as a last resort when other policies (e.g. sectoral licensing, competition policy, financial market regulations) cannot be used to eliminate security-related concerns". OECD Investment Committee, (2008), Report on "Sovereign Wealth Funds and Recipient Country Policies", 4 April 2008, p. 5.

A more "SWF-friendly" and indirect regulation of SWFs equity investments might be based instead on other harmonised sets of principles and legal provisions already in force in most EU Member States, in particular on those providing for shareholdings and voting rights transparency and disclosure regimes, as well as on those imposing possible limits on shareholdings and/or the exercise of voting rights by EU companies' shareholders.

For instance, with reference to the lack of transparency on SWFs equity holdings, it is worth noting that non-listed EU companies are usually required (under Member States' company laws) to regularly file to the competent Company Register the list of their shareholders. A more burdensome and comprehensive disclosure regime is instead provided for in case of qualifying and major holdings in listed companies, companies issuing equity- like instruments, companies with financial instruments widely distributed among the public and regulated firms (e.g. banks, insurances, investment firms, mutual funds, etc.).

A specific disclosure regime is also typically provided for by EU Securities Laws with reference to:

- Shareholders' agreements (i.e. agreements, in whatsoever form concluded, whose object is the exercise of voting rights in companies with listed shares or companies controlling them), and

- Agreements that: create obligations of consultation prior to the exercise of voting rights in companies with listed shares or companies controlling them; set limits on the transfer of the related shares or of financial instruments entitling holders to buy or subscribe for them; provide for the purchase of shares or financial instruments; have as their object or effect the exercise, jointly or otherwise, of a dominant influence on such companies; aim to encourage or frustrate a takeover bid or equity swap.

In the event of non-compliance with the relevant disclosure requirements, it is usually provided that:

- Voting rights attached to listed shares or to financial instruments not properly notified may not be exercised;

- Agreements shall be null and void.

Moreover, also considering that the financial sector has been mostly alluring for SWFs equity investments, it is worth noting that in the EU a specific harmonised legal framework governs "acquisitions and increase of holdings in the financial sector" (Directive 2007/44/EC) providing for a transparency and disclosure regime as well as an *ex-ante* authorisation regime by the competent national authorities.

For example, whereby the influence exercised by a qualifying shareholder is likely to operate to the detriment of the sound and prudent management of a credit institution (e.g. whereby risk of exploitation/expropriation exists) the relevant authority may impose suspension of the exercise of the voting rights (Directive 2006/48/EC and Directive 2007/44/EC).

Suspension of the corresponding voting rights, or nullity of votes cast, or possibility of obtaining their annulment is also provided whereby a holding in a credit institution is acquired in spite of the competent supervisory authorities' opposition. While assessing the request for authorisation, the competent authorities must not examine the proposed acquisition in terms of the "economic needs of the market"; instead, they must appraise (only) the "suitability of the proposed acquirer" and the "financial soundness of the proposed acquisition" – in order to ensure the "sound and prudent management" of the financial institution in which the acquisition is proposed and taking into account the likely influence of the proposed acquirer on the financial institution – against all of the following criteria:

- Reputation of the proposed acquirer;
- Reputation and experience of any person who will direct the business of the insurance undertaking as a result of the proposed acquisition;
- Financial soundness of the proposed acquirer, notably as to the type of business pursued and envisaged in the financial institution in which the acquisition is proposed;
- Whether the financial institution will be able to comply and continue to comply with the relevant prudential requirements – notably, whether the group it will partake has a structure enabling effective supervision, effectively exchange information among the competent authorities and determine responsibilities allocation among them;
- Whether reasonable grounds exist to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing within the meaning of Article 1 of Directive 2005/60/EC is being or has been committed or attempted, or that the proposed acquisition could increase the risk thereof.

As a result, following the above legal principles and provisions, strategic and politically biased acquisitions by SWFs of shareholdings in the EU financial sector may already be limited or prohibited whereby such acquisitions are not likely to ensure the "sound and prudent management" of the concerned financial institution.

At a more general level it is worth noting that, under the main assumption that SWFs influence on portfolio companies essentially depends on their "ability to vote their shares", allowing for possible limitations to (or suspension of) the exercise of voting rights attached to SWFs strategic shareholdings or to SWFs shareholdings above a certain threshold might be regarded as a useful tool to offer a more market-friendly and proportionate solution (if compared with other protectionist measures resulting in direct or indirect limitations to the general freedom of capital movement and payments) so as to mitigate risks and ease concerns associated with SWFs equity investments' strategic/political motive (i.e. portfolio companies exploitation due to SWFs strategic behaviour and SWFs influence on portfolio companies benefiting its sovereign beneficial owner in ways not proportionally benefiting or not accessible to other shareholders).

As pointed out by two academics (Gilson R. J. and Milhaupt C. J.)[144], vote suspension/sterilisation mechanism (a mechanism mirroring the "break through" rule[145] provided by the EU Takeover Directive) might indeed represent a tool to constrain potential strategic/politically biased investments but leave "genuine" SWFs (equity) investments – and their important economic benefits – almost unaffected.

Nevertheless, it is fair to assume and assert that the limitation/suspension of voting rights is far from being a flawless solution. As a matter of fact:

- It would reduce the value of the affected shares, thus the incentives to invest (GAAP Principle No 21 clearly states that "SWFs view shareholder ownership rights as a fundamental element of their equity investments' value");

- It would result in a protectionist restriction to foreign direct investments with a negative impact also on the attractiveness of the relevant capital market (as also noted by the U.S. Treasury Assistant Secretary for International Affairs[146]);

- SWFs and explicit/formal use of voting rights are not the only tools governments can use to influence the business decisions of a foreign

[144] Gilson R. J. and Milhaupt C. J., (2008), Sovereign Wealth Funds and corporate governance: a minimalist response to the new merchantilism, (February 18, 2008). Stanford University Law and Economics Olin Paper No 355 and Columbia University Law and Economics Olin Paper No 328, p. 1.

[145] The "break through" rule provides that shareholder voting restrictions provided by corporate charter, contracts or different shareholders' agreements do not apply whereby the offeror has gained 75% of the shares of the target company, see: Papadopoulos T. , (2007), The Mandatory Provisions of the EU Takeover Bid Directive and Their Deficiencies. Law and Financial Markets Review-LFMR, Vol. 1, No. 6, pp. 525-533, November 2007(http://ssrn.com/abstract=1088894); Papadopoulos T. , (2008), Legal Aspects of the Breakthrough Rule of the European Takeover Bid Directive. Takeover Regulation: A Legal Approach, Icfai Books, Icfai University Press (IUP), Icfai University, 2008 (http://ssrn.com/abstract=1114671).

[146] In particular "there are those who say that sovereign wealth funds should not be allowed to vote their shares when they take a non-controlling stake in a U.S. company. I think this goes too far. Most – but not all – classes of equity securities allow their owner to vote on major matters of corporate policy and the board of directors. That is one of the most fundamental rights of ownership in U.S. corporations. It is integral to the vitality and attractiveness of our capital markets", Remarks by Treasury Assistant Secretary for International Affairs Clay Lowery at Barclays Capital's 12th Annual Global Inflation-Linked Conference, (hp-836), February 25, 2008.

corporation in which they invest, in order to secure private benefits or strategic advantage (others could be the granting of license, acquisition of bonds and other debt securities, guarantees, “check-book diplomacy”, etc.);

- Benefits arising from (actual or potential) institutional shareholders’ activism are lost or significantly reduced.

Moreover, the limitation/suspension of voting rights would pose the critical problem of how legitimate SWFs equity investments/capital injections in a company can be properly distinguished from political/strategic biased investments.

As a result, mandatory or voluntary measures (see GAAP Principle No 21) “merely” providing for disclosure of SWFs shareholdings, voting policies and voting records should be preferred, in the first instance, to the possible suspension of SWFs voting rights.

Indeed, as the decision on whether to vote their own shares should be left in principle to SWFs, disclosure of SWFs voting policies and voting records – by allowing for public monitoring of SWFs behaviour as shareholders[147] – is deemed to effectively and proportionately “mitigate concerns about real or perceived conflicts between economic and political interests that can arise with large cross-border government investment vehicles like SWFs. Experience with mutual funds in the United States suggests the overall costs of disclosure are minimal”[148].

10.4. How to asses SWF equity investment motives: “Market Economy Investor” legal test.

So as to properly distinguish between a legitimate SWFs shareholding in a company and politically biased investments, reference could be made to the so-called “private investor test” adopted by the EU Commission to enforce the EC Treaty provisions on "State Aid".

For the above test to be fulfilled, it is necessary to demonstrate that a private investor, whose purpose is long-run profit, would have acted as the State (in our case a SWF) did in its shareholder capacity.

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[147] Keller A. D., (2008), Sovereign Wealth Funds: Trustworthy Investors or Vehicles of Strategic Ambition? (September 11, 2008), Georgetown Journal of Law & Public Policy, Vol. 7, No. 1, 2008 (http://ssrn.com/abstract=1264349), p. 66.

[148] See: Remarks by Treasury Assistant Secretary for International Affairs Clay Lowery at Barclays Capital’s 12th Annual Global Inflation-Linked Conference, (hp-836), February 25, 2008.

For example, the EU Commission typically requires evidence that "it can reasonably be supposed that there will be a normal return on the State's investment in the whole operation which would be acceptable to a private investor in a market economy. Otherwise, there is a State aid component". In particular, in case of a public holding in a company's capital, it is necessary to establish whether the public holding "is intended to earn a return, and has consequently been acquired by the State or public holding corporation in the same way as it might have been acquired by a private buyer, or whether it has been acquired in the public interest, so that the acquisition has to be considered a form of assistance by the State in its capacity as public authority. When public capital is to be injected into a business, the question arises whether a private investor would do the same. The test is satisfied where the capital invested can be expected to produce a normal return on the investment in the form of dividends or capital gains"[149].

In this respect, so as to avoid problems related to possibly erratic scrutiny, by third-party subjects (e.g. foreign authority), of the underlying motive of SWF equity investments:

- A general shareholding threshold to SWFs investments could be set;
- SWFs could consider to self-enforce the voting suspension on their shareholdings (or consciously restrict their equity investments to purchase of "non-voting" shares, as with the 2007 China CIC investment in Blackstone)[150];
- SWFs could consider irrevocably delegating their voting powers to a trustee or third-party asset managers that will vote compliantly with predefined and disclosed guidelines (e.g. California Public Employees Retirement System – CalPERS – discloses "information about how CalPERS will vote its portfolio securities, and whether CalPERS has engaged in discussions with company management"[151]).

As a result:

- SWFs only interested in strategic holdings will have lower incentives to invest;

[149] EU Commission XXX Report on Competition Policy 2000, par. 304.

[150] As reported, "on May 20, 2007, China Jianyin Investment Company, a wholly-owned subsidiary of the Central Huijin Investment Company (CHIC), signed an agreement to purchase a less than 10% stake in Blackstone Group in non-voting shares worth $3 billion. The decision to purchase less than 10% of Blackstone's shares, and to purchase non-voting shares, was apparently not an arbitrary one. According to Blackstone's CEO and Chairman Stephen A. Schwarzman, "The deal is 'purely commercial' and do [sic] not need the U.S. government approval as the stake is less than 10 percent", Martin M. F., (2008), China's Sovereign Wealth Fund, CSR Report for Congress, January 22, 2008, p. 8.

[151] Speech by SEC Commissioner: Remarks to the Investment Company Institute Procedures Conference by Paul R. Carey Commissioner, U.S. Securities & Exchange Commission, December 9, 1999.

- SWFs only interest in the investment financial value will not be (completely) deterred.

That said, limitation or suspension of the voting rights of SWFs strategic holdings is far from being a perfect solution to issues and concerns raised by SWFs equity investments. It could rather be regarded as a mere tool to (temporarily) reduce risks of protectionist backlash from recipient countries, and adoption of defensive measures by target companies. The absence of a protectionist response will probably "allow the global markets to demonstrate that, in the long run, governments make ineffective capitalists, especially where innovation is the ultimate currency. Buying time to allow the competition between the two systems of capitalism to work itself out is no small matter" (Gilson R. J. and Milhaupt C. J. - 2008)[152].

Moreover, the expected progressive unwinding of global imbalances would meanwhile probably lead to a decrease in both size and number of SWFs, thus automatically reducing the importance and relevance of related issues.

Nevertheless – also considering the negative "side effects" of possible SWFs voting rights suspension, confirmed by GAAP Principle No 21 stating that "SWFs view shareholder ownership rights as a fundamental element of their equity investments' value" – mandatory or voluntary disclosure of SWFs shareholdings, voting policies and voting records should be regarded as the "first-best" solution to tackle issues and concerns related to SWFs behaviour as shareholders.

11. The EU approach to SWFs and complementary "soft law" measures: "Santiago Principles" and OECD "legal" instruments.

As mentioned, as any other foreign investors, SWFs are already subject to a comprehensive set of rules governing foreign investors' operations, both at international and European level. Nevertheless, the political and economic implications of large cross-border investments by state-owned investors such as SWFs and related new focus on improved SWFs transparency and governance has sparked a harsh public debate among both SWFs owners and recipient countries on whether a proper "hard" regulatory regime for SWFs investments should be introduced.

[152] Gilson R. J. and Milhaupt C. J., (2008), Sovereign Wealth Funds and corporate governance: a minimalist response to the new merchantilism, (February 18, 2008). Stanford University Law and Economics Olin Paper No 355 and Columbia University Law and Economics Olin Paper No 328, p. 31.

Different solutions have been proposed so far, ranging from staunch "*laissez-faire*" positions to requests for protectionist measures.

In particular, the policy endorsed by the EU institutions aims "to promote a cooperative effort between recipient countries and SWFs and their sponsor countries to establish a set of principles ensuring the transparency, predictability and accountability of SWFs investments", primarily by supporting and contributing to the efforts already undertaken at international level – e.g. by the IMF in order to design a code of conduct for SWFs and their sponsor countries, and by the OECD in order to identify best practices and principles expected to be applied by recipient countries when dealing with SWFs[153].

In this respect, from the EU Commission point of view a balanced and proportionate approach to SWFs treatment as investors should be based on the following principles: *i)* commitment to an open investment environment for foreign capital and investor-friendly investment climate, in line with the Lisbon Strategy for growth and jobs (any protectionist move may trigger a spiral of protectionism, negatively affecting both global growth and the EU economy); *ii)* support to multilateral work carried out by international organisations, in particular IMF and OECD; *iii)* use of existing legal instruments currently allowing the EU and Member States to formulate appropriate responses to risks or challenges raised by cross-border investments for "public policy" and "public security" reasons; *iv)* respect of EC Treaty obligations and EU international commitments; *v)* proportionality and transparency of any possible measures and rules taken on foreign investments for (national) "public interest" reasons.

