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Multilateral governance of financial markets: the case of sovereign wealth funds

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Abstract

The glaring deficiencies of the US sub-prime market in 2007 evolved through 2008 and 2009 into a fully blown global financial crisis (GFC), the worst since the Great Depression of the 1930s. That in turn has spawned sovereign debt crises in a number of European countries in 2010, most dramatically in Greece and Ireland. These events have prompted not only national responses, such as the austerity budgets that have been handed down by a large number of European governments including Greece, Spain and the UK, but also multilateral regulatory initiatives under the auspices of organisations such as the G20[2] and the International Monetary Fund (IMF). Governments across the world have felt compelled to hurl billions of dollars into saving financial institutions from collapse, in some jurisdictions effectively the nationalisation of some banks. The regulatory landscape of the financial sector both nationally and internationally is being dramatically reshaped. This increasing regulatory activism of the state is clearly recognised and has received widespread support. What is less widely known is the increasing number of jurisdictions in recent years that are ramping up their levels of investment activity and the potential regulatory repercussions of larger state-related pools of capital in international financial markets. This paper considers the issue of multilateral regulation of financial markets through the lens of Sovereign Wealth Funds (SWFs),[3] discussing their evolution, especially the implications of their increasing size and prevalence in relation to developments in multilateral governance of the financial sector. The paper incorporates the findings of a number of semi-structured interviews (n = 42) with SWF stakeholders in Australia, China, Norway, the UK and the US. Those interviewed include: SWF personnel, regulators (both national and international), analysts, bankers, brokers, fund managers, governance professionals, academics and financial journalists.

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2 The Group of Twenty (G20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important industrialised and developing economies to discuss key issues in the global economy. The inaugural meeting of the G20 took place in Berlin, on 15–16 December 1999, hosted by the German and Canadian finance ministers. The G20 is made up of the finance ministers and central bank governors of 19 countries: Argentina; Australia; Brazil; Canada; China; France; Germany; India; Indonesia; Italy; Japan; Mexico; Republic of Korea; Russia; Saudi Arabia; South Africa; Turkey; United Kingdom; United States of America. The European Union, which is represented by the rotating council presidency and the European Central Bank, is the 20th member of the G20. See www.g20.org/about_what_is_g20.aspx.

3 The difficulties and ambiguities surrounding the definition of SWFs are discussed in more detail in the paper, but a working definition is that they are state-owned investment funds comprised of financial assets.

Introduction

The aftermath of the GFC[4] that for many is symbolised by the collapse in mid-September 2008 of the giant US investment bank Lehman Brothers[5] is still unfolding. There have been substantial regulatory reactions and reform proposals at a national level, most notably in the US. In June 2009, President Obama and Treasury Secretary Timothy Geithner officially launched the Financial Regulatory Reform Program.[6]

These reforms have five key objectives:

i) promote robust supervision and regulation of financial firms;

ii) establish comprehensive regulation of financial markets;

iii) protect consumers and investors from financial abuse especially through the establishment of a new Consumer Protection Agency;

iv) provide the government with the tools it needs to manage financial crises;

v) and raise international regulatory standards and improve international cooperation.

They represent the most significant set of financial reforms in the US since President Roosevelt's Great Depression New Deal reforms of the 1930s that established the Securities and Exchange Commission (SEC).[7] Much of that June 2009 program survived the inevitable and often fractious political *horse-trading arena* that is the US Congress as part of HR4173 the Wall Street Reform and Consumer Protection Act 2009 (comprising more than 1700 pages and 11 separate Bills), that passed the House of Representatives in December 2009. As it moved through the US Senate it stretched to 2300 pages and became S3217 Restoring American Financial Stability Act of 2010.[8] Eventually the reforms were packaged as the Wall Street Reform and Consumer Protection Act 2010 and signed into law on 21 July 2010 by President Obama, who affirmed that they "represent the strongest consumer financial protections in history", but acknowledged that his administration had

