

SWFS:
MYTHS AND REALITIES
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David Murray

OVERVIEW

There is a dichotomous tension in many views of the roles and treatment of Sovereign Wealth Funds (SWF). On the one hand, the SWF group is seen as homogenous, requiring uniform standards and benchmarks. On the other hand, when compared with institutional investors generally, SWFs are seen as peculiar and in need of differential treatment. Both views are misplaced and stem from a series of myths and misinformation about Sovereign funds. In debunking these myths, this paper allays unjustified concerns regarding SWFs, identifies risks flowing from potential differential treatment and re-focuses the debate on the benefits of SWFs to their constituencies and the global economy. The paper emphasizes the crucial role of the Santiago Principles in providing a robust and transparent framework for investment and suggests a way forward for how recipient countries might utilize the Santiago Principles to ensure that SWFs are treated equally with other commercial institutional investors.

INTRODUCTION

Since widespread recognition of SWFs as a part of the global investment environment in the mid 2000s, growing curiosity about these entities has been matched by persistent misunderstanding regarding their true nature. Rather than ushering in a deeper understanding of sovereign funds, the growing pool of commentary remains plagued by myths and misinformation. This has unfairly given rise to some negativity and skepticism that seems unjustified given the track record of SWF investment. Continued explanation regarding their commercial nature and behaviour is therefore essential if the benefits of SWFs are not to be wasted or impaired by ill-founded fears. Accordingly, the objective of this paper is to provide a true reflection of SWF activities as well as the opportunity presented by the Santiago Principles to help maintain a stable global financial system and free flow of capital and investment.

To this end, this paper will address the key myths surrounding SWFs, the potential for the Santiago Principles to help overcome these and the consequences of discrimination if the current debate remains unchallenged. It starts by identifying and debunking these myths, exposing essential information about SWFs that needs integration into public discussion. The efforts made by the international investment community to enhance understanding of SWFs through the creation of Generally Agreed Practices and Principles (the GAPP) known as the Santiago Principles are reviewed. As the core objective of this voluntarily created framework was to create a robust and transparent set of principles for SWF investment practices, it provides a way forward for assisting the increase in global investment. If these myths are left unchallenged and the opportunity presented by the

Santiago Principles wasted, harmful consequences from differential SWF treatment are likely to follow. Only dispelling these myths, combined with a re-focus on the opportunity offered by the Santiago Principles for achieving a less inhibited investment regime will ensure maximum benefit from SWF activities. The paper concludes by highlighting how recipient countries should respond to the Santiago Principles to ensure that SWFs are treated equally with other commercial institutional investors.

I DEBUNKING MYTHS

The creation of SWFs fuelled significant interest in the objectives and activities of these entities, but as noted above, some negativity and skepticism accompanied this growing interest. The cumulative effect of these unchallenged myths produced a dichotomous view of sovereign funds. On the one hand, the SWF group is seen as homogenous, requiring uniform standards and benchmarks. On the other hand, among institutional investors generally, the group is viewed as having differing objectives and investment drivers. Both views are misplaced, leading to unnecessary and potentially harmful differential treatment. In fact, the *opposite* of these views is true. There are marked differences among SWFs given their different objectives and mandates and country circumstances, and it is not the case that as a group, they are different from other commercially-focused investors. But to appreciate this reality, we must dispel the myths. Three misguided beliefs have been especially pervasive in the debate.

MYTH ONE: *SWFs are a homogenous investor class*

The first and most misleading is the belief that all SWFs are largely the same. The development of a collective moniker for this category of investor may have proven more harmful than helpful in this regard. For, while SWFs certainly constitute a distinct investor group, their membership is diverse. Within this discrete group, the members are completely different and are becoming increasingly more diverse.¹ There is indeed no such thing as a ‘typical’ SWF.²

Yet, much public discussion proceeds as if there was only one institutional manifestation of Sovereign Wealth Fund. The investor class is spoken of as if its members were identical, implying all sovereign funds possess similar governance, investment strategies, risk management approaches and objectives. This has driven the inappropriate characterisation of the SWF investor class as homogenous. If one examines the purpose and roles of each individual SWF, it is clear they are all different. SWF policy should be sensitive to this context-dependent diversity. To illustrate, it may not be prudent policy for funds dedicated to long-term savings, intergenerational wealth transfer or contingent pension reserve accumulation to also have a stabilisation role involving draw downs to meet fiscal needs; but for other funds which do have stabilization-like functions, specific draw downs in prescribed circumstances may be entirely compatible with this type of overall objective.