As a result, the EU approach to SWFs issues appears to be broadly compatible with the "two-layer regulatory approach" to SWFs of "self-regulation within a statutory framework" herein proposed. Indeed, the position formally endorsed by the EU institutions appears to confirm the idea hereby suggested that most of the issues raised by SWFs (namely, misallocation of resources due to their lack of transparency, suspicions and uncertainty surrounding their strategies and investment motives) may be more efficiently tackled by market participants themselves through development of reasonable and appropriate "soft law" measures (i.e. voluntary codes of conduct, guidelines and best practices for SWFs and recipient countries), if necessary complemented with a "light" regulatory intervention aimed (and limited), at least in the first instance, at minimising transaction and "bargaining" costs between SWFs (interested in secure and liberal access to industrial-country markets for their capital) and other stakeholders (concerned about SWFs objectives and operations).

Indeed, as correctly pointed out, the collaborative process established to identify and draft the "Santiago Principles" indicates that "the growing trade and

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[153] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "A common European approach to Sovereign Wealth Funds", COM (2008) 115 final, 27.2.2008, par. 4.1; European Parliament resolution of 23 September 2008 with recommendations to the Commission on transparency of institutional investors (2007/2239(INI).

investment ties that bind the economies of the world together are more likely to promote responsible economic behavior than to entice mayhem. Investment is about creating wealth, not destroying it"[154].

Of course, whereby a conflict of interests, rather than mutual interest, arises between the parties involved, efficiency increase may result in wealth transfer from one group of "market participants" to others – thus the party benefiting from inefficiency (e.g. a SWF taking advantage of privileged information by the sponsor government while competing with private undertakings and/or benefit from private interests in portfolio companies by using their voting rights or through other means, or a recipient country trying to protect its "national champions" or other local interests) does not have strong incentive to change the situation. As a result, voluntary or "soft law" instruments alone are not likely to ensure efficient outcome, thus making a (EU harmonised) formal regulatory intervention more desirable.

As said, the international debate on SWFs essentially revolved around the lack of transparency of SWFs investments and operations and possible strategic/political bias in SWFs operation. In order to ease the related concerns, two key aspects – also standing at the core of the EU approach to SWFs – are expected to be addressed, primarily by SWFs and their sponsor countries: *i)* adoption of appropriate SWFs governance structure (guaranteeing, *inter alia*, clear division of rights and responsibilities between sponsoring governments and SWF managers); *ii)* delivery of greater transparency (on their activities, investments, AUM value, investment objectives and strategies, target portfolio allocations, risk management systems, and internal controls)[155].

In this respect, according to the EU Commission, principles of good governance should include: *i*) clear allocation and separation of responsibilities in SWF internal governance structure; *ii*) development and issuance of an investment policy defining the overall objectives of SWF investment; *iii*) operational autonomy for the entity to achieve its defined objectives; *iv*) public disclosure of the general principles governing SWFs interaction with governmental authority; *v*) disclosure of the internal governance general principles providing for integrity assurance; and *vi*) development and issuance of risk-management policies.

[154] Markheim D., (2008), Sovereign Wealth Funds: New Voluntary Principles a Step in the Right Direction, Center for International Trade and Economics (CITE), The Heritage Foundation, Web memo, No. 2175, December 18, 2008, p. 3.

[155] In the opinion of the EU Commission "clarity about the degree of possible political interference in the operation of a SWF is a prerequisite for addressing concerns about the existence of political and other non-commercial considerations in the operation of a fund", while "transparency provides a disciplinary effect on the management of sovereign assets, as relevant stakeholders can exercise some degree of oversight on the activities of investors, and monitor whether or not funds deviate from their stated objectives. As such, transparency promotes accountability. In the case of SWFs, transparency not only serves to foster market discipline, but also reduces the incentives for any government intervention. It is therefore a critical factor in offering the confidence that underlies an open investment environment", Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, "A common European approach to Sovereign Wealth Funds", COM (2008) 115 final, 27.2.2008, par. 4.3

On the other hand, the following transparency best practices deserve consideration: *i*) annual disclosure of investment positions and asset allocation, in particular for majority ownership investments; *ii*) exercise of ownership rights; *iii*) disclosure of leverage use and currency composition; *iv*) size and source of entity's resources; *v*) disclosure of the home country regulation and oversight governing SWFs.

Considering that – as also recognised by EU institutions – multilateral solutions and multilateral agreements on SWFs are to be preferred to unilateral actions[156], significant steps have been already taken at international level to better understand the SWFs phenomenon and properly address related challenges and issues. In particular, on the occasion of the meeting held in Washington in October 2007, the G-7 Finance Ministers and Central Bank Governors[157] agreed, among other things, that "sovereign wealth funds (SWFs) are increasingly important participants in the international financial system and that our economies can benefit from openness to SWF investment flows" and thus requested the IMF, the World Bank and the OECD to examine the following main issues: identification of possible "best practices for SWFs in areas such as institutional structure, risk management, transparency and accountability" and the importance for "recipients of government-controlled investments […] to build on principles such as non-discrimination, transparency, and predictability"[158]. A G-7 outreach dinner with Finance Ministers and Heads of SWFs from China, Korea, Kuwait, Norway, Russia, Saudi Arabia, Singapore, and the United Arab Emirates was consequently hosted to build up support for a set of SWFs best practices.

Following the recommendations endorsed by the G-7, the IMF (rightly) decided not to take unilateral actions, but instead to closely cooperate with the International Working Group of Sovereign Wealth Funds (IWG-SWF) – established on 30 April-1 May 2008 in Washington D.C. and comprising 26 IMF member countries with SWFs – in order to develop a voluntary code of conduct for SWFs. A preliminary survey of SWFs current institutional and operational practices was therefore conducted, soliciting responses on a voluntary and confidential basis from IWG-SWF members[159].

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[156] Indeed as noted "unilateral action has at least three problems. First, unilateral action could easily acquire a protectionist slant, especially if protectionists articulate their concerns in the language of national security as happened in the aborted acquisition effort by Dubai Ports World and in the case of the Chinese national oil company, China National Offshore Oil Corporation (CNOOC). Second, there could be proliferating and hence highly heterogeneous standards imposed by different capital-receiving governments, which could impose undue costs of compliance on SWFs and hence affect the efficient flow of capital. Third, even where unilateral legislation is enlightened and uniform and takes the form of stipulating reasonable restrictions on SWFs in return for secure access, there are likely to be difficulties in monitoring compliance with these restrictions unilaterally or even bilaterally", Mattoo A. and Subramanian A., (2008), Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization, Peterson Institute for International Economics, Working Paper Series 08-02, January 2008, p. 16.

[157] Members of G-7 are: Canada, France, Germany, Italy, Japan, United Kingdom, and United States.

[158] Statement of G7 Finance Ministers and Central Bank Governors, Washington, October 19, 2007.

[159] See: IWG Secretariat in collaboration with the Members of the IWG, Sovereign Wealth Funds, Current Institutional and Operational Practices, September 15, 2008, p. 4.

The work facilitated and coordinated by the IMF led the IWG-SWF to adopt (October 2008) a set of 24 Generally Accepted Principles and Practices (GAPP) – a.k.a. "Santiago Principles" – that IWG-SWF members agreed to follow on a voluntary basis (**Box 1**).

The IWG benefited not only from the mixed interest represented by its members but also from the input from a number of SWFs investments recipient countries (i.e. Australia, Brazil, Canada, France, Germany, India, Italy, Japan, South Africa, Spain, the United Kingdom, and the United States) as well as from the European Commission (acting on behalf of the European Union, as agreed by the European Council on 14 March 2008), the OECD, and the World Bank[160].

<table>
<tr><th colspan="2">Box 1 – Generally Accepted Principles and Practices (GAPP) – Santiago Principles (October 2008)</th></tr>
<tr><td>GAPP 1. Principle: The legal framework for the SWF should be sound, and support its effective operation and the achievement of its stated objective(s).</td><td>GAPP 1.1 Subprinciple The legal framework for the SWF should ensure the legal soundness of the SWF and its transactions.

GAPP 1.2 Subprinciple The key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and the other state bodies, should be publicly disclosed.</td></tr>
<tr><td colspan="2">GAPP 2. Principle: The policy purpose of the SWF should be clearly defined and publicly disclosed.</td></tr>
<tr><td colspan="2">GAPP 3. Principle: Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.</td></tr>
<tr><td>GAPP 4. Principle: There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations</td><td>GAPP 4.1 Subprinciple The source of SWF funding should be publicly disclosed.

GAPP 4.2 Subprinciple The general approach to withdrawals from the SWF and spending on behalf of the government should be publicly disclosed.</td></tr>
<tr><td colspan="2">GAPP 5. Principle: The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.</td></tr>
</table>

[160] International Working Group of Sovereign Wealth Funds (2008), Sovereign Wealth Funds, Generally Accepted Principles and Practices. "Santiago Principles", October 2008, p. 2.

GAPP 6. Principle: The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives.
GAPP 7. Principle: The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations.
GAPP 8. Principle: The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions.
GAPP 9. Principle: The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities
GAPP 10. Principle: The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.
GAPP 11. Principle: An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.
GAPP 12. Principle: The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner
GAPP 13. Principle: Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff.
GAPP 14. Principle: Dealing with third parties for the purpose of the SWF's operational management should be based on economic and financial grounds, and follow clear rules and procedures.
GAPP 15. Principle: SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.
GAPP 16. Principle: The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.
GAPP 17. Principle: Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.

GAPP 18. Principle: The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.	*GAPP 18.1 Subprinciple* The investment policy should guide the SWF's financial risk exposures and the possible use of leverage. *GAPP 18.2 Subprinciple* The investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored. *GAPP 18.3 Subprinciple* A description of the investment policy of the SWF should be publicly disclosed.
GAPP 19. Principle: The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.	*GAPP 19.1 Subprinciple* If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed. *GAPP 19.2 Subprinciple* The management of an SWF's assets should be consistent with what is generally accepted as sound asset management principles.
GAPP 20. Principle: The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.	
GAPP 21. Principle: SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.	

GAPP 22. Principle: The SWF should have a framework that identifies, assesses, and manages the risks of its operations.	*GAPP 22.1 Subprinciple* The risk management framework should include reliable information and timely reporting systems, which should enable the adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function. *GAPP 22.2 Subprinciple* The general approach to the SWF's risk management framework should be publicly disclosed.
GAPP 23. Principle: The assets and investment performance (absolute and relative to benchmarks, if any) of the SWF should be measured and reported to the owner according to clearly defined principles or standards.	
GAPP 24. Principle: A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.	

GAPP adoption is intended to support SWFs sponsor countries to better structure and manage their SWFs and promote market confidence, which in turn may help counteract the move toward the adoption of protectionist barriers to SWFs investments. As noticed, "although the current financial crisis has given SWFs a boost in popularity – these days nations are happy to get capital from any source – the implementation of GAPP practices should help prevent a return to the hostile investment environment of the recent past"[161].

In particular, the "Santiago Principles" – each subject to home country laws, regulations, requirements and obligations – essentially lay down a voluntary framework providing guidance to improve SWFs <u>governance structure</u> (primarily through clear separation between fund management and sponsor country government), <u>investment policies and decisions</u> (through commitment to implement investment policies based on economic and financial grounds, and not on political considerations, and make "proper" use of voting rights attached to SWFs shareholdings), <u>risk management</u>, <u>disclosure</u> and <u>accountability</u>.

As a result, according to the IMF, they are expected to "contribute to reducing concerns about these types of funds that could lead to counterproductive restrictions on such inflows […while on the other hand…] guidelines for recipient countries, which are under development at the Organization for Economic

[161] Markheim D., (2008), Sovereign Wealth Funds: New Voluntary Principles a Step in the Right Direction, Centre for International Trade and Economics (CITE), The Heritage Foundation, Web memo, No. 2175, December 18, 2008.

Cooperation and Development, would help reassure the SWFs of fair, transparent, and open access to markets"[162].

The content of the "Santiago Principles" is broadly sharable and indeed their assessment has been widely positive; nevertheless few important issues still stand out. Also due to its voluntary nature, a possible weakness of the "Santiago framework" could be primarily identified in the absence of proper enforcement and implementation mechanisms and in the related risk that its principles and commitments could turn out to be ineffective[163]. As a result, SWFs might "continue to face difficulties finding access to certain economies and being accepted as reliable institutional investors"[164].

In other words, "if committing to the GAPP were to develop into a seal of quality, SWFs would need to back up their commitment with action. They should adhere to financial objectives and implement and apply transparency and governance standards in a way that can actually be monitored by all stakeholders"[165], and above all by the competent authorities in recipient countries.

In this respect a significant example was provided by recent institutional developments in Italy where an Interministerial Strategic Committee was established in July 2008 (i.e. "*Comitato Strategico per lo Sviluppo e la Tutela all'Estero degli Interessi Nazionali in Economia*", literally: "Strategic Committee for Development and Protection Abroad of Economic National Interests") entrusted, *inter alia*, with the function of advising the government and devising policies on foreign investments and SWFs, manly in order "to promote useful investments and prevent dangerous ones".

Indeed Italy has been the first EU Member State to officially endorse the "Santiago Principles", conferring them a quasi-regulatory nature and function. For the specific purpose of distinguishing SWFs "to be encouraged (which is the case of the United Arab Emirates) from those to regard with caution"[166] – in other words to provide a sort of "approval stamp" to SWFs interested in investing in Italy – it was formally stated that reference would be made to actual compliance of the relevant SWF with the "Santiago Principles" approved by the IWG. That

[162] International Monetary Fund (IMF), 2008, Financial Stress, Downturns, and Recoveries, World Economic Outlook, October 2008, p. XX.

[163] Anyhow it has been argued that "these principles are not a set of ideals that SWFs will struggle to reach, but an inventory of best practices that already exist. This means that the GAPP do not require SWFs to do anything that is not already being done by at least one other SWF. It should therefore be harder for SWFs to argue that they cannot live up to the GAPP's standards of accountability and transparency. Now that SWFs have signed up to the GAPP, there may even be a process of competitive emulation", Barysch K., Tilford S. and Whyte P., (2008), State, money and rules: An EU policy for sovereign investments, Centre for European reform essay, December 2008, p. 14.

[164] Kern S., (2008b), Control mechanisms for sovereign wealth funds in selected countries, CESifo DICE Report, No 4/2008, p. 47.

[165] *Ibidem*, p. 47.

[166] Cifoni L., (2008), Intervista al Ministro Frattini: "I Fondi sovrani non superano quota 5%" (Interview with Minister Frattini: "Sovereign Wealth Funds no higher than 5%"), Il Messaggero, 20 October 2008.

said, additional criteria will be followed so as to tell the "welcomed" from the "unwanted" foreign investors. Guidelines so far formulated provide that those funds "that operate transparently, that aim at investing in and not controlling businesses and that, therefore, tend to stay at under 5%" will always be considered "trustworthy" investors. Assessment by the targeted industrial sector will be also carried out compliantly with the "Interministerial Strategic Committee" recommendations. It is however already evident that SWFs intervention would be deemed particularly beneficial in some specific sectors (i.e. infrastructure, transport and tourism) while in "sensitive sectors" (i.e. relevant for "national defence") industrial cooperation agreements will be preferred to direct capital investment[167].