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4 An enormous and growing literature is available on the GFC. This paper does not analyse the GFC in great detail but some of the many available commentaries on the GFC include: CJ Arup, "The global financial crisis: learning from regulatory and governance studies" (2010) 32(2) *Law and Policy* 363; E Avgouleas, "The global financial crisis, behavioural finance and financial regulation: in search of a new orthodoxy" (2009) 9 *Journal of Corporate Law Studies* 23; P Booth (ed.), *Verdict on the Crash: Causes and policy implications* (London: Institute of Economic Affairs 2009); Essential Information and Consumer Education Foundation, *Sold Out: How Wall Street and Washington betrayed America* (Washington DC: 2009); GB Gorton, *Questions and Answers about the Financial Crisis*, NBER Working Paper No w15787, (2010), www.nber.org/papers/w15787; International Monetary Fund, *Global Financial Stability Report: Meeting new challenges to stability and building a safer system* (Washington DC: April 2010); International Monetary Fund, *Fiscal Implications of the Global Economic and Financial Crisis*, SPN/09/13 (Washington DC: 2009); CM Reinhart and KS Rogoff, *This Time is Different: Eight centuries of financial folly* (Princeton: Princeton UP 2009.

5 The interviews that are referred to in this paper were conducted just before and during the GFC in 2008 and 2009 and had a specific focus on SWFs, but nevertheless hopefully they add a sense of *coalface pragmatism* to the analysis. One of the most memorable interviews was with US financial regulators in their Wall Street offices on Groundhog Day as the Lehman Brothers collapse was unfolding live on television screens in the US and around the world.

6 Department of the Treasury, *Financial Regulatory Reform, a New Foundation: Rebuilding financial supervision and regulation* (Washington DC: 2009).

7 The SEC, which is probably the world's most influential securities regulator, was created by s. 4 of the Securities Exchange Act 1934 (codified as 15 USC 78d). The SEC enforces this Act as well as the Securities Act 1933, the Sarbanes–Oxley Act 2002 and other statutes.

8 Open Congress, HR 4173 Wall Street Reform and Consumer Protection Act 2009 www.opencongress.org/bill/111-h4173/show, and S3217 Restoring American Financial Stability Act of 2010 www.opencongress.org/bill/111-s3217/show.

to: "overcome the furious lobbying of an array of powerful interest groups and a partisan minority determined to block change".[9] It is not surprising that interest groups' activity should be high regarding national financial sector reform and, as discussed below, it is very significant in the development of multilateral regulatory initiatives. In the UK, the Chancellor of the Exchequer announced in June 2010 that the new Coalition government (major partner the Conservative Party, minor partner the Liberal Democrats) would abolish the old tripartite regulatory regime and that the Financial Services Authority (FSA) would cease to exist in its current form. The government would create a new Prudential Regulatory Authority (PRA) that would be a subsidiary of the Bank of England and be responsible for the day-to-day prudential supervision of financial institutions. Also, a new Consumer Protection and Markets Authority (CPMA) would be established with responsibility for the conduct of all retail and wholesale financial firms.[10]

There has been significant regulatory activity in the international sphere as well as in national environments. The key avenue for multilateral regulatory progress post-GFC has been the G20, which at its summit in Toronto in June 2010 announced that its financial sector reform agenda is based on four pillars:

i) a strong regulatory framework;

ii) effective supervision;

iii) resolution and addressing systemic institutions;

iv) and transparent international assessment and peer review.

The G20 Declaration stated "that the core of the financial sector reform agenda rests on improving the strength of capital and liquidity and discouraging excessive leverage".[11] However, with regard to multilateral arenas the constitutional and jurisdictional challenges for post-crisis regulatory reform are obviously much greater than in national contexts.[12] It is not yet clear how the international financial regulatory architecture will change during 2010 and 2011 but there will be significant change with the G20 and the IMF sure to be lead actors in these processes.

For example, in September 2010 the Basel Committee on Banking Supervision announced the details of changes to capital adequacy standards for banks, increasing the minimum common equity requirement from 2 per cent to 4.5 per cent and an additional conservation buffer of 2.5 per cent.[13] Together with the introduction of a global liquidity standard, these capital reforms were endorsed as part of the Seoul Action Plan by the Seoul G20 leaders' summit in November 2010 and will be phased in between 2011 and 2019.[14] They represent substantial changes in the calibration of international capital frameworks and are intended to militate against future global financial crises. Political economy factors have been, and will continue to be, crucial in shaping these international reform processes

9 *The White House Blog*, "President Obama signs Wall Street reform: no easy task", 21 July 2010, www.whitehouse.gov/blog/2010/07/21/president-obama-signs-wall-street-reform-no-easy-task.

10 HM Treasury, *Reform and Regulation: The government's approach to financial services regulation* (2010), www.hm-treasury.gov.uk/reform_and_regulation.htm.