Is there any use then in utilizing an umbrella term for the group if it risks falsely

¹ Victoria Barbary et al (2010) *Sovereign Wealth Fund Investment Behaviour: Semi-Annual Report January – June 2010*, Monitor Group, Boston USA

² Andrew Rozanov (2010) Definitional Challenges of Dealing with Sovereign Wealth Funds *Asian Journal of International Law*, pp.1-17, p.2

homogenizing the members? If we start by recalling the reason why a discrete term for these funds evolved in the first place, then we can see both the need for a collective label but also its vulnerability to misinterpretation in the absence of precise usage.

The explanation for the emergence of the SWF category is partly negative and partly positive. The first prominent identification of the group as such was negative. This followed the acquisition of British shipping company P&O by UAE state-owned enterprise Dubai Ports World (DPW), resulting in the transfer of control over six US port facilities to the government of Dubai. Despite approval of the deal by the Committee on Foreign Investment in the United States (CFIUS), the investment was widely criticized on national security grounds. To allay concerns, DPW ultimately agreed to sell P&O's US operations to US insurance firm American Investment Group. The untimely emergence of SWFs as a new and recognizable investor class amidst this growing concern regarding state-controlled investors meant Sovereign Wealth Funds offered a convenient target for potential discrimination. Despite the fact that DPW was not a SWF, the opportunity to collectively identify investors that caused political discomfort was not lost on American politicians. The SWF label offered a convenient means for identifying a target for potential differential treatment.

The simultaneous occurrence of several high-profile investment proposals involving foreign state-controlled entities in countries that can cause foreign policy sensitivities among Western powers also fanned protectionist fears. Recall for instance the 2005 proposal by the China National Offshore Oil Corporation (CNOOC) to acquire the US-

based Unocal Oil Company; the 2006 purchase by Russian Bank Vneshtorgbank of a 5 percent stake in European Aeronautic Defence and Space (EADS); and, the increasing investment by the China Development Bank and China EXIM Bank in Africa and Latin America, particularly in extractive industries.³ The fact that none of these deals involved SWFs but rather state-owned corporations and banks was lost in the demand for a label that could be harnessed to monitor and discriminate against politically sensitive investors. SWFs became collateral damage in a politically opportunistic campaign to target state-controlled investors. Such were the unfortunate circumstances surrounding the birth of the SWF category. A half decade later, the imprecision and conflation that characterized the genesis of the sovereign fund label persists.

The second, more positive reason driving independent SWF categorization relates to functionality. Unlike other institutional investors such as pension funds which have a defined beneficiary, SWFs hold assets in the shared interest of the community. There is no individual beneficiary. This unique trait sets them apart. But given the multifarious nature of shared community interests they might serve, the funds share little in common operationally that warrants universal policy prescriptions. Commonality exists only at the highest-level.

This imprecise, opportunistic labeling of SWFs combined with their high-level nature of their common trait underscores the superficiality of the group's shared identity. With this backdrop, we can see that the label *Sovereign Wealth Fund* emerged as a loose, umbrella

³ Cornerhouse Report (2008) 'Sovereign Wealth Funds: Frequently Asked Questions', *The Cornerhouse Briefing* 38, Cornerhouse, Dorset UK, October 2008, pp.20-21.

term, which, like the word ‘government’, implies shared features warranting a collective descriptor but whose institutional realization and practice is diverse and requires context-sensitive study. While there is an indisputable basis for identifying SWFs as a distinct investor class, there is little more than an abstract resemblance uniting the group, a resemblance that strains to justify universal group policy, bringing us to the second myth.

MYTH TWO: *Benchmarking of SWFs should be standardized*

Based on this homogeneity myth, a second myth has emerged regarding the appropriateness of universal benchmarks for SWFs. There is a push from the academic commentariat⁴ to standardize benchmarks rather than properly investigate how benchmarks may be adapted and modified for the particularities of context. Given this is largely built on an exaggerated sense of SWF sameness, its foundations are shaky. Moreover, global indexes and universal benchmarking tend to overlook country-fund specifics that make replication of the same model of compliance unrealistic.⁵ This unevenness in compliance with universal benchmarks creates a false sense of SWF misbehaviour. On the contrary, variation in practice is precisely what to expect from a non-homogenous group of investors.