Beside the efforts in developing guidelines and "soft law" principles for SWFs – following the mandate received by the G-7 Finance Ministers and Central Bank Governors (and other OECD members) and "as part of an ongoing project on Freedom of Investment and National Security, which was launched in view of the rise of investment protectionism and to maintain open markets"[168] – the OECD started working at the development of a set of harmonised principles, best practices and guidance for recipient countries' policies towards investments from SWFs, essentially "to ensure that they are evaluated on an equal basis as other investments and to make sure that recipient countries' policies do not create barriers to efficient flows of capital across borders"[169] or unnecessary limitations to market access. In this respect, it has been pointed out that "economies worldwide are separated from each other in terms of foreign investments by substantial regulatory barriers. […] The EU and its member states are, on average, the most open and liberal economies in the world, with Latvia, Belgium, Germany, the UK, Italy, the Netherlands, Ireland, Lithuania and France leading the field. Japan, the US and other industrial and emerging economies follow. Russia, India and China are the most restrictive countries. Paradoxically, a comparison of the degree of restrictiveness on foreign direct investments versus the volumes of sovereign assets at issue suggests that it is particularly countries with extensive stateowned funds at their disposal which currently maintain the strictest regimes when it comes to preventing foreign investment from entering their domestic markets" [170].

Although the OECD project is focused on host/recipient country policies and is independent from efforts undertaken to develop SWFs voluntary best practices, SWFs observance of high governance and transparency standards (i.e. "Santiago Principles") is deemed to "facilitate recipient countries' efforts to

[167] *Ibidem*.

[168] OECD, Sovereign wealth funds and recipient country policies, Letter transmitting the Report of the OECD Investment Committee to G7 Finance Ministers, 4 April 2008.

[169] Paulson A. L., (2009), Raising capital: The role of sovereign wealth funds, Chicago Fed Letter, The Federal Reserve Bank of Chicago, January 2009, Number 258, pp. 3-4.

[170] Kern S., (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, pp. 20-21.

implement their OECD commitments and its recommendations for preserving open markets while safeguarding national security"[171].

The OECD final report of the "Freedom of Investment" Project (covering also SWFs investments) is expected to be released in Spring 2009. The resulting policy guidance will take the form of a menu of best practices consistent with existing OECD investment instruments (i.e. OECD Code of Liberalisation of Capital Movements (1961) and OECD Declaration on International Investment and Multinational Enterprises (1976), as revised in 2000) and with the key principles of transparency and predictability, non discrimination, regulatory proportionality and accountability that should govern foreign investment policies designed by recipient countries to safeguard national security, as agreed by participants in OECD "Freedom of Investment, National Security and Strategic Industries" Project.

In the meanwhile the OECD Investment Committee published an interim report on "Sovereign Wealth Funds and Recipient Country Policies"[172] based on a wide consultation with the thirty OECD countries, fourteen non-member countries participating in the project, the European Commission and SWFs.

The OECD report acknowledges that SWFs have much to offer, not only to their sponsor countries (e.g. through better management of their foreign exchange assets and general contribution to economic development, macroeconomic stabilisation or inter-generational saving) but also to recipient countries, as confirmed by the stabilising effects of their capital injections into several OECD distressed financial institutions, their ability to recycle savings internationally, their track record as long-term investors, and the stimulating effect of their (foreign) investments on business activity and the job market.

At the same time, the report underscores that "the growing role of SWFs raises issues regarding the smooth functioning of financial markets and they raise investment policy questions, including legitimate concerns in recipient countries about protecting national security"[173].

In this respect, the OECD deems that the existing instruments on foreign investments – developed under the OECD *acquis* – already provide for adequate guidance and principles for recipient country policies, also as to SWFs

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[171] *Ibidem*.

[172] OECD Investment Committee, (2008), Report on "Sovereign Wealth Funds and Recipient Country Policies", 4 April 2008.

[173] In particular, "investments controlled by foreign governments, such as those by SWFs, can raise concerns based on uncertainty regarding the objectives of the investor and whether they are commercially based or driven by political or foreign policy considerations. They can raise concerns with respect to foreign government control or access to defence related technologies – for example, that such investments could provide a channel for the acquisition of dual-use technologies for military purposes by the acquiring country or for denying technology or other assets critical for national defence to the recipient government itself, or for aiding the intelligence capabilities of a foreign country that is hostile to the host country", *Ibidem*, pp. 2-3 and 4.

investments. In particular, through their adherence to OECD investment instruments, the OECD and other adhering governments have committed to the following main principles designed to maintain open markets and preserve an open international investment system: *i*) non discrimination (i.e. treat foreign investors not less favourably than domestic investors in like situations. "While the OECD instruments protect directly the investment freedoms of those SWFs established in OECD member countries, they also commit members to using their best endeavours to extend the benefits of liberalisation to all members of the International Monetary Fund"[174]); *ii*) transparency and predictability (investment-relevant laws should be public); *iii*) progressive liberalisation (commitment towards a more open regime for capital movements); *iv*) "standstill clause" (commitment to not introducing new restrictions); *v*) unilateral liberalisation or "no reciprocity" principle (as long as liberalisation is considered beneficial to all, especially for the country undertaking liberalisation, OECD members commit to not conditioning the application of their own liberalisation measures upon the liberalisation measures adopted by other countries).

With specific reference to concerns as to whether the objectives of SWF investments are either commercial or driven by political, defence or foreign policy considerations, the OECD "Code of Liberalisation of Capital Movements" (also covering direct investment and establishment) and "Code Of Liberalisation Of Current Invisible Operations" (covering services)[175] already acknowledge countries' right to adopt measures to protect their national security. Indeed Article 3 ("public order and security") in both Codes provides that their provisions "shall not prevent a Member from taking action which it considers necessary for: *i*) the maintenance of public order or the protection of public health, morals and safety; *ii*) the protection of its essential security interests; or *iii*) the fulfilment of its obligations relating to international peace and security". Nevertheless, as clarified, this "national security clause" should be applied with restraint, indeed possible "safeguard provisions relating in particular to public order and essential security interests are deemed to address exceptional situations. In principle, they allow Members to introduce, reintroduce or maintain restrictions not covered by reservations to the Code, and, at the same time, exempt these restrictions from the principle of progressive liberalisation"[176].

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[174] *Ibidem*, p. 3.

[175] As pointed out "the OECD Capital Movements Code is the only multilateral instrument promoting liberalisation of the full range of international capital movements, other than the rules of the European Union and of the European Economic Area. When it was created in 1961, its coverage was rather limited. However, since then, […] member countries have gradually extended the list of transactions until it could be considered complete. Today, the Capital Movements Code applies to all long- and short-term capital movements between residents of OECD countries. […]Coverage of cross-border trade in services by the Current Invisibles Code is large, but not quite as comprehensive", OECD, (2008), Codes of Liberalisation: user's guide, p. 9

[176] OECD, (2003), OECD Codes of Liberalisation of Capital Movements and of Current Invisible Operations, User's Guide, p. 34.

As reported by the OECD Investment Committee, surveys of participating countries' policies "have revealed that most countries have one or more investment measures designed to safeguard national security. However, few presently have explicit policies regarding foreign government-controlled investors, such as SWFs"[177]. As a result, participants in the OECD project on "Freedom of Investment, National Security and Strategic Industries" have recently agreed on a number of key policy principles (i.e. non-discrimination; transparency and predictability, regulatory proportionality and accountability) that should be followed when adopting and implementing legal and regulatory measures intended to address national security concerns that arise in the general context of foreign investments as well as in the specific context of investments from SWFs[178] (**Box 2**).

Box 2 – Guidance for recipient countries' policy measures designed to safeguard national security toward SWFs and other foreign investments **(As agreed by participants in OECD Investment Committee's project on Freedom of Investment, National Security and 'Strategic Industries' (2008) and by governments at the 8th Roundtable on Freedom of Investment, under the auspices of the OECD Investment Committee - 8 October 2008)**	
1) Non-discrimination	Governments should be guided by the principle of non-discrimination. In general governments should rely on measures of general application which treat similarly situated investors in a similar fashion. Where such measures are deemed inadequate to protect national security, specific measures taken with respect to individual investments should be based on the specific circumstances of the individual investment which pose a risk to national security.
2) Transparency and Predictability	While it is in investors' and governments' interests to maintain confidentiality of sensitive information, regulatory objectives and practices should be made as transparent as possible so as to increase the predictability of outcomes. **A) Codification and publication**. Primary and subordinate laws should be codified and made available to the public in a convenient form (e.g. in a public register; on internet). In particular, evaluation criteria used in reviews should be made available to the public. **B) Prior notification**. Governments should take steps to notify interested parties about plans to change investment policies.

[177] OECD Investment Committee, (2008), Report on "Sovereign Wealth Funds and Recipient Country Policies", 4 April 2008, p. 4.

[178] *Ibidem*.

	C) Consultation. Governments should seek the views of interested parties when they are considering changing investment policies. **D) Procedural fairness and predictability**. Strict time limits should be applied to review procedures for foreign investments. Commercially-sensitive information provided by the investor should be protected. Where possible, rules providing for approval of transactions if action is not taken to restrict or condition a transaction within a specified time frame should be considered. **E) Disclosure of investment policy actions is the first step in ensuring accountability**. Governments should ensure that they adequately disclose investment policy actions (e.g. through press releases, annual reports or reports to Parliament), while also protecting commercially-sensitive and classified information.
3) Regulatory Proportionality	Restrictions on investment, or conditions on transaction, should not be greater than needed to protect national security and they should be avoided when other existing measures are adequate and appropriate to address a national security concern. **A) Essential security concerns are self-judging**. OECD investment instruments recognize that each country has a right to determine what is necessary to protect its national security. This determination should be made using risk assessment techniques that are rigorous and that reflect the country's circumstances, institutions and resources. The relationship between investment restrictions and the national security risks identified should be clear. **B) Narrow focus**. Investment restrictions should be narrowly focused on concerns related to national security. **C) Appropriate expertise**. Security-related investment measures should be designed so that they benefit from adequate national security expertise as well as expertise necessary to weigh the implications of actions with respect to the benefits of open investment policies and the impact of restrictions. **D) Tailored responses**. If used at all, restrictive investment measures should be tailored to the specific risks posed by specific investment proposals. This would include providing for policy measures (especially risk mitigation agreements) that address security concerns, but fall short of blocking investments.

	E) Last resort. Restrictive investment measures should be used, if at all, as a last resort when other policies (e.g. sectoral licensing, competition policy, financial market regulations) cannot be used to eliminate security-related concerns.
4) Accountability	Procedures for internal government oversight, parliamentary oversight, judicial review, periodic regulatory impact assessments, and requirements that important decisions (including decisions to block an investment) should be taken at high government levels should be considered to ensure accountability of the implementing authorities. **A) Accountability to citizens.** Authorities responsible for restrictive investment policy measures should be accountable to the citizens on whose behalf these measures are taken. Countries use a mix of political and judicial oversight mechanisms to preserve the neutrality and objectivity of the investment review process while also ensuring its political accountability. Measures to enhance the accountability of implementing authorities to Parliament should be considered (e.g. Parliamentary committee monitoring of policy implementation and answers or reports to Parliament that also protect sensitive commercial or security-related information). **B) International accountability mechanisms.** All countries share a collective interest in maintaining international investment policies that are open, legitimate and fair. Through various international standards, governments recognise this collective interest and agree to participate in related international accountability mechanisms (e.g. the OECD notification and peer review obligations in relation to restrictive investment policies). In particular, these help constrain domestic political pressures for restrictive and discriminatory policies. Recipient governments should participate in and support these mechanisms. **C) Recourse for foreign investors.** The possibility for foreign investors to seek review of decisions to restrict foreign investments through administrative procedures or before judicial or administrative courts can enhance accountability. However, some national constitutions' allocation of authority with respect to national security may place limits on the scope of authority of the courts. Moreover, judicial and administrative procedures can be costly and time-consuming for both recipient governments and investors, it is important to have mechanisms in place to ensure the effectiveness, integrity and objectivity of decisions so that recourse to such procedures is rare. The possibility of seeking redress should not hinder the executive branch in fulfilling its responsibility to protect national security.

	D) The ultimate authority for important decisions (e.g. to block foreign investments) should reside at a high political level. Such decisions require high-level involvement because they may restrict the free expression of property rights, a critical underpinning of market economies, and because they often require co-ordination among numerous government functions. The final decision to prohibit (or block) an investment should be taken at the level of heads of state or ministers. **E) Effective public sector management.** Broader public sector management systems help ensure that the political level officials and civil servants responsible for security-related investment policies face appropriate incentives and controls for ensuring that they exercise due care in carrying out their responsibilities and are free from corruption, undue influence and conflict of interest.
Source: OECD Investment Committee, (2008), Report on "Sovereign Wealth Funds and Recipient Country Policies", 4 April 2008; OECD, (2008), Sovereign Wealth Funds and Recipient Countries - Working together to maintain and expand freedom of investment, Message by the OECD Secretary-General to the International Monetary and Financial Committee, 11 October 2008, Washington.	

As a result, although the final report of the OECD "Freedom of Investment" Project (also covering SWFs investments) is not expected to be released until Spring 2009, the principles and guidance so far supported/developed by the OECD appear to already lay down a comprehensive, cooperative and sound approach to the concerns and issues raised by SWFs investments and provide important yardsticks for national investment policies. Nevertheless, it has been argued that "principles are still too vague to constitute a proper framework for SWF investment. For example, proportionality and accountability need to be more clearly defined for the SWFs to be satisfied"[179]. In particular, "for the SWFs to be satisfied, the OECD should make bigger efforts to involve them in the deliberations about the final report. […] And it needs to be prepared to give SWF countries a role in ascertaining whether recipient countries stick to the principles that they have signed up to (just like the recipient countries want a role in monitoring SWF compliance with new principles on transparency and accountability)"[180] provided for in the "Santiago Principles".

As to the latter remark, it is evident that, unlike the "Santiago Principles" approved and endorsed on a mere voluntary basis by (however authoritative and influential) IWG members, the OECD investment instruments on foreign

[179] Barysch K., Tilford S. and Whyte P., (2008), State, money and rules: An EU policy for sovereign investments, Centre for European reform essay, December 2008, p. 15.

[180] *Ibidem*, p. 16.

investments and Codes constitute “legally binding rules” of behaviour for the governments of OECD member countries and countries signing up to them[181].

Even though OECD principles and commitments cannot be “legally” enforced through court decisions or other statutory enforcement actions and although “the Codes’ procedures do not provide for coercion or applying of leverage”[182] (thus “effectively leaving political application to national governments, so that the degrees of commitment and the ways of implementation and enforcement are likely to vary”[183]), adherence is promoted (and achieved) by the “peer pressure” exercised through the provided processes of “peer monitoring” and “peer review” of adhering government’s observance[184]. In this respect, the OECD “Freedom of Investment” Project – launched in 2006 to support governments in their efforts to preserve and expand an open international investment environment while safeguarding the essential security interests of their countries – has further “strengthened peer monitoring of country developments. This includes country notifications and deadlines for responding to Secretariat enquiries, roundtable question & answer sessions, and published accounts of the discussions”[185].