11 G20 Toronto Summit Declaration, 26–27 June 2010, p. 15, www.g20.org/Documents/g20_declaration_en.pdf.

12 For a discussion of these issues with a focus on initiatives in the UK and how they are affected by European Union responsibilities, see J Black, *Managing the Financial Crisis: The constitutional dimension*, LSE Legal Studies Working Paper No 12/2010, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1619784.

13 Bank for International Settlements, "Group of governors and heads of supervision announces higher global minimum capital standards", press release, 12 September 2010, www.bis.org/press/p100912.htm

14 The G20 Seoul Summit Leaders' Declaration, 11–12 November 2010, www.g20.org/Documents2010/11/seoulsummit_declaration.pdf

and it is useful to consider how similar pressures were highly influential in recent regulatory initiatives surrounding SWFs. SWFs and other state-related pools of capital such as State Owned Enterprises (SOEs),[15] State Pension Funds and Commodity Stabilisation Funds are acknowledged as increasingly valuable sources of liquidity in capital markets that have been drained of liquidity in recent years,[16] and this issue[17] – what SWFs are and what they do – is discussed in more detail below. As GFC ramifications, such as governments part-nationalising/saving failing banks (e.g. Royal Bank of Scotland and Lloyds TSB in the UK), or nationalising them (e.g. Fannie Mae and Freddie Mac in the US, Northern Rock in the UK), continue to impact so heavily on contemporary political, economic and legal agendas,[18] the entwined regulatory/investment role of the state comes into sharper focus. SWFs are an example of a space where this dual role is at work and where there have been concerns raised in many fora (discussed in more detail below), about how the state can manage simultaneously the potential conflicts of being an active investment actor, a detached and independent regulator, a recipient of inward investment from both state and non-state sources and the promoter of the national interest. The increasing investment role of SWFs, SOEs and other state-related pools of capital reflect changing relationships in the global economy, especially the economic rise of Asian players, such as China and India. As their strategic economic and political importance grows, so does the need to understand how international regulatory infrastructures need to evolve in order to accommodate such changes. This is why it is worth examining multilateral regulatory initiatives regarding SWFs as it reveals some of the challenges and potential benefits that are applicable to other sectors and contexts, for example, climate change.

The activities of SWFs and other state-related pools of capital have to be understood within the context of an era of globalisation, in which economic and political ties between many jurisdictions are deepening, and jurisdictions increasingly are playing a mediating role regarding the interests of much business that may be conducted within their spheres of influence.[19] One significant effect of globalisation has been to further elevate deficits and surpluses run by countries and the subsequent macro-economic trade imbalances that they bring. As ever with regard to international trade, the political context remains crucial and almost inevitably it is intertwined with expectations regarding vested interests. These developments are affecting the sovereignty of jurisdictions as local political priorities become more intertwined with international politics and the requirements of international business. The regulatory world reflects the realities of those domains, which it purports to

15 A working definition of SOEs is that they are widely deemed to be state-owned operating companies rather than investment mechanisms as SWFs are.

16 For example, Abu Dhabi's Investment Authority (ADIA) in November 2007 invested US$7.5 billion for a 4.9 per cent share of Citigroup, which allowed the latter to immediately make US$6.8 billion in sub-prime write-offs and thus ward off potential bankruptcy in the midst of the global financial crisis.

17 There is uncertainty about how big SWFs actually are and this is discussed in more detail below, but the general view is that SWFs control circa US$3 trillion of assets and some analysts have projected that accumulated SWF assets will reach US$ 12 trillion by 2015.

18 There has been significant academic and media coverage of these events and their implications. For example: DA Oesterle, *The Collapse of Fannie Mae and Freddie Mac: Victims or villains?*, Ohio State Public Law Working Paper No 127, 2010, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1645330; P Aldrick, "RBS and Northern Rock to unveil radical strategies", 22 February 2009, www.telegraph.co.uk/finance/newsbysector/banksandfinance/4782762/RBS-and-Northern-Rock-to-unveil-radical-strategies.html; RA Tomasic, "The rescue of Northern Rock: nationalization in the shadow of insolvency" (2008) 1(4) *Corporate Rescue and Insolvency* 109; RJ Rhee, "Nationalization of corporate governance and purpose during crisis" (2010) 17 *George Mason Law Review* 661.