Beyond falsely vilifying SWFs, subjecting divergent funds to universal optimal standards

⁴ See for instance Andrew Ang (2010) *The Four Benchmarks for Sovereign Wealth Funds*, Columbia Business School and NBER, 28 September 2010; Maurizia de Bells (2010) ‘Global Standards for Sovereign Wealth Funds: The Quest for Transparency’, *Asian Journal of International Law* pp.1-34; Edwin Truman (2008) *Blueprint for Sovereign Wealth Fund Best Practices*, Peterson Institute for International Economics, Washington DC, April 2008; and, Sven Behrend (2011) ‘Sovereign Wealth Funds and their Commitment to the Santiago Principles’, *GeoEconomica Briefing*, April 2011; and the Sovereign Wealth Fund Institute Linaburg-Maduell Transparency Index.

⁵ Stella Tsani, Ingilab Ahmadov and Kenan Aslanli (2010) *Governance, Transparency and Accountability in Sovereign Wealth Funds: Remarks on the Assessment, Ranking and Benchmarks to Date*, Public Finance Monitoring Centre, March 2010, p.20

may cause detrimental outcomes. Consider the current push for SWFs to pursue local infrastructure investment. To universalize and say all SWFs should acquire infrastructure assets by virtue of some definitional feature – that they are long-horizon investors using public funds and therefore should look to invest in illiquid public assets that earn long-term returns - might lead to financially harmful outcomes in some contexts. A country with high dependence on petroleum and inflationary pressures will heighten the risk of Dutch Disease through pursuit of a domestic infrastructure investment strategy.⁶

Equally, mandating a fixed purpose for draw downs or requiring a particular transfer rule between SWFs and their national budgets ignores the diversity of fiscal contexts in which these funds operate. Rules that maximize outcomes for certain funds, will be ill-suited for others. For instance, small population, resource-dependent, non-diversified economies must use SWFs to convert resource windfalls into permanent financial assets through tightly controlled savings. Alternatively, countries with different fiscal profiles may require resource windfalls for more urgent present expenditure needs. Of course, there is also a cohort of funds whose revenue flows from trade surpluses and which are therefore subject to different considerations on account of their specific fiscal context. Accordingly, sovereign funds must be taken on their own terms and not forced to subscribe to universal benchmarks.

Finally, given that citizens are the ultimate beneficiaries of SWF operations, they offer

⁶ On the issue of infrastructure investment, the real question is whether to invest in infrastructure versus other assets. What is the cost benefit of infrastructure asset over other assets? The question is whether the Return on Investment is consistently higher than growth in real economy. This is an issue of what the hurdle should be to demonstrate benefit of savings, over immediate expenditure.

the most effective and legitimate monitor of funds.⁷ Rather than pushing to develop international rankings and universal initiatives on best practice, further recognition should be given to the central role existing monitoring and auditing that occurs within within countries. Santiago Principle 3 recognises the essential role of SWF coordination with domestic fiscal and monetary authorities where these funds have significant direct domestic macroeconomic implications. In sum, ‘Best Practices’ assume there is only one way to achieve fund outcomes. SWF regulation needs to abandon a ‘one size fits all’ approach in favour of context-sensitivity and diversity accommodation.

MYTH THREE: *SWFs are unique investors requiring differential investment treatment*

The most problematic myth is the idea that SWFs as an investor class are unlike any other investor and on this basis, should be treated differently. The SWF ‘uniqueness’ belief comes from their status as government-sponsored investors. The assumption behind this view is that state ownership of SWFs renders both the entities and their behaviour different from peer institutional investors and therefore a separate set of political, legal and ethical expectations should govern their regulation. To test the plausibility of this belief, we need to disaggregate the ‘uniqueness’ myth. It distills down to three discrete sub-claims.

⁷ Tsani et al (2010).

(a) Governments are a different type of investor

The essential idea at play is captured by SWF observer - Edwin Truman of the Peterson Institute: 'A government is a different type of animal in the investing world.... We call them sovereign wealth funds, but once you're operating outside your own borders, you're not sovereign in the same sense.'⁸ As with much SWF commentary, there is a tone of caution and uncertainty regarding the difference of government-investors, but the precise nature of this difference to other investors remains unarticulated and given the evidence, a tenuous idea. Indeed, this sort of statement with its vague but negative connotations overlooks the fact that the GAPP framework explicitly acknowledges SWFs will operate in compliance with 'applicable regulatory and disclosure requirements of the countries in which they operate.'⁹ This naturally renders a SWF deferential to the laws of the jurisdiction in which they are operating.