That said, a concluding remark is now required. As mentioned, the pace of globalisation and the related growing economic importance of international trade and foreign investment flows (resulting in persistent global imbalances fuelling also SWFs increase in size and number) bring about significant ties and interdependence between countries, all over the world, more likely to promote commitment and compliance to responsible policies and cooperative economic behaviour by national governments than to result in disruption of the <u>international legal and economic order</u>.

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[181] However, as clarified, they are “not a treaty or international agreement in the sense of international law”, such as for instance the WTO agreements” (e.g. the General Agreement on Trade in Services), OECD, (2008), Codes of Liberalisation: user's guide, p. 8.

[182] *Ibidem*, p. 10.

[183] Kern S., (2008b), Control mechanisms for sovereign wealth funds in selected countries, CESifo DICE Report, No 4/2008, p. 46.

[184] In particular, as specified, “the OECD Investment Committee is the structure where member countries meet to discuss application and implementation of the Codes. The European Commission is represented. Other representatives, including from non-member countries, may be invited; the IMF, WB, WTO, UNCTAD and EFTA are also observers. […] The Committee conducts peer reviews of each country’s position under the Capital Movements Code […]. Horizontal peer reviews are another instrument under the Current Invisibles Code which look at a specific sector only but cover all countries. […] The Committee usually adopts written reports on each of these reviews which are submitted to the OECD Council. These reports are often accompanied by draft recommendations to the country or countries concerned, or by draft decisions to modify the reservation lists. Final decision on these lies with the OECD Council”, OECD, (2008), Codes of Liberalisation: user's guide, p. 13

[185] OECD, (2008), Sovereign Wealth Funds and Recipient Countries - Working together to maintain and expand freedom of investment, Message by the OECD Secretary-General to the International Monetary and Financial Committee, 11 October 2008, Washington, p. 6.

12. Concluding remarks

This paper argues that the sharp increase in SWFs size and number stands for one of the by-products of large and persistent global imbalances – imbalances possibly threatening global financial and economic stability – and that the increasing transfer of "excess reserves" from Central Banks and Monetary Authorities to SWFs is expected to result in a significant rebalancing of capital flows in the global financial markets.

The research shows that SWFs have provided significant benefits to global capital markets (e.g. via liquidity increase, more efficient risks diversification and resources allocation). Nevertheless, significant (to some extent unjustified) concerns have also been expressed as to: *i)* SWFs limited disclosure and transparency; *ii)* SWFs multiple investment objectives; and, notably *iii)* being sovereign entities' instruments (mainly established by oil producing countries and fast-growing Asian economies), as SWFs may be managed and utilised to pursue not only "genuine" economic and financial objectives but, rather, political and/or strategic objectives or in a fashion entailing national security concerns for the countries where SWFs financial resources are invested.

That said, the factors underlying SWFs gain in prominence – making them emerge as among the most important institutional investors in global financial markets – and the legal and economic issues and concerns raised – not only in the recipient countries – by the cross-border activities of such state-owned investment vehicles appear to require multilateral and multi-layered regulatory approach and response. Indeed, the pace of globalisation and the related growing economic importance of international trade and foreign investment flows have created strong ties and interdependence between countries' policies and economies, which would provide neither effective nor efficient unilateral policy response to SWFs issues. Moreover, recent developments in regulation of international financial markets show that "hard law" is not necessarily the best and most effective "tool" to influence and shape market participants' incentives. As a matter of fact, "soft law" instruments and a "light" regulatory approach may turn out to be the most appropriate and/or "first-best" solution to attain specific policy objectives.

With specific reference to SWF cross border investments, two elements do stand out – namely, *i)* SWFs sponsor countries' interest in secure and liberal access to foreign markets; and *ii)* recipient countries' interest in protecting their legitimate national interest towards foreign investments (notably by foreign sovereign entities) without hindering the increasing liberalisation of trade and capital flows and without stepping back from the international commitment to open investment regime for foreign capital.

Aiming to attain balance between such diverse interests, a flexible, light, indirect and multilateral regulatory framework (based on both "hard" and "soft law" instruments) promoting and facilitating an open "bargaining" process between main stakeholders (e.g. through the IMF, IWG and OECD) turns out to be most appropriate and effective, at least for the time being.

Indeed, such approach would successfully address the primary concerns raised by SWFs while ensuring compliance with the fundamental national, EU and international principles (e.g. fairness, legality, proportionality, reasonableness, transparency and accountability) with which any regulatory scheme addressing SWFs should adhere, also in order not to "discourage" the free flow of (sometimes essential) foreign investments and not to curb associated benefits.

Accordingly, the proportionate and coherent common EU approach to SWFs investments formally endorsed in 2008 by the European Commission in response to emerging concerns (also among EU Member States) is broadly shareable and further implementation would thus be advisable. While aiming to provide a European contribution to the global effort towards adequate measures to increase transparency, predictability, responsibility and accountability of SWF operations, the EU approach suggested that (in the mutual interest of all recipient countries and SWFs sponsor countries) openness to capital investments should be primarily sustained by engaging SWFs and other stakeholders in the development of multilateral and cooperative instruments (e.g. "soft law" codes of conduct and effective cooperative behaviours) aiming to enhance SWF governance and transparency standards.

In particular, while reaffirming the EU commitment to an open investment regulatory environment for foreign capital (pursuant to the EC Treaty principles, the Lisbon Strategy for growth and jobs and EU international obligations), the European Commission, rather than calling for the adoption of new specific statutory and regulatory measures, expressed full support to the multilateral work expected to be carried out, on a voluntary basis, at international level among SWFs, recipient countries and other stakeholders in order to develop and implement a set of guidelines to build the necessary confidence in SWFs fair and transparent operation (e.g. the "Santiago Principles") and in recipient countries' commitment to keep their markets "open for business" towards foreign and SWF investments (e.g. the OECD "Freedom of Investment and National Security" Project).

In this respect, it is worth noting that – at the moment – the adoption within the EU of new legislative or regulatory measures towards SWFs investments could be deemed not appropriate or necessary, also in light of the several legal instruments and provisions currently in force: *i*) prohibiting all restrictions "on the movement of capital and on payments between Member States and between Member States and third countries"; *ii*) allowing both EU institutions and Member States' competent authorities to properly tackle public security issues, or threats to other legitimate national interests (e.g. competition and intellectual property), possibly associated with foreign investments, including SWFs investments.

In other words, it appears that gut reactions are to be avoided, as the current EU legal framework applicable to cross border investments already provides a useful frame of reference for the guidelines and voluntary codes of conduct urged for SWFs investments, which would also contribute to strengthening their effectiveness and facilitating the adoption of cooperative and constructive behaviours among national governments and other relevant stakeholders.

It is of course too early to draw conclusions on whether the resulting regime of "self-regulation within a statutory framework" would deliver the expected policy outcomes. Nevertheless, while patiently testing the effectiveness of the mentioned "soft law" instruments – without rushing into new (burdensome) regulatory measures – the expected progressive unwinding of global imbalances would probably lead to a decrease in both size and number of SWFs and thus would automatically reduce the importance and relevance of the related issues.

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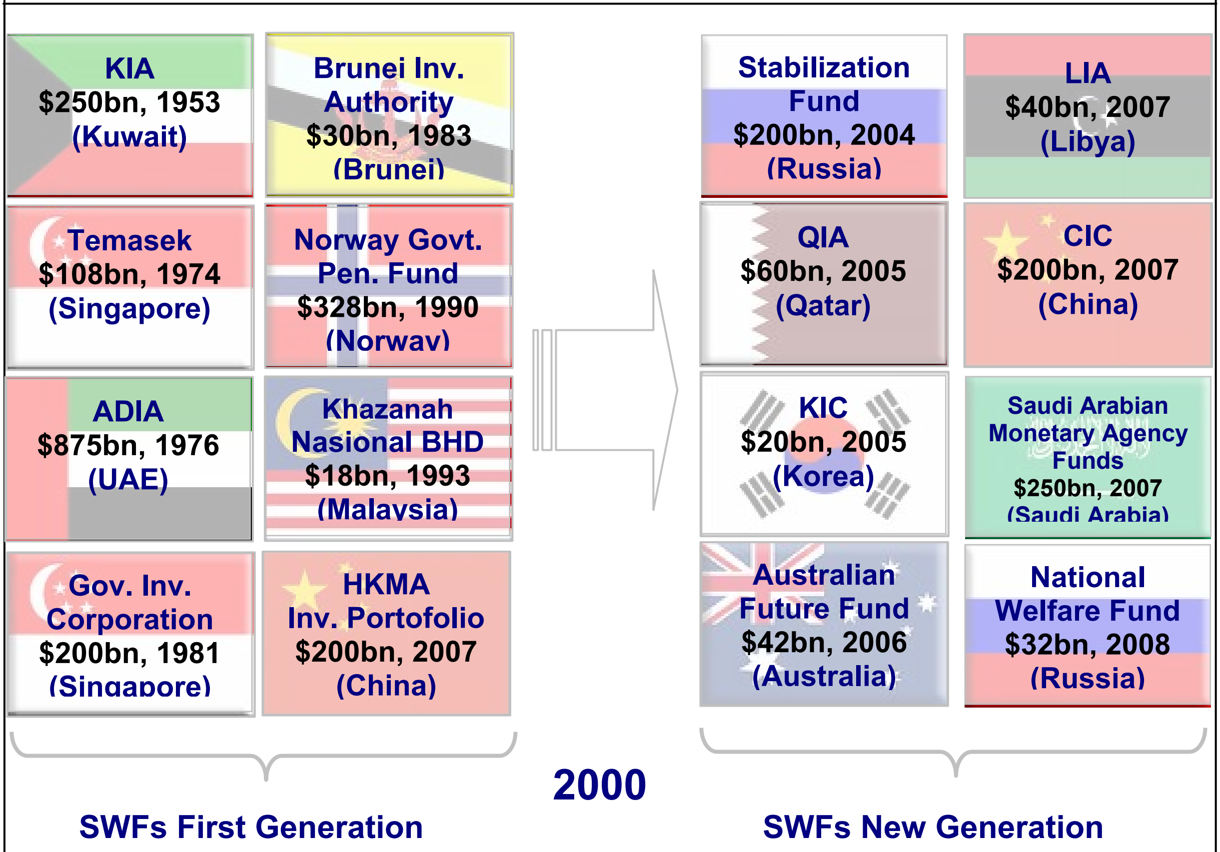
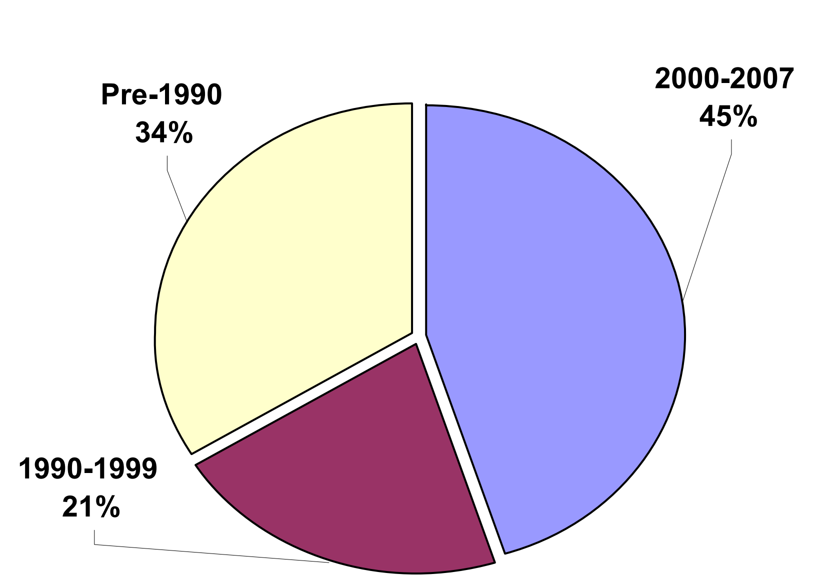
Appendix

Picture 1 – Inception Year and AUM of Selected SWFs



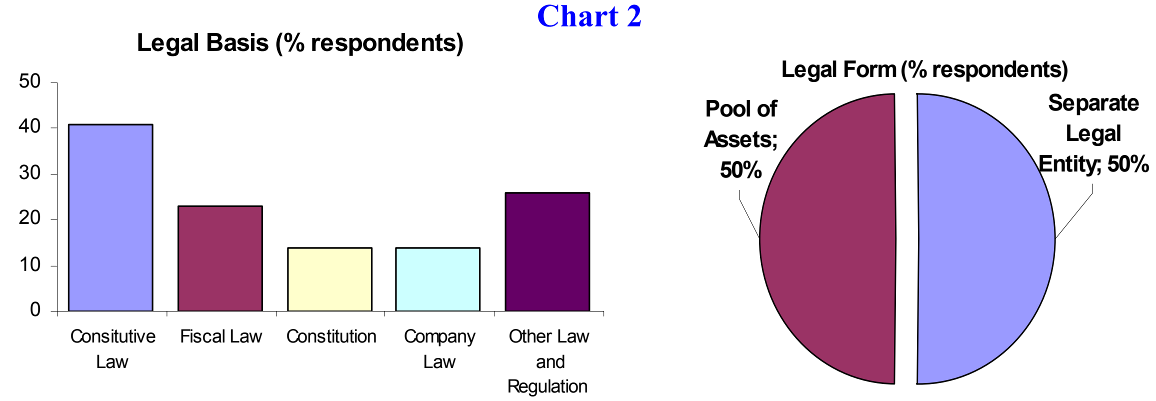
(Source: François Bujon de l'Estang Chairman, Citi France Sovereign Wealth Funds: A Growing Global Force)

Chart 1 - Inception Year of Top 40 SWFs



(Source: IFSL, Sovereign Wealth Funds 2008; Standard Chartered, State Capitalism: the rise of sovereign wealth funds, 2007).

Chart 2



Source: IWG, Sovereign Wealth Funds, Current Institutional and Operational Practices, 2008.