19 See, for example: JA Frieden, *Global Capitalism: Its fall and rise in the twentieth century* (New York: WW Norton & Company 2006); JA Scholte, *Globalization: A critical introduction* (Houndmills: Palgrave Macmillan 2005); and J Stiglitz, *Globalization and its Discontents* (New York: WW Norton & Company 2003).

influence, and so a major consequence of these developments is that regulatory structures and processes have become more internationalised. A variety of modes of governance are emerging that have a capacity for impacts of broad international scope. This political reality reflects an era of networked governance as regulatory relations are reconfigured, driven by trends towards hollowed-out government and hollowed-out corporate governance. It is in this environment that SWFs and other state-related pools of capital have been increasing, not only in their number, but also in the scale of their effect. As the effects of the GFC continue to unwind, a new era of more proactive state-led investment capitalism is emerging in which SWFs and other state-related pools of capital form part of the key advance guard of this process.

Recently there has been multilateral regulatory innovation regarding SWFs and so they may provide indicators as to how one might expect global prudential financial regulatory reform more generally to evolve in the coming years. This is because of the way many of the intrinsic challenges associated with regulating the international finance sector in a post-GFC era have come into play in recent years in multilateral efforts to mediate the increasing levels of activity and influence exercised by the diverse constituency of financial sector actors that have been bundled together under the SWF label. These mutual challenges include: balancing the interests of state and private actors; the transnational nature of much financial sector activity; creating market regulatory conditions that can deliver appropriate balances between liquidity supply and opportunity for profit; the need to protect the national interest of jurisdictions but not encourage protectionism; and the increasing hybridisation of financial sector actors, products and services

The evolution of SWFs

The first question one must ponder regarding SWFs is: what are they? This is not as simple a proposition as one might at first think as was confirmed by the responses to Question 3.[20] Although some SWFs have been in existence for more than 50 years,[21] respondents agreed that public recognition of the label SWF is quite recent.[22] The category SWF is problematic in many ways because numerous types of actor have been collapsed into popular understandings of the term. There is definitional uncertainty about not only SWFs but other forms of state-related capital and how they should be classified. Truman defines SWFs as "a descriptive term for a separate pool of government-owned or government-controlled financial assets that includes some international assets".[23] Lowery (at the time US Undersecretary for International Affairs) defined SWFs as "a government investment vehicle which is funded by foreign exchange assets, and which manages these assets separately from official reserves".[24] The European Commission (EC) notes that SWFs are"generally defined as state-owned investment vehicles, which manage a diversified

20 The questions that guided the interviews and which were sent to the respondents prior to meeting are reproduced as an appendix at the end of this article, see p. 410.

21 The Kuwait Investment Office was established in London in 1953 as an asset manager for Kuwait's Foreign Ministry.

22 The term "sovereign wealth fund" appears to have been introduced by Rozanov in 2005; A Rozanov, "Who holds the wealth of nations?" (2005) 15(4) *Central Banking Journal* 52–7.

23 EM Truman, *A Blueprint for Sovereign Wealth Fund Best Practices*, Policy Brief No PB08-3, Petersen Institute for International Economics, Washington DC, 2008 www.iie.com/publications/interstitial.cfm?ResearchID=902, at p. 1.

24 US Department of Treasury, "Remarks by Acting Undersecretary for International Affairs Clay Lowery on sovereign wealth funds and the international financial system", press release hp-471, San Francisco, 21 June 2007, www.ustreas.gov/press/releases/hp471.htm.

portfolio of domestic and international financial assets".[25] The IMF sees SWFs as a heterogeneous group with five sub-categories based on their main objective:

i) stabilisation funds whose primary objective is to help insulate the economy from the effects of commodity (usually oil) price swings;

ii) savings funds for future generations and so mitigate the effects of Dutch disease;[26]

iii) reserve investment corporations;

iv) development funds;

v) and contingent pension reserve funds that provide for unspecified pension liabilities on the government's balance sheet.[27]

Jen believes SWFs have five basic ingredients:

i) sovereign;

ii) high foreign currency exposure;

iii) no explicit liabilities;

iv) high risk tolerance;

v) and long investment horizon.[28]

It is only very recently that the SWFs themselves have combined as an interest group in any meaningful way (this process is detailed later in this paper), and they offered their own definition in September 2008 as part of their Generally Accepted Principles and Practices (GAPP):

> SWFs are defined as special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets.[29]

So, it can be seen that SWFs are a slippery beast to classify and respondents confirmed this. A senior Finance Ministry official who helps to administer an SWF emphasised that classification of SWFs is difficult and there are many grey areas, for example, between central banks' foreign reserves management and other types of investment vehicles. Pension funds are not SWFs even though they may be government sponsored, but they do have a clear link to the beneficiaries via fiduciary duties. Some SWFs are legal entities (e.g. ADIA/ADIC –

25 Commission of the European Communities, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, 2008, Brussels, XXX, COM (2008) 115 provisional, p. 3, http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf.