At a more fundamental level, the immediate response to this claim must be what *is* different about a government-sponsored investor in the investment world? Even if differences exist between SWFs and peer investors, are they so qualitatively significant as to justify that governments investing on behalf of their communities should not have the same rights as any other investor? The burden of proof must lie with those who use *apparent* SWF uniqueness as a basis for discriminatory treatment of sovereign funds.

⁸ Steven R. Weisman (2007) 'A Fear of Foreign Investments,' *New York Times*, 21 August 2007

⁹ GAPP Principle 15

(b) Sovereign sponsorship means SWF investments are driven by non-commercial motives

The suspicion that sovereign sponsorship of an investment vehicle means the investment is driven by non-commercial or strategic objectives is both theoretically unsound and practically unsubstantiated. From a theoretical perspective, assuming SWFs to be rational investors, non-commercial investment strategies are self-defeating. Managing a nation's capital with a non-commercial strategy 'is a recipe for huge losses rather than world domination.'¹⁰

Moreover, those who fear a non-commercial investment strategy in SWFs overlook a crucial subtlety. A clear distinction must be made between the *objectives* and operations of a SWF within a domestic economy and the investment *strategy* used to help achieve those objectives. As noted above, SWF purposes vary from stabilization to providing intergenerational savings. In the domestic economy setting, typical government involvement in SWFs is limited to determining governance structures, investment guidelines and overall fund objectives.¹¹ Indeed, fund design in many cases simply does not provide scope for the type of influence necessary to realize a political investment agenda. For example, in the case of my own fund, the Future Fund, a series of provisions help quarantine the fund from political influence including: exclusion of government representatives on the Board; no restrictions in mandate; the right to make a submission to Parliament if the mandate is changed; and, the requirement that expenses of the fund come from the fund, not from a Budget appropriation liable to politicization.

¹⁰ The Economist (2008) *Asset Backed Insecurity*, 17 January 2008

¹¹ Cornerhouse Report (2008) p20

Besides fund design, another check on SWFs operating according to grand strategies is their need to secure legitimacy in the eyes of domestic constituencies. Since this is primarily done through strong investment returns, non-toleration of poor returns by the people constitutes a destabilising factor regarding a fund's domestic legitimacy. Considering the domestic ire certain funds have faced following poor financial performance, this scrutiny leaves little room for non-financial objectives.¹²

Crucially, these theoretical objections are supported by the practical experience of SWF investment behaviour. To date, there is simply no clear evidence of SWFs pursuing narrow political, strategic or non-commercial investments.¹³ Hostile takeovers are virtually non-existent in the sovereign fund investment universe. Moreover, SWFs have not set out seeking controlling interests in their investments and certain funds have explicit policies against their fund seeking controlling stakes in their investments.¹⁴

Furthermore, detailed analysis of SWF investment behaviour also confirms that concerns regarding SWFs non-commercial motives are speculative. A 2009 OECD investigation into the possibility of political bias in the investment behaviour of SWFs concluded that

¹² See a case-study of this argument in the context of the Chinese Investment Corporation in Jean-Marc F. Blanchard (2011) 'China's Grand Strategy and Money Muscle: The Potentialities and Pratfalls of China's Sovereign Wealth Fund and Renminbi Policies' *Chinese Journal of International Politics* (2011) 4 (1): 31-53.

¹³ For reviews of Western government's perceived concerns regarding SWFs and how these are exaggerated or ill-founded, see Matthew Saxon (2009) 'It's Just Business, Or is It?: How Business and Politics Collide with Sovereign Wealth Funds', 32 *Hastings International and Comparative Law Review*, 693, 2009, p.699ff; Brendan J. Reed, 'Sovereign Wealth Funds: The New Barbarians at the Gate? An Analysis of the Legal and Business Implications of their Ascendancy', *Virginia Law and Business Review*, 4, (97) (2009), pp.106-117; and Zhao Feng, (2009) 'How Should Sovereign Wealth Funds Be Regulated?' *Brooklyn Journal of Corporate Finance and Commercial Law* (2009) 3 (2): 483-511.