Chart 3

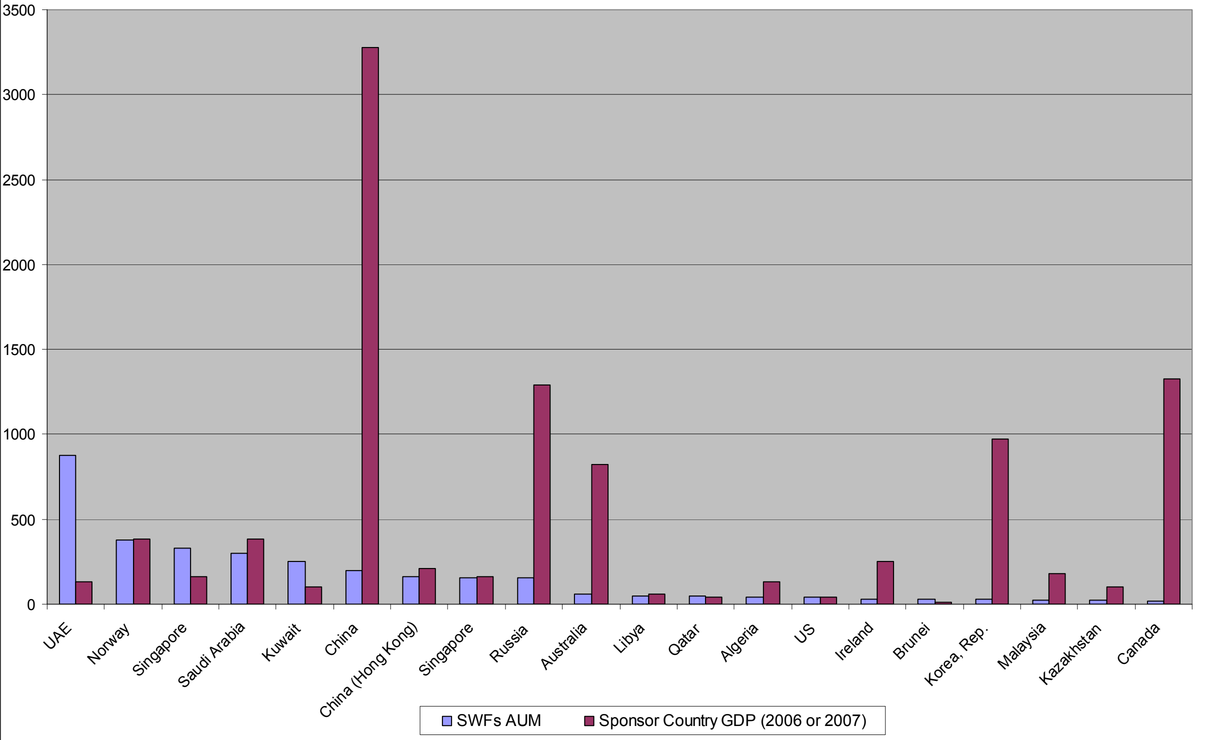
Central Banks - Monetary Authorities	Sovereign Stabilization Funds	Sovereign Saving Funds	Government Investment Corporations	Affiliated Corporate Entities / SOEs
○ China ○ Japan ○ India ○ Hong Kong ○ Saudi Arabia	○ Russian Oil Stabilization Fund ○ Algerian Revenue Regulation Fund ○ Chilean Economic and Social Stabilization Fund	○ Abu Dhabi Investment Authority ○ Norway Government Pension Fund ○ Kuwait Investment Authority ○ China Investment Corporation ○ Temasek ○ Qatar Investment Authority	○ Mubadala Development Company ○ Dubai International Capital ○ Dubai World ○ SAGIA ○ GIC ○ Temasek ○ Qatar Investment Authority	○ Gazprom ○ SABIC ○ Abu Dhabi National Energy Company ○ China National Offshore Oil Corp.
	SWFs			

Note: Some central banks and monetary authorities may not only manage official FX reserves but also other foreign assets. **Source**: Citi, Sovereign Wealth Funds: A Growing Global Force, 2008.

Table 1						
NAME	**AUM (USD bn)**	**Sponsor Country**	**Inception Year**	**Wealth Source**	**% of total AUM**	**AUM as % of 2007 GDP**
Abu Dhabi Investment Authority	875	UAE	1976	Commodity	25.3%	673.1%
Government of Singapore Investment Corporation	330	Singapore	1981	Non-comm	9.6%	205.0%
Government Pension Fund of Norway	301	Norway	1990	Commodity	8.7%	78.8%
Saudi Arabia – various holdings	300	Saudi Arabia	n/a	Commodity	8.7%	78.5%
Kuwait Investment Authority	265	Kuwait	1953	Commodity	7.7%	259.8%
Stabilisation Fund (and National Welfare Fund)	225	Russia	2004	Commodity	6.5%	17.5%
China Investment Corporation	200	China	2007	Non-comm	5.8%	6.1%
Hong Kong Monetary Authority Invest. Portfolio	173	China	1998	Non-comm	5.0%	83.2%
Temasek Holdings	134	Singapore	1974	Non-comm	3.9%	83.3%
Investment Corporation of Dubai	82	UAE	2006	Commodity	2.4%	63.1%
Qatar Investment Authority	60	Qatar	2005	Commodity	1.7%	142.8%
Libyan Arab Foreign Investment Company	50	Libya	1981	Commodity	1.4%	86.2%
Revenue Regulation Fund	47	Algeria	2000	Commodity	1.4%	34.9%
Australian Future Fund	44	Australia	2004	Non-comm	1.3%	5.3%
Kazakhstan National Fund	38	Kazakhstan	2000	Commodity	1.1%	36.6%
National Pensions Reserve Fund	31	Ireland	2001	Non-comm	0.9%	12.2%
Brunei Investment Agency	30	Brunei	1983	Commodity	0.9%	250.0%
Korea Investment Corporation	30	Korea, Rep.	2005	Non-comm	0.9%	3.1%
Alaska Permanent Fund	29	US	1976	Commodity	0.8%	70.8%
Khazanah National	26	Malaysia	1993	Non-comm	0.8%	14.4%
Alberta's Heritage Fund	16	Canada	1976	Commodity	0.5%	1.2%
Others	168	***	***	***	4.9%	***
TOTAL	**3454**					

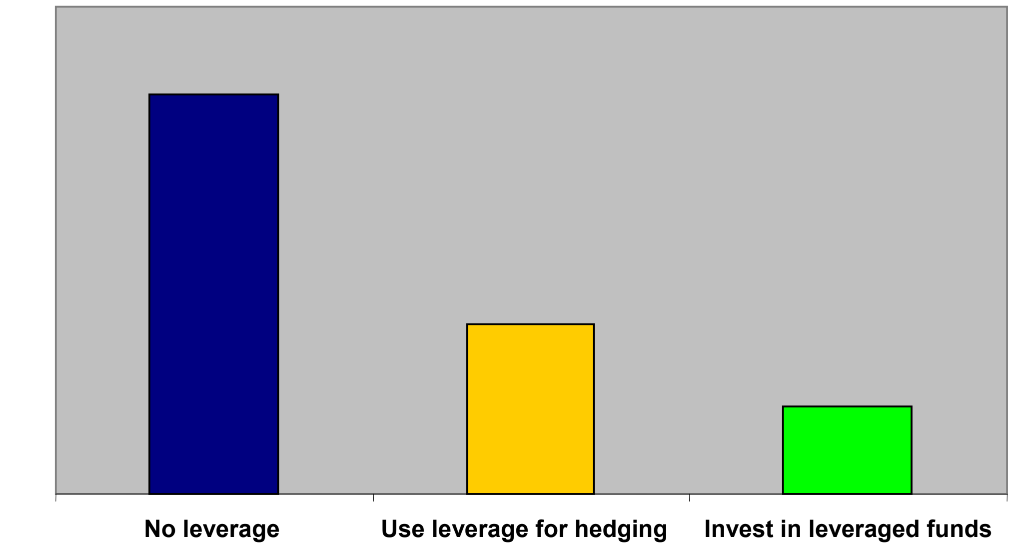
Source: IFSL, (2008 and 2009), Sovereign Wealth Funds 2008 and 2009; Standard Chartered, (2007), State Capitalism: The rise of sovereign wealth funds; World Bank, (2008), World Development Indicators database, World Bank, September 2008.

Chart 4 **Estimated AUM (US$bn) of selected SWFs compared to the GDP (US$bn) of relative sponsor countries**

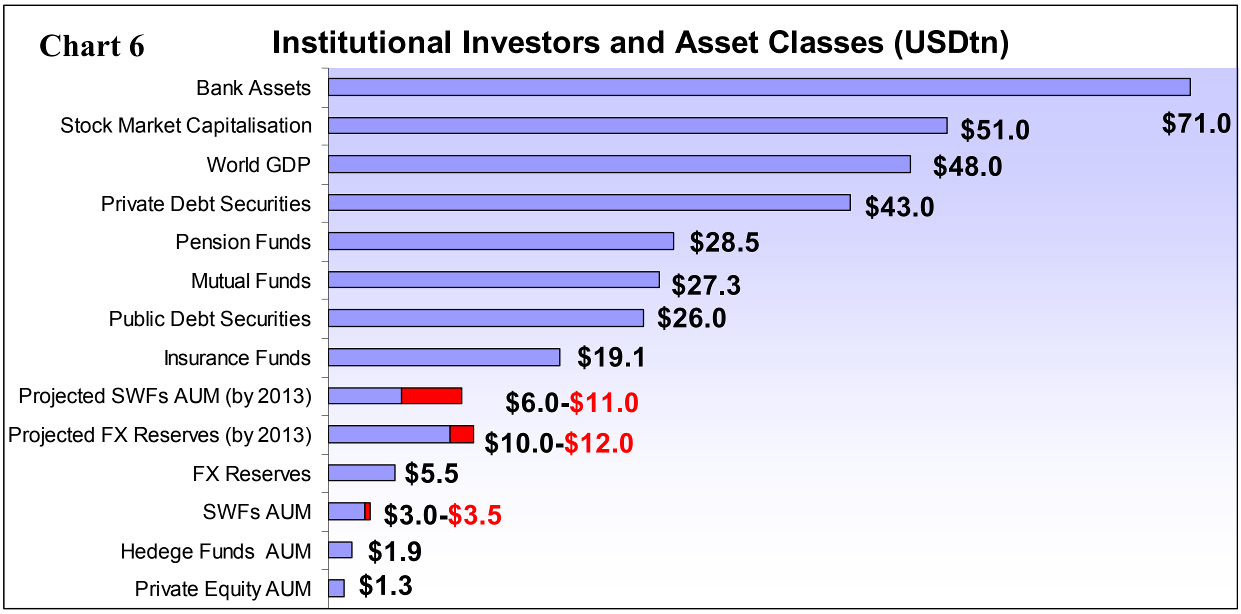


(Source: Standard Chartered, State Capitalism: The rise of sovereign wealth funds, 2007; World Development Indicators database, World Bank, September 2008)

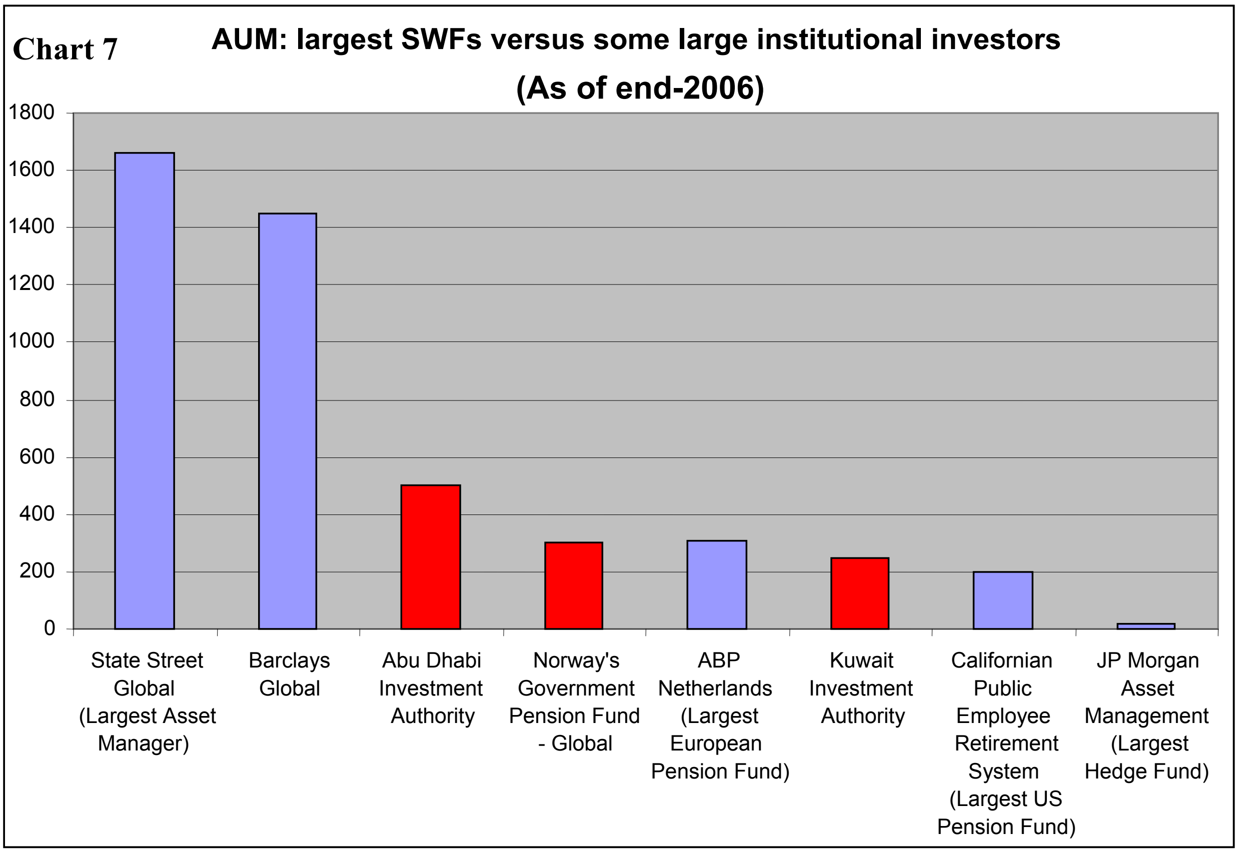
Chart 5 **SWFs Use of Leverage (% of Respondents)**



(Source: IWG Secretariat in collaboration with the Members of the IWG, Sovereign Wealth Funds, Current Institutional and Operational Practices, 15 Sept. 2008, p. 16)

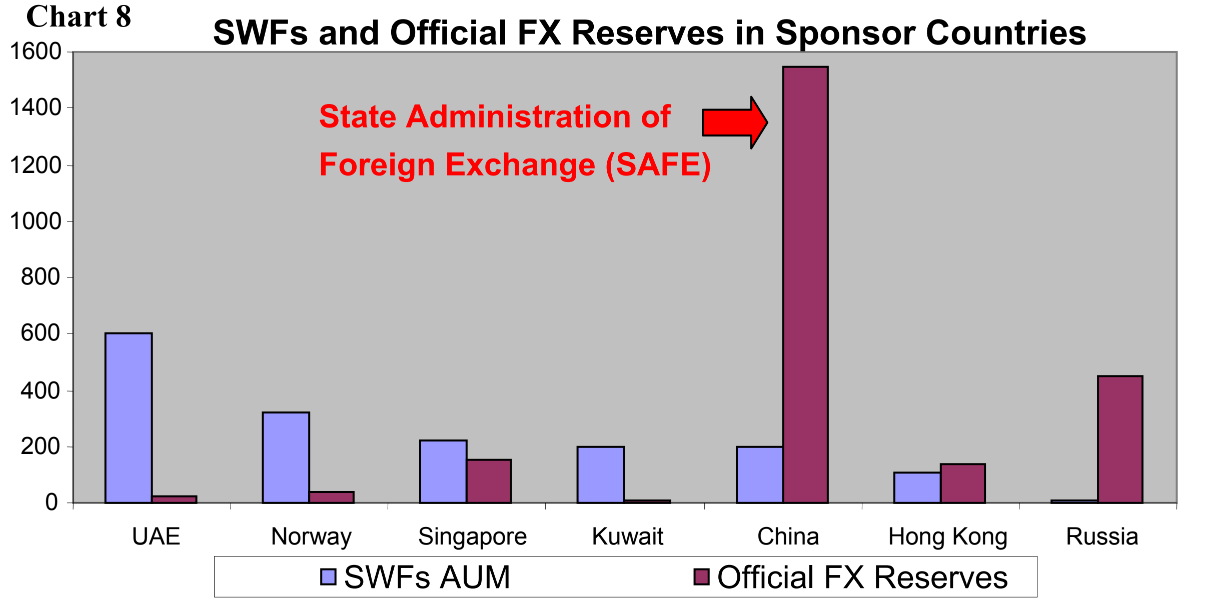


(Source: Citi, (2008), Sovereign Wealth Funds: a growing global force; IFSL, (2008), Sovereign Wealth Fund Institute, August 2008; International Monetary Fund, (2008), Financial Stress, Downturns, and Recoveries, World Economic Outlook, October 2008; World Bank, (2008), World Development Indicators database, September 2008).