26 Dutch disease is defined by investorwords.com as: "The deindustrialization of a nation's economy that occurs when the discovery of a natural resource raises the value of that nation's currency, making manufactured goods less competitive with other nations, increasing imports and decreasing exports." The term originated in the Netherlands after the discovery of North Sea gas in the 1970s and is an ongoing concern for resource-rich jurisdictions, prompting several to establish SWFs: www.investorwords.com/1604/dutch_disease.html. See also P Krugman,. "The narrow moving band, the Dutch disease, and the competitive consequences of Mrs Thatcher." (1987) 27(1–2) *Journal of Development Economics* 50.

27 IMF, *Sovereign Wealth Funds: A work agenda* (Washington DC: 2008), p. 5, www.imf.org/external/np/pp/eng/2008/022908.pdf.

28 S Jen, *The Definition of a Sovereign Wealth Fund* (Hong Kong: Morgan Stanley Research October 2007), www.morganstanley.com/views/gef/archive/2007/20071026-Fri.html.

29 IWG of SWFs, Generally Accepted Principles and Practices (GAPP): The Santiago Principles, 2008, p. 3: www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf.

Abu Dhabi), others are corporations (e.g. Temasek – Singapore) and others are not legal persons (e.g. Norway Government Global Fund). Thus, there needs to be an unbundling of what constitutes an SWF and this conundrum was reiterated by most respondents.

One international banker noted that it is extremely difficult to measure SWFs and their impact because even though one might argue that their two main functions are long-term returns and the provision of liquidity through credit resource management: "where do SWFs, resource managers and credit managers begin and end, and where and how do you discriminate between them?" Another international banker made the obvious point that "categorisation of SWFs depends on the questions asked". A respondent who works for a global investment bank stated that their organisation had done some work on SWF measurement through categories such as: funding sources (e.g. Norway); fixed transfer (e.g. China); foreign transfer (e.g. Korea); stabilisation (e.g. Russia); general investment (e.g. GIC – Singapore); and holding companies (e.g. Temasek – Singapore). An international regulator believes SWFs are "a historical new class of investment actor in financial history, but they will always remain *close cousins* with Central Bank surpluses".

One national regulator suggested that SWFs could be classified in terms of source of funds, levels of development, sustainability of funds and capacity for investment, but nevertheless there would always be measurement problems politically, especially in relation to energy security. This reflects what another respondent (an analyst) referred to as "underlying anxiety about *The Sputnik Moment*", in reference to the decoupling effects of contemporary fundamental changes in East–West capital flows with attendant global imbalances regarding the management of exchange rates and reserves. The most obvious example of this is the rapidly increasing global economic influence of countries such as China, India and Brazil. For instance, China has increased its foreign reserves from $21 billion in 1992 (5 per cent of its annual gross domestic product (GDP)) to $2.4 trillion in 2009 (almost 50 per cent of its GDP).[30] Interestingly, the same respondent felt that – although a difficult process due to data access etc. – SWFs could be classified and measured in similar ways to other non-listed pools of capital such as private equity and hedge funds, based on variables such as: asset portfolio make-up; capital ownership; executive control; institutional framework; investment strategies; and source of funding. The same analyst went on to say that, as all SWF countries are members of the IMF, then the IMF may be the best place to measure SWFs and their effects. The IMF through the International Finance Corporation has 187 members, including all jurisdictions that have SWFs, so it does possess significant clearing-house potential in relation to SWFs. The jurisdictions that operate SWFs are extremely diverse. Some are authoritarian one-party states. Others are sophisticated democracies, ranging from highly developed oil/gas exporters in Europe (e.g. Norway, Russia) to less-developed ones in the Middle East (e.g. UAE, Kuwait). Some are large and small manufacturing/trading entrepots in Asia (e.g. China, Korea Singapore), others broad-based commodity exporters (e.g. Australia, Chile), or smaller emerging economies (e.g. Mauritania, Uzbekistan).