¹⁴ Cornerhouse Report (2008) p.21

sovereign wealth funds are ‘more oriented towards risk-return and profit-maximisation objectives than commonly believed.’¹⁵ The study compared the investment patterns of SWFs with mutual funds, a peer institutional investor. The comparison revealed ‘considerable similarity in political regime and corporate governance in countries targeted by both sovereign wealth funds and mutual funds... [o]ther indicators of political regime are also all nearly equal.’ The study concluded that ‘there is no difference between the investments of sovereign wealth funds and mutual funds in terms of political regime or corporate governance.’ This finding leads the authors to make a similar point to the message of this paper, namely that: ‘Sovereign wealth funds investors, like mutual funds, invest in countries because it is financially rewarding, regardless of political regime. *A straightforward consequence of this is that double standards should be avoided.*’

Other examinations of SWF investment behaviour also find no support for allegations of non-commercial or extra-financial investing. Notably, one of the most comprehensive studies of historical SWF transactions found no evidence of anything other than financial-oriented investment.¹⁶ A 2008 report by Monitor Group analyzed over 1,100 publicly-reported SWF transactions between 1975 and March 2008 and interviewed fund managers and investors, concluding that the funds were primarily driven by financial concerns and that fears regarding their political motives were overdone. The report found that investments in sectors traditionally associated with national security concerns such as

¹⁵ Rolando Avendaño and Javier Santiso (2009) ‘Are Sovereign Wealth Funds’ Investments Politically Biased? Comparison with Mutual Funds’, *OECD Development Centre Working Paper 283*, December 2009

¹⁶ William Miracky et al (2008) *Assessing the Risks: The Behaviours of Sovereign Wealth Funds in the Global Economy*, Monitor Group, Boston USA, 4 June 2008

transportation, defence and aerospace and high technology made up less than one per cent of the value of deals tracked. It also determined that over half the deals done in the period from the year 2000 occurred in emerging markets, contradicting the stereotype of non-Western funds attempting to secure power and influence in Western only markets.

Of course, not all studies concur, with some analyses finding evidence of patterns in SWF investment that implies a preference for certain markets for industries.¹⁷ Critically though, such studies always still emphasise the central role of financial portfolio objectives in driving SWF investment and explaining these outcomes. Ultimately, it is entirely natural to see trends within this investment group and it is indeed something we see among other institutional investors.

(c) Government ownership means SWFs should be subject to a different set of ethical expectations regarding investment policy

Civil society calls for SWFs to incorporate certain ethical considerations into their investment strategies are also increasing. Such calls use SWF's status as government-sponsored entities holding public capital as a ground for arguing that higher duties should apply to SWF investments. SWFs should not operate simply according to profit motive, goes the claim, but they should be concerned with social and ethical return as well.

Calls for SWFs to use their financial assets as instruments of policy, no matter how laudable those policy objectives, must be met with caution. While the ultimate decision

¹⁷ See for instance, I. J. Alexander Dyck and Adair Morse, 'Sovereign Wealth Fund Portfolios', *Chicago Booth Research Paper No 11-15*, 1 February 2011.

to pursue responsible investing mandates must lie with each fund and will reflect the expectations of local populations and the cultural preferences of SWF owning economies regarding investment objectives, SWFs are first and foremost wealth preservation and augmentation vehicles. This purpose may be jeopardized if funds are required to pursue multiple bottom lines. There are potentially harmful consequences of SWFs investing according to non-financial considerations. Such an approach detracts from manager effectiveness as managers either (1) second guess the social objective behind an investment, effectively creating a “Financial Parliament” where investment personnel make policy decisions that are the proper province of legislators and policy specialists; or (2) managers take the lead from government, which compromises the independence of the fund. Owning communities suffer under both scenarios. In the former, a democratic deficit occurs when financial managers determine policy outcomes, usurping the role of elected officials. In the latter, direct government involvement in investment decisions politicises a fund’s investment strategy jeopardizing optimal return. Compromising the potential return on sovereign funds to meet separate policy objectives undermines the core purpose of sovereign funds – to preserve, create and manage public wealth.