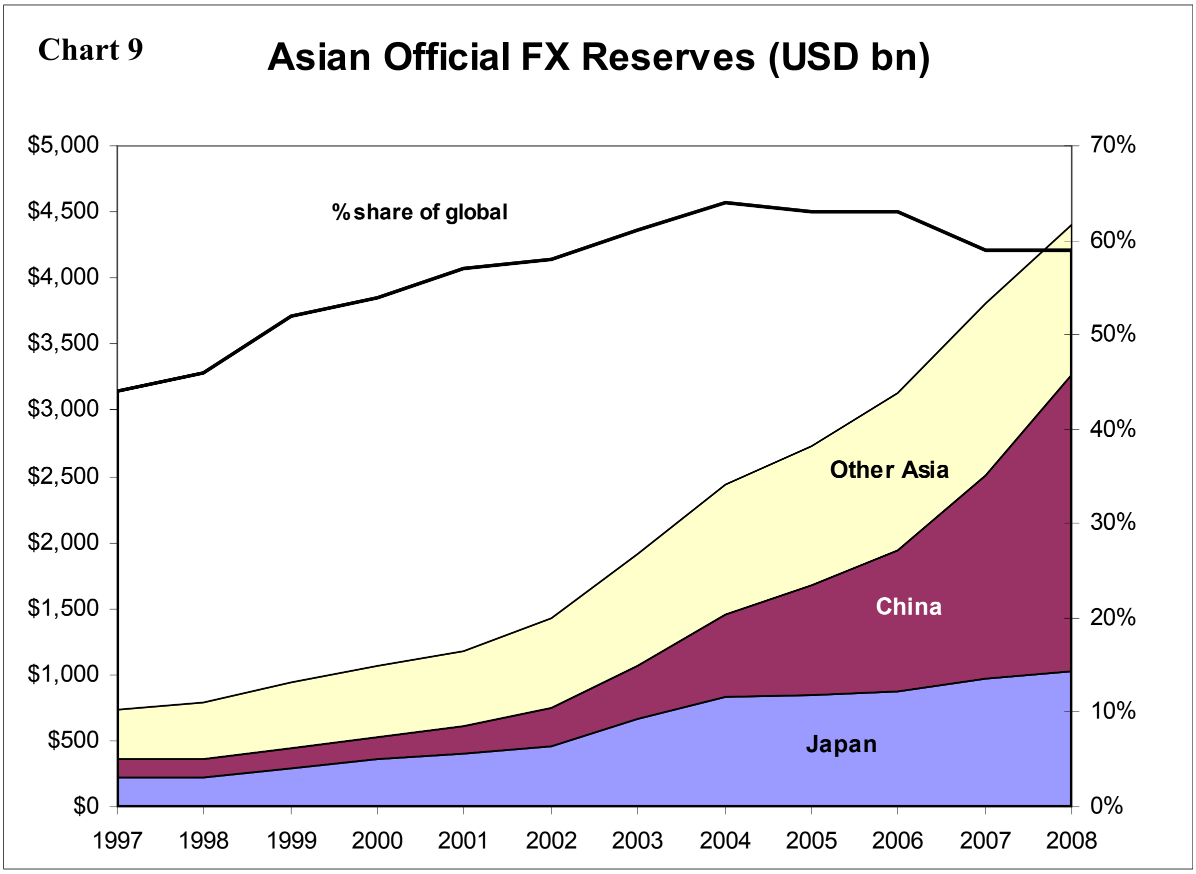
(Source: European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by R. Beck and M. Fidora, Occasional Paper, n. 91/2008)

Chart 8

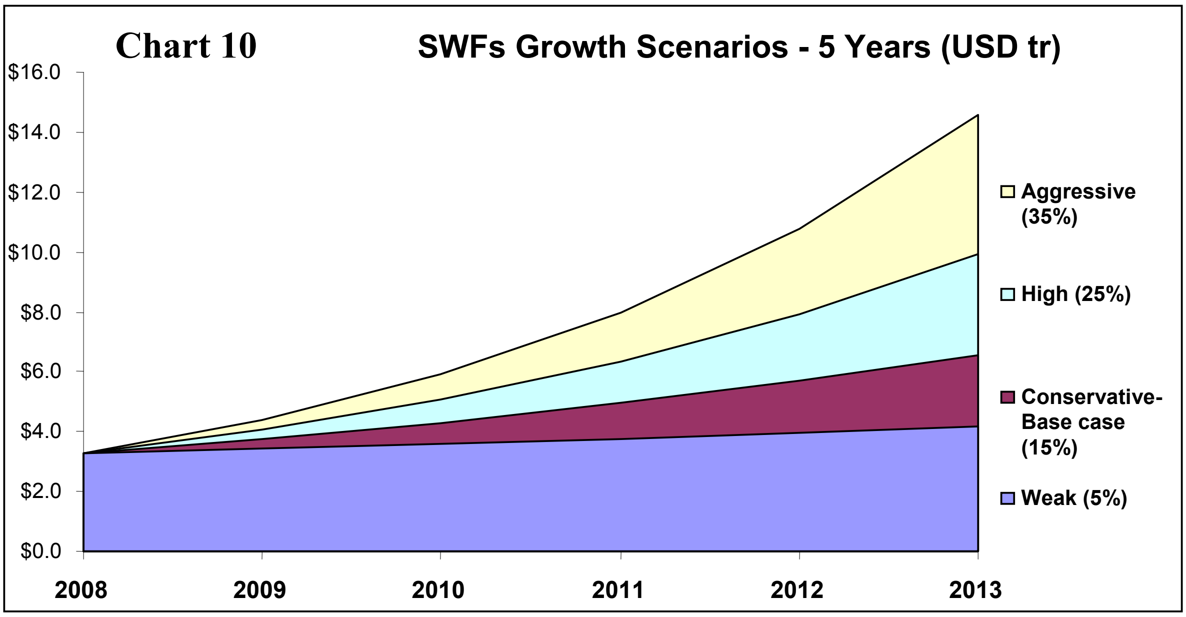


(Source: European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by R. Beck and M. Fidora, Occasional Paper, n. 91/2008).

Table 2			
Official Foreign Exchange Reserves			
End-2008	**USD bn**	**% share**	**% change 2007**
China	**2,243**	**30**	**43**
Japan	**1,031**	**14**	**11**
Russia	**387**	**5**	**17**
India	**248**	**3**	**3**
South Korea	**201**	**3**	**---**
Brazil	**201**	**3**	**9**
Hong Kong	**183**	**2**	**25**
Singapore	**166**	**2**	**106**
Algeria	**138**	**2**	
Germany	**133**	**2**	**15**
Others	**2,469**	**33**	**20**
Total	**7,400**	**100**	
Source: IFSL, Sovereign Wealth Funds 2008 and 2009			



(Source: IFSL, Sovereign Wealth Funds 2009)



(Source: Lehman Brothers, Sovereign Wealth Funds an EU Perspective, 2008; International Monetary Fund (IMF), 2008, Financial Stress, Downturns, and Recoveries, World Economic Outlook, October 2008).

Chart 11

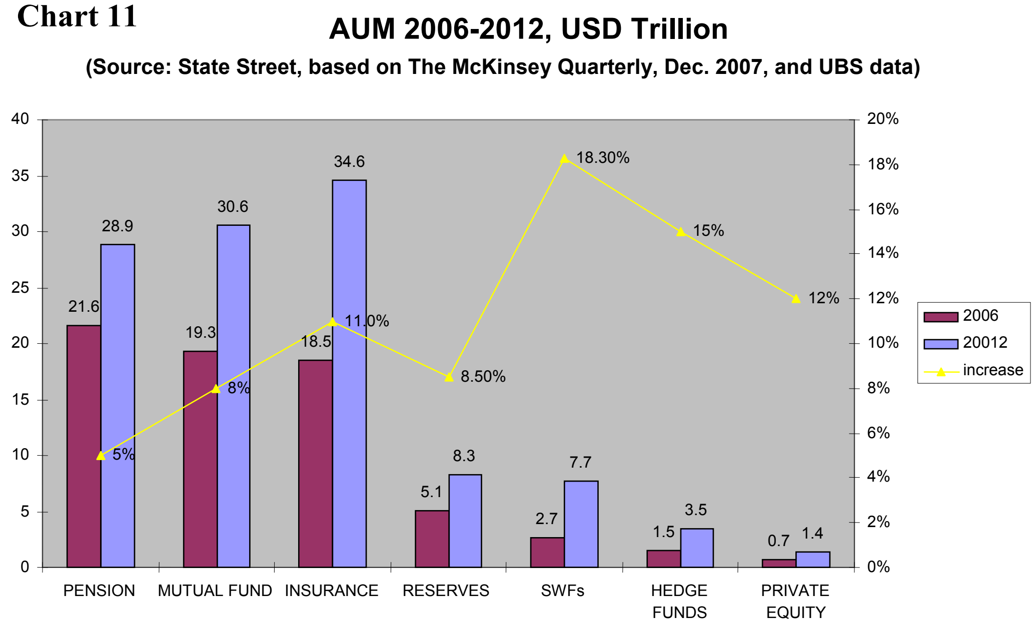
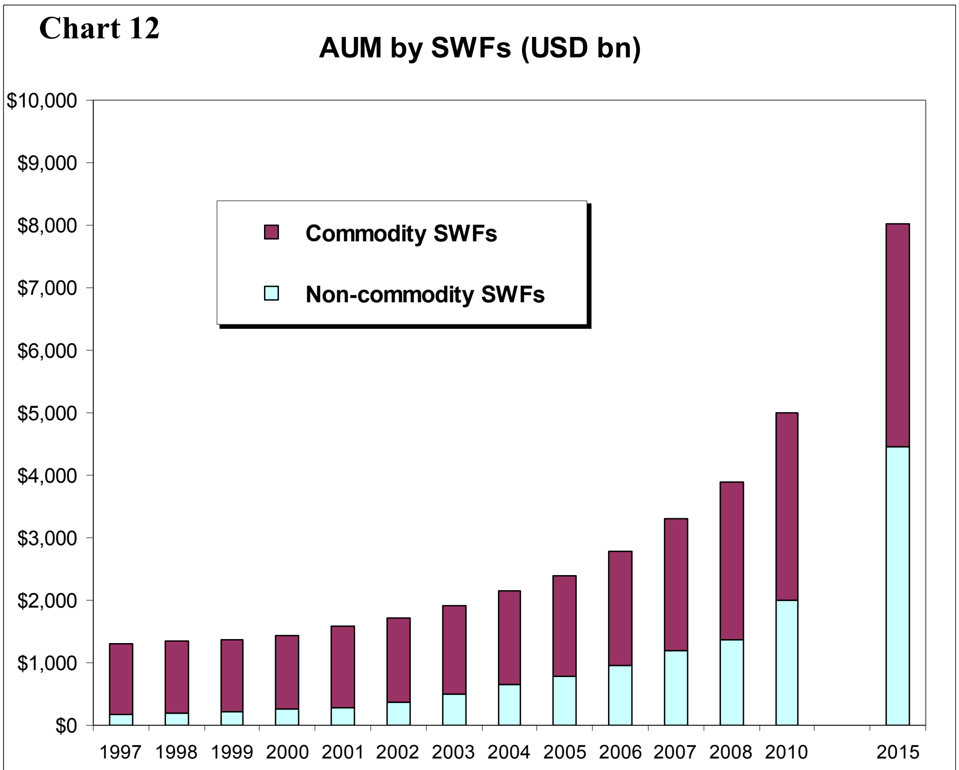


Table 3			
Expected New SWFs			
Sponsor Country	USD bn AUM	Wealth Source	Status
Bolivia	n.a.	Commodity	Planned
Brazil	8	Commodity	Planned
Canada	n.a.	Commodity	Discussed
India	5	Non Comm	Discussed
Japan	10	Non Comm	Planned
Nigeria	n.a	Commodities	Planned
Taiwan	62	Non Comm	Planned
Thailand	10	Non Comm	Discussed
TOTAL	3300		
Source: Steffen Kern (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008.			