Despite the definitional uncertainties and the lack of uniformity surrounding SWFs, various commentators and organisations have sought to tabulate which jurisdictions operate SWFs and estimate the scale of assets that they have under management. For example, in 2008, Truman identified 54 separate SWFs (44 non-pension funds, 10 pension funds), from 39 different jurisdictions and he estimated that they held US$5294 billion in assets, with

30 ZM Song, K Storesletten and F Zilibotti, *Growing like China*, Centre for Economic Policy Research, Discussion Paper No DP7149, 2010, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1345675.

US$3483 billion held in foreign assets.[31] Kambayashi estimated SWF holdings to have risen from $US500 billion in 1990 to $US2.5 trillion in 2007.[32] Based on February 2008 data, the IMF estimated the total assets of SWFs to be between US$2–3 trillion and projected that they would be between US$6–10 trillion by 2013.[33] 2008 data from Global Insight confirms their growth and places funds under the control of SWFs at US$3.5 trillion. To put this total in context, assets under the control of SWFs are greater than the combined funds of private equity and hedge funds, estimated at US$1.5 trillion.[34] They are therefore a significant element of global equity market capitalisation, which is estimated at US$50 trillion.[35] In terms of how significant SWFs are in relation to the conventional global economy in goods and services, Deutsche Bank in 2009 estimated global GDP at US$61 trillion and SWFs at US$3 trillion or 5 per cent.[36] More recently in June 2010 the Sovereign Wealth Funds Institute (SWFI) released a ranking of 50 SWFs estimating their total combined holdings at US$3938.4 billion, with oil-and-gas-related SWFs managing US$2256.8 (60 per cent) and other SWFs, underpinned by minerals or non-commodity, controlling assets of US$1681.6 (40 per cent).[37] The current recessionary influences in the global economy mean that it is more difficult to be certain of trend forecasting, but some analysts project that SWF assets will surpass the size of the world's total official reserves by 2011 and reach $US12 trillion by 2015.[38] To put the latter figure into perspective $US12 trillion is the size of the GDP of the United States.[39]

As mentioned earlier, there have been a number of motivations that have stimulated so many jurisdictions to establish an SWF. These include: diversification away from non-renewable commodities (most commonly, oil); investing currently unneeded liquidity (most commonly away from US dollars or gold); increasing the return on national savings; implementing domestic economic development objectives; and enhancing the value and capability of national assets.[40] A specific objective such as the inter-generational transfer of wealth can lead to the establishment of an SWF, for example, the Future Fund in Australia. Whether motivated by commodity price booms (e.g. Abu Dhabi) or trade-generated fiscal surpluses (e.g. China), a key factor common to many of these SWF stimuli has been to increase the capacity of jurisdictions to manage cyclical trends, because global trade imbalances lead to savings gluts and SWFs are a useful mechanism to help manage these gluts. Many of the respondents saw SWFs as a story largely of commodities and inextricably linked with the priorities of the state, so going forward the input of state capitalism is likely to grow, especially in emerging markets. One international regulator emphasised the importance of past history:

> Recent increases in the number of SWFs are a reaction to problems that are similar to the 1980s and 1990s. In the intermediation of the 1970s, concerns regarding the liquidity from oil production led to a flood of Eurodollars, which

31 Truman, *A Blueprint*, n. 23 above, pp. 2 and 4.

32 S Kambayashi, "The world's most expensive club", *The Economist*, 24 May 2007.

33 IMF, *Sovereign Wealth Funds*, n. 27 above, pp. 6–7.

34 Global Insight, *Sovereign Wealth Fund Tracker* (London: 2007).

35 European Commission, Communication, n. 25 above, p. 4.

36 S Kern, *Sovereign wealth funds – state investments during the financial crisis* (Franfurt: Deutsche Bank Research 2009), p. 5.

37 SWFI, *Sovereign Wealth Fund Rankings*, June 2010, www.swfinstitute.org/fund-rankings/.

38 S Jen, *How Big Could Sovereign Wealth Funds Be by 2015?* (Hong Kong: Morgan Stanley Research 2007).

39 S Johnson, "The rise of sovereign wealth funds" (2007) 44(3) *Finance and Development* 56.

40 BW Bean, "Attack of the sovereign wealth funds: defending the republic from the threat of sovereign wealth funds?" (2010) 18(1) *Michigan State University College of Law Journal of International Law* 65.