III THE SANTIAGO PRINCIPLES

The need to tackle such myths was a major impetus behind the creation of the Santiago Principles, a set of 24 Generally Agreed Practices and Principles for SWFs that for all the reasons above, were deliberately not named “Best Practices”. Negotiated and endorsed as a code of voluntary principles by SWFs from 23 countries, the Santiago Principles include input from the IMF, the OECD and recipient country governments. As a

principle aim of the GAPP was to enhance public understanding of SWFs, the GAPP had to ‘properly reflect the investment practices and objectives of SWFs’ to be credible.¹⁸ Accordingly, it offers a robust, applicable framework for driving forward the debate on SWFs and the behaviour of recipient countries who were substantially involved in the creation of the Santiago Principles. The universal adoption and endorsement by members of the International Forum of Sovereign Wealth Funds (IFSWF) and its frequent use by the international community to evaluate SWF behaviour indicates that it enjoys widespread credibility.¹⁹

Much of the misinformation and misunderstanding outlined above is explicitly addressed by the Santiago Principles. Two elements of the GAPP are especially crucial for this purpose: the distinction drawn between SWFs and State Owned Enterprises (SOEs), and emphasis on the economic/commercial orientation of SWF investment behaviour.

In defining SWFs, the GAPP explicitly distinguishes from SOEs. Describing SWFs as ‘special purpose investment funds or arrangements that are owned by the general government’, the GAPP immediately clarifies that this excludes ‘state-owned enterprises in the traditional sense.’ The latter are typically corporations fully or partly managed by the state, that report directly to the central government with access to below market rate

¹⁸ International Working Group, *Sovereign Wealth Funds: Generally Accepted Principles and Practices: the “Santiago Principles”*, October 2008, p.1

¹⁹ For recent analyses acknowledging the valuable contribution of the Santiago Principles to the investment community, see Donghyun Park and Gemma Esther Estrada (2010) ‘Developing Asia’s Sovereign Wealth Funds: The Santiago Principles and the case for Self-Regulation’, *Asian Journal of International Law*, pp.1-20; and Bells (2010).

capital. SOEs often result from a political decision to retain government ownership.²⁰ In contrast, SWFs are investment vehicles sponsored by states, run by financial experts and in some cases independent Boards. Given the problematic conflation of SOEs and SWFs, it is timely to recall that a definitional virtue of SWFs as set out by the GAPP is the distinction between these two entities.

The second aspect of the GAPP helping to combat SWF mythology is the emphasis on the economic and commercial orientation of SWF investment. One of the four guiding objectives for SWFs underpinning the Santiago Principles is that SWF investment is made on the ‘basis of economic and financial risk and return-related considerations.’ Several individual principles are dedicated to articulating the realization of this central principle. Take for instance principles such as GAPP 2 and 19. GAPP 2 makes sure the purpose of an SWF is not co-mingled with other purposes and that the focus is on investing not geopolitical goals. This principle not only manages the expectations of a domestic public regarding the purpose of these entities but it also reassures the investor community that SWFs are first and foremost financial operators and not broader tools of foreign policy. This commitment is supplemented by Principle 19, which sets out that SWFs operate solely ‘based on economic and financial grounds’ aiming to maximize ‘risk-adjusted returns’.

At this point, it is important to address a common riposte that surfaces when referring to the role of the Santiago Principles. Critics are quick to point to the voluntary, non-

²⁰ Robert M. Kimmitt (2008) ‘Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy,’ *Foreign Affairs*, January-February 2008

binding nature of the principles. But this is to misunderstand the contemporary nature of global financial governance. Associate Professor of Law Anna Gelpern has identified resurgence in the role of soft law mechanisms within international finance.²¹ Factors such as market discipline, competition, and process institutionalisation deliver results in the SWF space. Persistent criticisms of the Santiago Principles as non-binding are therefore overstated in light of this trend in international finance. But if the reality is that the Santiago Principles provide confidence to recipient countries and third party regulators, and the evidence suggests concerns regarding SWF regulation is excessive, then why are there discriminatory discussions or special provisions against SWFs?

III CONSEQUENCES OF DIFFERENTIAL TREATMENT AND POTENTIAL DISCRIMINATION

Despite these efforts to allay concerns regarding the nature and intentions of SWFs, the prospect and discussion of discriminatory treatment of sovereign funds persists. The potential differential treatment may manifest itself through negative suasion,²² taxation arrangements and calls for more onerous investment constraints on SWFs.²³ Such discussions also lead to calls for SWFs to be the investment vehicle that deals with public policy challenges such as climate change, poverty alleviation and other non-commercial goals. Not only is such discrimination unjustified, its harmful consequences reach well beyond the target funds. Casualties include market participants in recipient countries, the citizens of SWF-owning communities and long-term prosperity of the global economy.