Chart 12



(Source: IFSL, Sovereign Wealth Funds 2008 and 2009)

Table 4

Major SWFs Equity Investments in Financial Institutions since May 2007

Date	SWF	Portfolio Company	$bn	% Stake	Security type
May 2007	China Inv. Corp.	The Blackstone Group	3.0	9.9	Non-voting common units
Dec 2007	GIC	UBS	9.8	8.6	New Conv. Units
2007-2008Q1	Saudi Arabia Mon. Agency	UBS	1.8	1.6	New Conv. Units
2007-2008Q1	Undisclosed Middle East Investor	UBS	1.8	1.6	n.a.
Dec 2007	China Inv. Corp.	Morgan Stanley	5.5	9.9	Trust Preferred Securities
Nov 2007	ADIA	CITI	7.5	4.9	Trust Preferred Securities and Forward Purchase Contracts to acquire Common Stock
Jan 2008	GIC	CITI	6.9	4.4	New Non-Cumulative Convertible Preferred Securities
Jan 2008	Kuwait Inv. Auth.	CITI	3.0	1.6	New Conv. Units
Jan 2008	Korea Inv. Corp.	Merrill Lynch	2.0	4.3	New Non-Voting Mandatory Convertible Non-Cumulative Preferred Stock
(Dec 2007) - 2008Q1	Temasek	Merrill Lynch	5.0	11.3	New Commons Stock

2007-2008Q1	Kuwait Inv. Auth.	Merrill Lynch	3.4	7.0	New Non-Voting Mandatory Convertible Non-Cumulative Preferred Stock
2007-2008Q1	Temasek	Barclays PLC	2.0	1.8	Common Stock
2007-2008Q1	China Development Bank	Barclays PLC	3.0	3.1	Common Stock
2007-2008Q4	Qatar Inv. Auth.	Barclays PLC	3.5	8.9	n.a.
2007-2008Q4	Qatar Inv. Auth.	Credit Suisse	0.6	1.0	Common Stock
2007-2008Q1	Investment Corp. of Dubai	London Stock Exchange	3.0	28.0	n.a.
2007-2008Q1	Qatar Investment Authority.	London Stock Exchange	2.0	20.0	n.a.
2007-2008Q1	Temasek	Standard Chartered	8.0	18.0	n.a.
2007-2008Q4	Investment Corp. of Dubai	Standard Chartered	1.0	2.7	n.a.
2007-2008Q4	Investment Corporation of Dubai	ICICI Bank Ltd	0.8	2.9	n.a.
2007-2008Q1	SAFE (China)	Commonwealth Bank of Australia	0.2	0.3	n.a.
2007-2008Q1	SAFE (China)	Australia and New Zealand Banking Group	0.2	0.3	n.a.
2007-2008Q1	SAFE (China)	National Australia Bank	0.2	0.3	n.a.
2007-2008Q1	Abu Dhabi Inv. Council	Carlyle Group	1.4	7.5	n.a.
		Total	**81.1**		

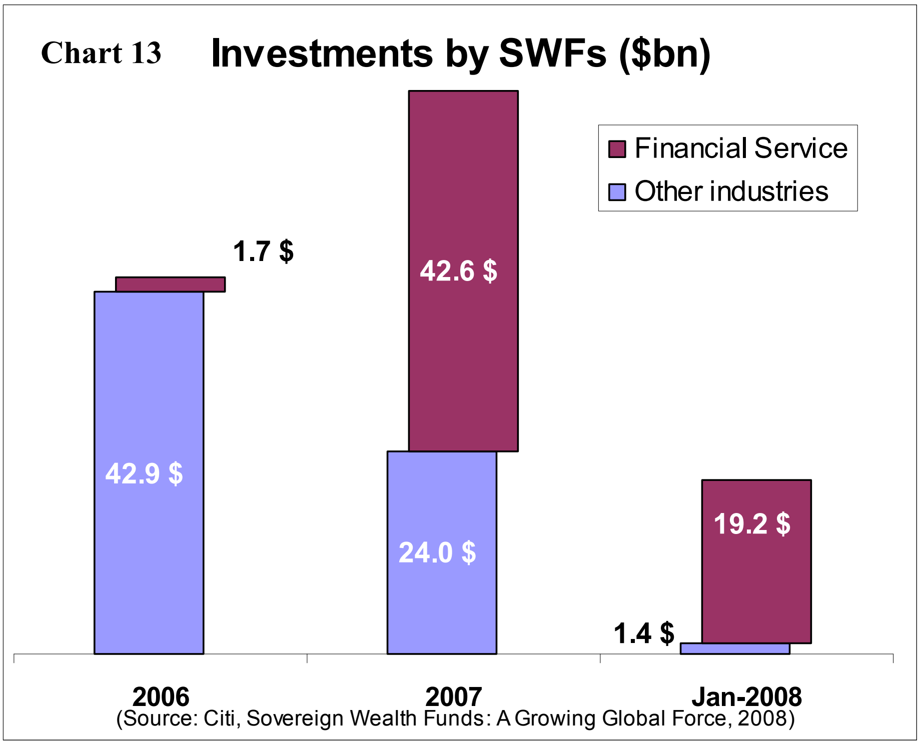
Source: Bank of England, Sovereign wealth funds and global imbalances, Quarterly Bulletin, 2008 Q2, p. 199; Lehman Brothers, Sovereign Wealth Funds an EU Perspective, 2008; Sovereign Wealth Fund Institute; Press Release (updated: April 2008); Steffen Kern (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 12; European Central Bank, The Impact of Sovereign Wealth Funds on Global Financial Markets, by R. Beck and M. Fidora, Occasional Paper, n. 91/2008, p. 11; U.S. Government Accountability Office, (2008), SOVEREIGN WEALTH FUNDS Publicly Available Data on Sizes and Investments for Some Funds Are Limited, Report to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, GAO-08-946, September 2008, pp. 44-45.

Table 5

SWFs Shareholdings in Major Financial Institutions (end-October 2008)

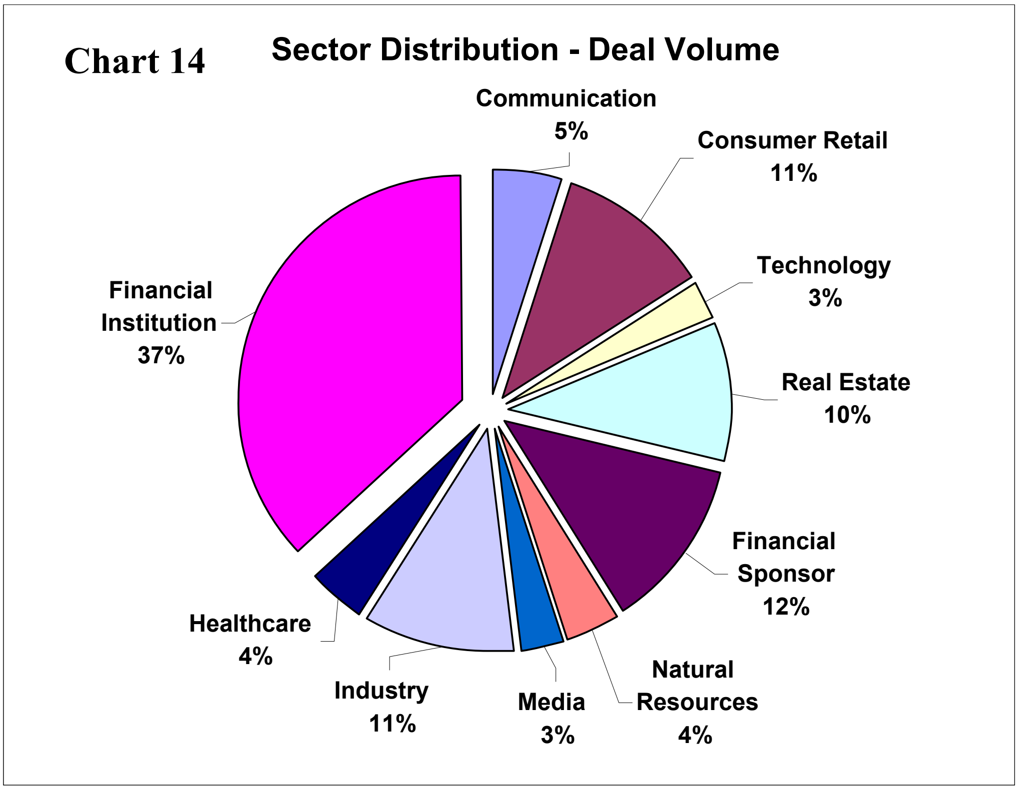
Portfolio Company	$bn	stake (%)
Citigroup	$22.0	12.7%
Merrill Lynch	$12.2	23.0%
UBS	$11.5	12.0%
Morgan Stanley	$5.0	9.9%
Barclays	$5.0	5.2%
Canadian Imperial Bank	$2.7	11.1%
Bear Stearns	$1.0	6,0%
Total	**$59.4**	

Source: IFSL, Sovereign Wealth Funds 2009.



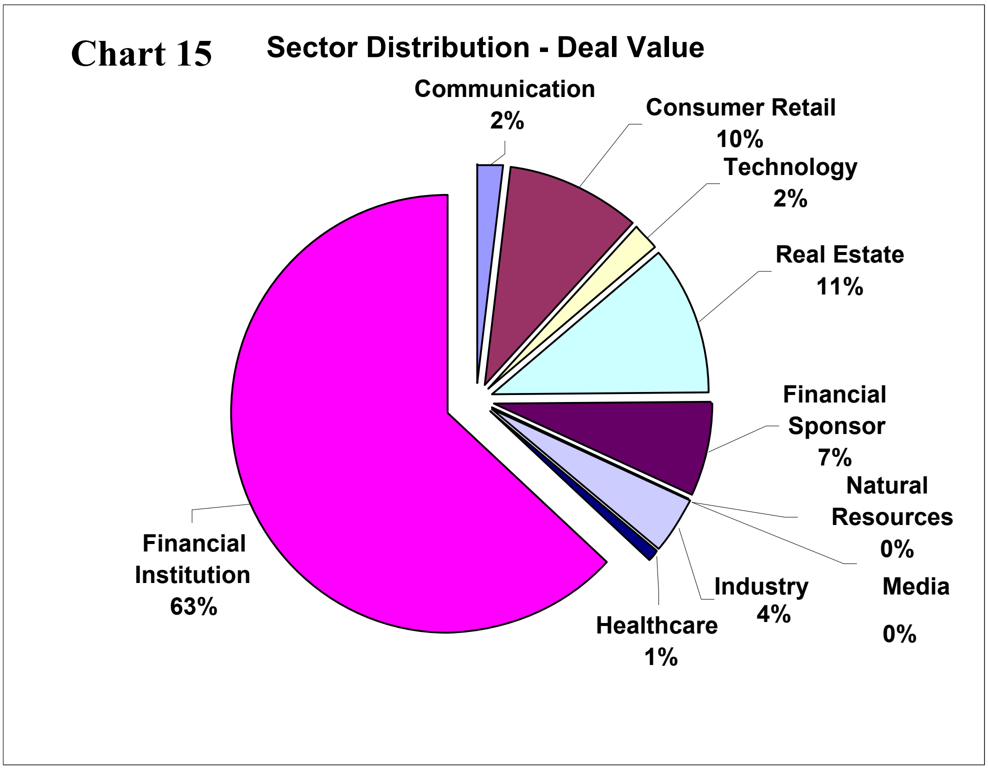
(Source: Citi, Sovereign Wealth Funds: A Growing Global Force, 2008)

Ten Largest SWFs Transactions 2007–2008

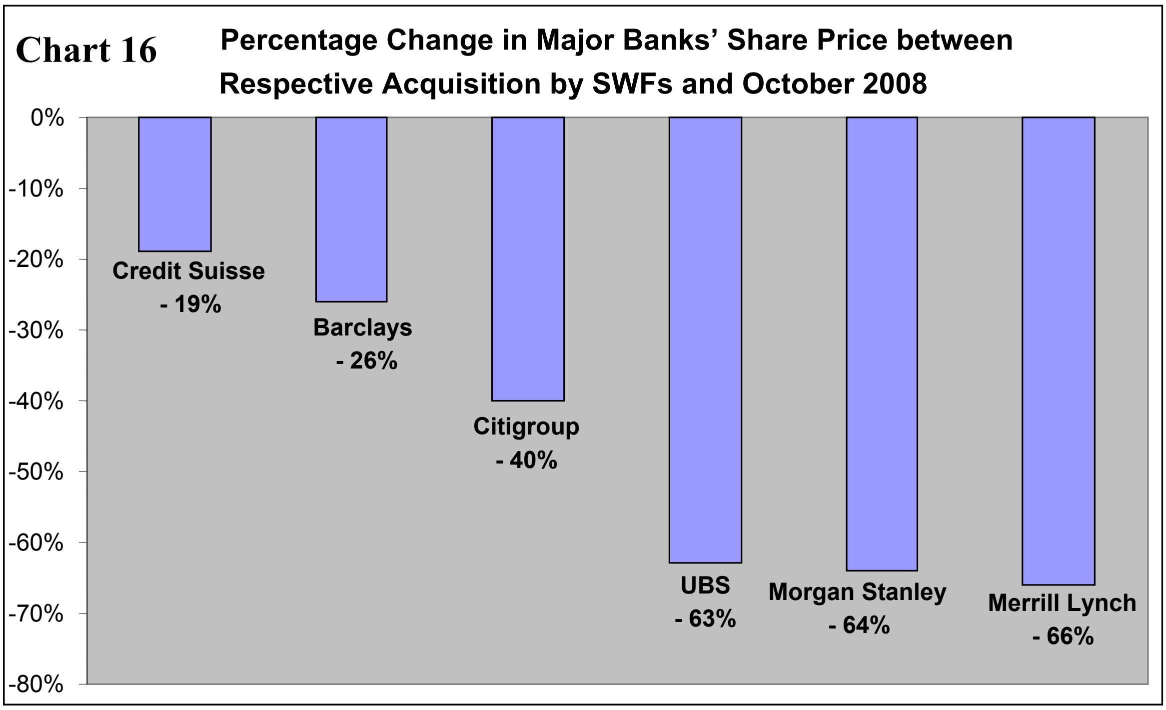


(Source: Lehman Brothers, Sovereign Wealth Funds an EU Perspective, 2008)

Ten Largest SWFs Transactions 2007–2008



(Source: Lehman Brothers, Sovereign Wealth Funds an EU Perspective, 2008)



(Source: Steffen Kern (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, p. 11)