> in turn led to a large number of non-performing loans which led to short-term priorities and a number of consortium bank collapses prompting a retreat from emerging markets. Intermediation therefore failed although better regulation did emerge e.g. Basel Principles. Today the totals of capital involved are much bigger. The more seminal change today is not to hold portfolios weighing heavily in US Treasuries, so there is a drive to increase liquid assets by China and other sovereign actors. The big shift is to move some sovereign assets into long-term positions. This more mature activity shows a big switch in mentality by SWFs. SWFs do not control other players in their country but they can have informal influence (e.g. re China Investment Corporation). Also, it is just as important to consider what the SWFs have NOT done – for example, they have not dumped their UK assets and so remain a stabilising influence on capital markets.

These are very salient points and emphasise the value in academic research to garner the views of "those at the coalface", so to speak. This is especially true in times of crisis and in the context of debates on the supposed fears of foreign investment/ownership and possible reactionary lurches towards protectionist lawmaking. For example, is it not better both economically and in other areas, such as social development and geo-political stability, that excess capital does not fuel a liquidity boom promoting excessive risk-taking (whether in the 1970s or 2000s), but rather helps to underpin growth more organically?

Question 1 asked respondents to evaluate the impacts of SWFs and, as one international banker noted, there are different ways of evaluating the effects of SWFs, for example: impact on recipient countries; impacts on different types of investors; impacts on national policy issues; and impacts psychologically on investors and policy makers. Nevertheless, it is important to remember that SWFs are long-term investors that can be a true provider of liquidity in times of crisis and have large "holding power". The often long-term investment horizons of SWFs were stressed as a great positive by virtually all respondents who noted that SWF owners had a lower need for volatility than other investment actors. However, there is an increasing trend amongst SWFs towards investment diversification and a growing desire and capacity for risk and several respondents stressed the implications these developments have for cross-border foreign exchange liquidity, potential economic overheating and inflationary issues.

If SWFs are taken as an example of the changing significance of the broader pools of state-related capital, then in recent years they have become more varied and aggressive in their investment strategies, raising fears that forms of financial protectionism will be thrown up by nation states to defend against such activity, subsequently threatening the momentum and gains of globalisation.[41] The most strident and high-profile criticism of SWFs and SOEs came from elements of the US Congress and media.[42] In particular, protectionist sentiment was stoked by the takeover in 2006 by Dubai Ports World (DPW), a state-owned company in the UAE, of the management of port management businesses of a number of seaports in the US that were already in foreign ownership by the UK firm P&O. Even though the Bush administration gave approval for the deal, protectionism sentiment stimulated the spectre of *cross-border nationalisation* because state-related capital was behind DPW and this gained public and congressional traction, including the House Panel voting

41 SJ Weisman, "Concern about sovereign wealth funds spreads to Washington", *International Herald Tribune*, 20 August 2007.

42 Some of the media coverage was quite hostile, for example, DR Francis, "Will sovereign wealth funds rule the world?", *Christian Science Monitor*, 26 November 2007, p. 16.

62:2 on 8 March 2006 to block the deal.[43] The controversy contributed to DPW in December 2006 selling the seaport management businesses to the American International Group.[44] The DPW controversy attests to sensitivities in the US towards investment by foreign government entities. One survey of 1000 registered US voters (weighted by race and education in an effort to be a representative sample), conducted by Public Strategies Inc. revealed significant levels of distrust about foreign investment in the US in general and SWFs in particular. Seventy-two per cent believed that foreign governments do not reveal enough about their investment portfolios; 68 per cent of those surveyed opposed government investment from Saudi Arabia; and similar scores were recorded for other jurisdictions, e.g. Abu Dhabi (62 per cent), China (65 per cent) and Russia (61 per cent).[45] The sample of course was not comprehensively representative of the US population in general but ongoing public pressure of this sort contributed to legislative change in the form of HR 556: Foreign Investment and National Security Act of 2007, which passed in the House 423:0 and was signed into law by President George W Bush on 26 July 2007. The US was not the only jurisdiction in which there was negative media coverage of state-sponsored investment, for example, in 2007 and 2008 there were a number of articles in the UK press that were not that favourable about China's investments in the UK.[46] Of course, most recipient countries including the US and the UK have foreign investment regimes to help in monitoring and partially controlling inward investment, but they are sensitive to the ongoing need to balance the national interest with trade openness. For example, in Australia the Treasurer is advised by the Foreign Investment Review Board on the issue of foreign investment, and this has been a controversial issue at times, especially with regard to state sponsored-entities acquiring Australian resources' assets. In February 2008, the commonwealth government released six principles to improve the transparency of foreign investment screening processes that more clearly distinguish between investments by private entities and by foreign governments.[47]