²¹ Anna Gelpern, 'Sovereignty, Accountability and the Wealth Fund Governance Conundrum', *Asian Journal of International Law*, forthcoming.

²² See Reed (2009) and Saxon (2009) for comprehensive overviews of negative suasion incidents in Western economies.

²³ See for instance Joint Committee of Taxation (2008) *Economic and U.S. Tax Income Issues Raised by Sovereign Wealth Fund Investment in the United States*, JXC-49-08, 17 June 2008

In recipient economies, restricted investment flows bring traditional consequences of distorted capital allocation, stunted future growth and reduced productive capacity. Academic research consistently demonstrates that restrictions to foreign investment impede innovation, employment, capital access and economic expansion.²⁴ Recent economic analysis of U.S. Federal Reserve data indicates that foreign capital inflows into the U.S rise during times of reduced household savings and diminished government surplus and fall when domestic funds are sufficient.²⁵ This suggests foreign capital can act as a bridge between supply and demand within domestic credit markets, supporting ongoing economic development. But such efficient allocation of capital only occurs in open markets. To the extent that SWF investment flows suffer from protectionism or are saddled with non-commercial considerations, domestic economies party to SWF transactions as well as global capital markets will suffer distortionary, constraining effects.

For the SWF-owning communities, the effect of discrimination is equally severe. As SWFs are tools for preserving and augmenting wealth of their founding communities, any constraint on investment strategy impairs a fund's ability to generate an optimal return for their domestic beneficiaries. This deprives not only the fund, but most crucially its owning community of wealth, adversely impacting the living standards of both current and future generations. This effect is especially harsh in savings short countries, where the need to ease the projected strain on future public finances motivates the establishment

²⁴ For a useful overview of quantitative literature on this topic, see Feng (2009) pp.499-500

²⁵ Ibid.

of savings vehicles. Most OECD nations forecast a medium term rise in public expenditure due to their ageing population and shrinking tax base. Reducing the ability of sovereign funds to maximize returns, effectively diminishes long-term public budgets for healthcare, pensions and critical infrastructure in savings deficient countries.

This is particularly acute in the case of resource-based SWFs. Typically, these funds are established to preserve resource windfalls, aiming to convert finite natural resources into infinite financial assets. Such mandates involve a commitment to intergenerational equity. Constraining the ability of these funds to optimally convert their natural resources into financial returns punishes those communities who are the beneficiary of the shared interest these funds represent. A diminished return on the fund risks reducing living standards for future generations dependent on this income for their country's post resource prosperity. Indeed, it is tantamount to appropriating these resources, violating the property rights of citizens whose collective ownership of natural resources is often constitutionally or customarily recognized.

Beyond offending our sense of what is right for SWF-owning communities, special constraints on SWF investment flows contradict technical wisdom on investment best practice. Hypothecating what SWFs should invest in contravenes all principles of Modern Portfolio Theory (MPT). The fundamental concept behind MPT that assets in an investment portfolio should not be selected individually, but on the basis of relative price changes within the portfolio, is thwarted when SWF investment is prevented or subjected to non-commercial considerations. Whether an SWF is prohibited from

carrying out a transaction in a particular market or burdened with non-commercial objectives, the result is the same – the core purpose of individual SWFs to seek a financial return is compromised.

CONCLUSION

Far from being a homogenous group of investors that is nonetheless a discrete investor class, when it comes to SWFs, the reverse is true: while there are marked differences among SWFs, it is not the case that as a group, they are qualitatively different from other institutional investors. Until this is recognized as the appropriate starting point for debate, the risk of differential treatment will continue to present challenges for global growth, capital flows and the ultimate beneficiaries of SWFs. The voluntary development and adoption of the Santiago Principles by SWFs was an important step forward. They have stood the test of time with existing funds applying them and with their use as the critical guidelines for the creation of new funds.

The opportunity to reinforce the Santiago Principles and address potential harmful protectionism is still to be taken by recipient countries. The way forward is for recipient countries to acknowledge that, through their development and adoption of the Santiago Principles, SWFs have demonstrated their commitment to accepted standards of governance and accountability and that they operate as investors with economic and financial objectives. Having met that high standard there remains no reason for SWFs to be treated differently to other institutional investors with similar objectives.

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