Chart 17

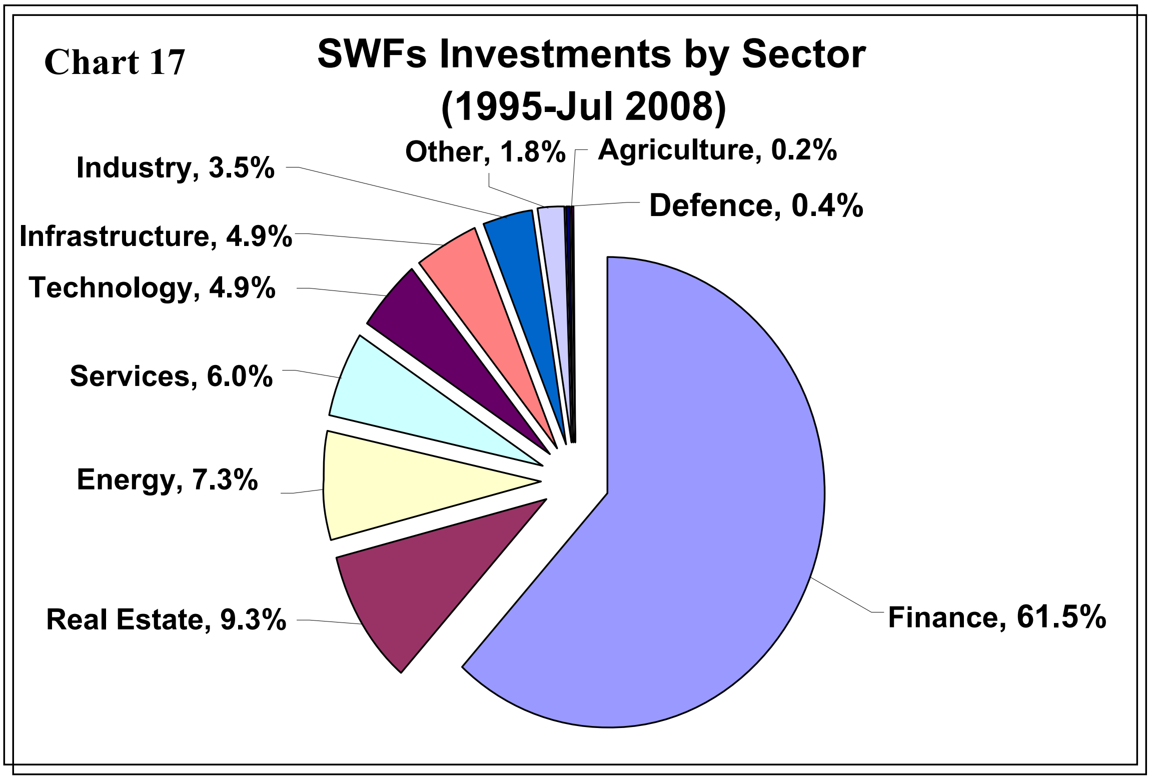
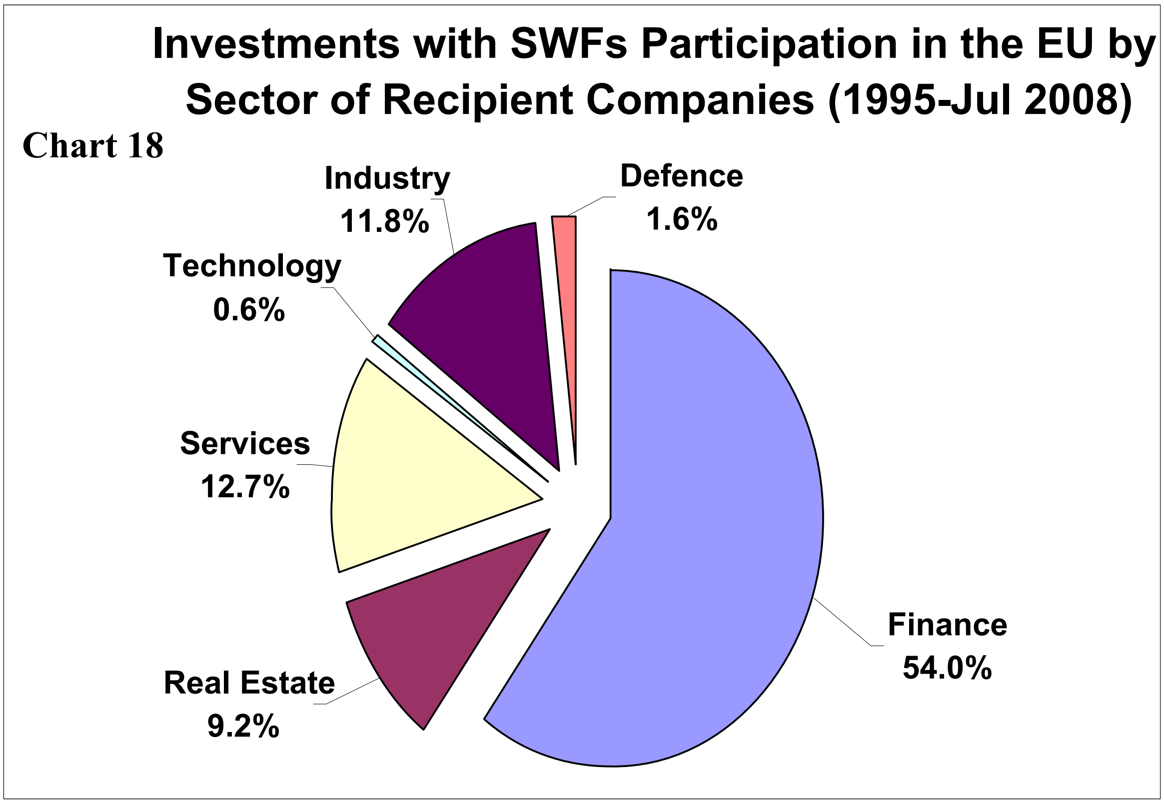
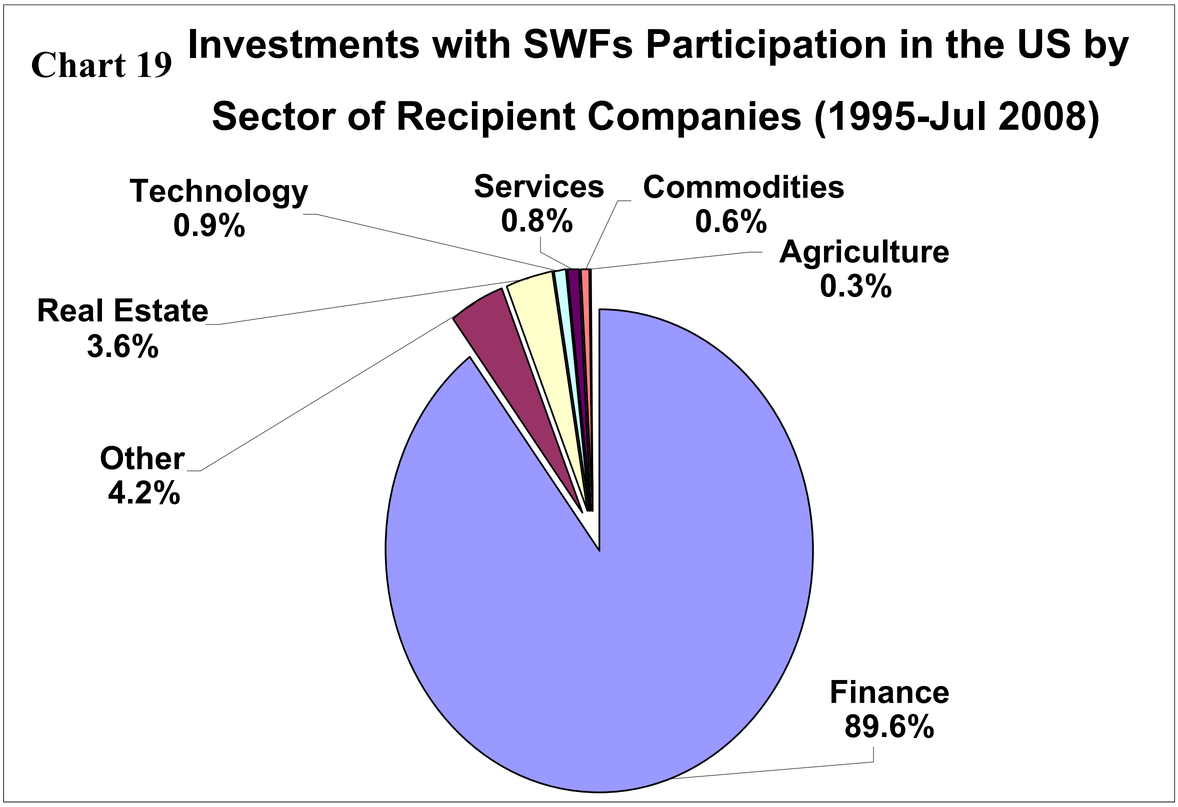
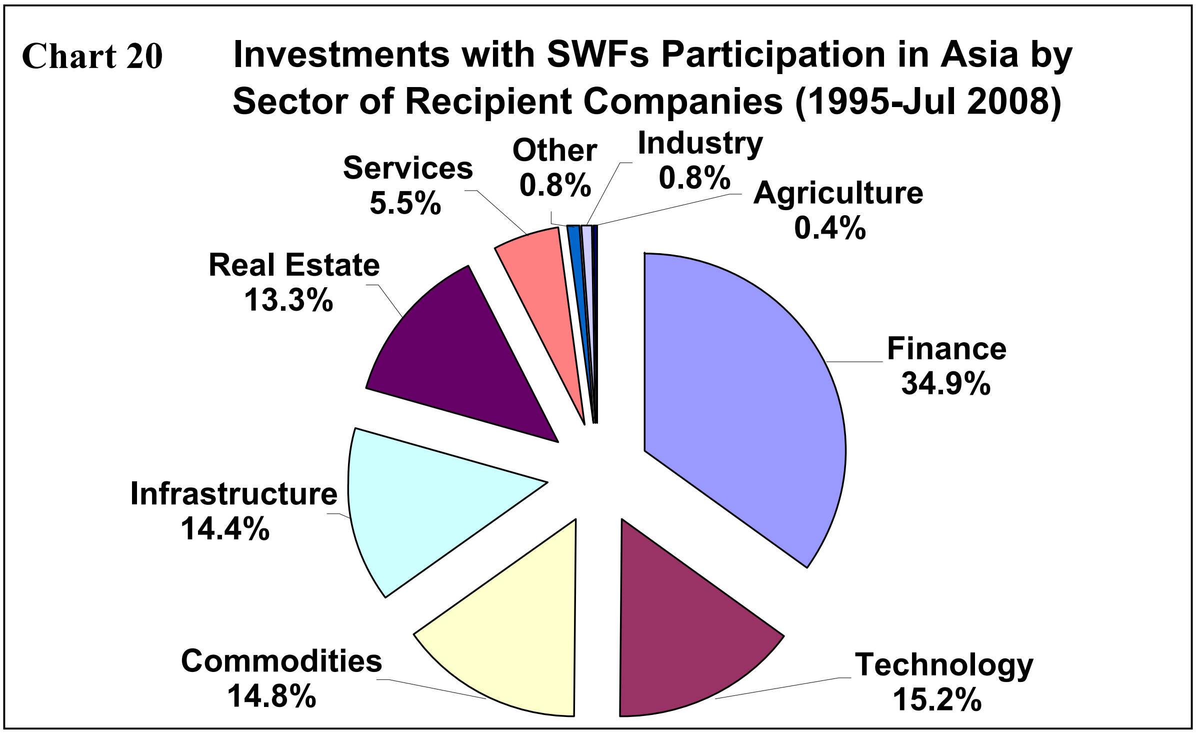


Chart 18



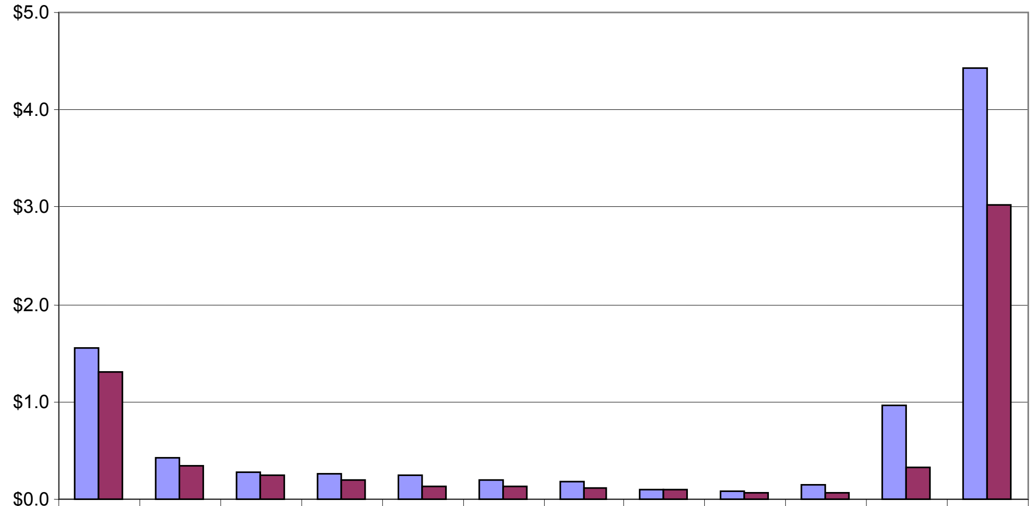
(Source: Steffen Kern (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, pp. 7-8)





(Source: Steffen Kern (2008), SWFs and foreign investment policies – an update, Deutsche Bank Research, October 22, 2008, pp. 9-10).

Chart 21 **Reserves and Excess Reserves in some Asian and Oil Exporting Countries ($tr)**

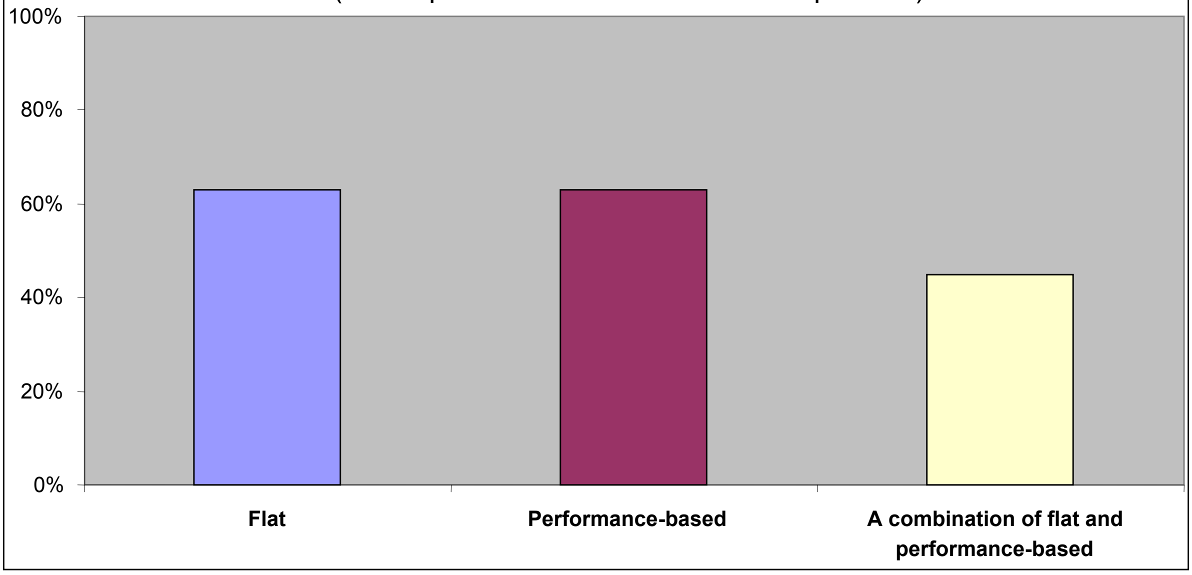


	China	Russia	Saudi Arabia	Taiwan	Korea	India	Brazil	Algeria	Libya	Singapore	Others	Total
Reserves	$1.6	$0.4	$0.3	$0.3	$0.2	$0.2	$0.2	$0.1	$0.1	$0.1	$1.0	$4.4
Excess Reserves	$1.3	$0.4	$0.2	$0.2	$0.1	$0.1	$0.1	$0.1	$0.1	$0.1	$0.3	$3.0

(Source: European Central Bank, (2008), The Impact of Sovereign Wealth Funds on Global Financial Markets, by R. Beck and M. Fidora, Occasional Paper, n. 91/2008, p. 14)

Chart 22 **External Managers' Fee Structure**

(% Respondents who answered the question)



(Source: IWG Secretariat in collaboration with the Members of the IWG, Sovereign Wealth Funds, Current Institutional and Operational Practices, September 15, 2008, p. 17)