However, it seems inevitable that there will be a geo-political security element to reporting about SWFs and that there will be some level of anxiety in the established West about the rising influence of SWFs. This can be seen in the comments of former US Treasury Secretary in the administration of President Bush, Mr Henry Paulson, who expressed concern about political motivations influencing the investments of SWFs and called for a multilateral regime to monitor their activities.[48] One US respondent commented in these terms on the increasing scrutiny of SWFs in the US:

> In 2007, FINRA [Financial Industry Regulation Authority] slightly increased requirements around sovereign investment, making mandatory what previously

43 For example, Senator Carl Levin, "Opening remarks at the Senate Armed Services Committee briefing on port security", press release, 23 February 2006, http://levin.senate.gov/newsroom/release.cfm?id=251838; SR Weisman, "Concern about 'sovereign wealth funds' spreads to Washington", *International Herald Tribune Business*, 20 August 2007; R Gay, "US feels power of cashed-up foreign funds", *Australian Financial Review*, 29 November 2007, p. 1.

44 "AIG buys DPW's US assets", *World Cargo News*, 11 December 2006, www.worldcargonews.com/htm/n20070118.117570.htm

45 Public Strategies Inc, "Survey reveals voters wary of foreign government investment", 21 February 2008, www.pstrategies.com/index.php/survey-reveals-voters-wary-of-foreign-government-investment.htm.

46 For example, M Kleinman and D Reece, "Revealed: Chinese bank's £9bn raid on British shares", *The Sunday Telegraph*, 7 September 2008, Business Section, p. 1.

47 Treasurer of the Commonwealth of Australia, "Government improves transparency of foreign investment screening process", press release Np.009, 17 February 2008 http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2008/009.htm&pageID=003&min=wms&Year=&DocType=0.

48 T Walker, "Call to keep funds free of political bias", *Australian Financial Review*, 22 October 2007.

> had been discretionary.[49] There has been a substantial increase in the numbers of examinations by the US Government of overseas investment in the US. This could be viewed as significant because in the US there almost has to be a national security issue for a Government examination to take place.

This comment reflects the reality that most countries are capital dependent and it is not feasible to screen all inward investment, so most will inevitably be approved. Other members of the G8 and the European Central Bank have expressed similar concerns.[50] The EC stated that it "cannot allow non-European funds to be run in an opaque manner or used as an implement of geo-political strategy" and reserved the right to introduce specific European legislation if increased transparency from SWFs was not achieved through voluntary means.[51] These concerns largely centred on whether the investment activities of these actors could lead to distortions in asset prices or excessive risk-taking. As one respondent noted:

> Continental countries seem to be seeking the best regulatory stick and Anglo American ones the best regulatory carrot. Middle East investors praise the UK's "Open Door" investment policy, whereas Continental Europe and Asia apply a lot more discretion regarding foreign investment.

Another respondent, a UK regulator, stressed in response to Question 3: "The FSA does not see SWFs as all that special and SWFs do not require authorisation from the FSA. The FSA has sufficient powers and rules already with which to deal with SWFs."

It is also important to note that many jurisdictions with SWFs, such as Australia and Norway, are not only recipient countries of SWF investment but also have high levels of foreign investment generally, for example, 44 per cent of all listed assets in Norway are owned by foreign investors. This scenario is likely to become more common amongst those jurisdictions with SWFs, in the words of one respondent (an analyst with a global investment bank): "The *clock is ticking* for many SWF countries in terms of becoming recipient countries themselves." The activities of SWFs raise issues of the implications of cross-nationalisation of assets and industries for jurisdictions all over the world. For example, states that are downstream consumers of commodities potentially could use their state-related pools of capital and investment vehicles such as SWFs to acquire the foreign companies that produce or own the rights to such commodities, leading to what one international regulator referred to as "potential entrapments of governance in some domestic contexts". Scenarios of this nature could have far-reaching implications for the securities regulation, corporate governance, competition and tax policies in the recipient countries of such investment and governments around the world are increasingly taking note of these issues.[52] Several respondents saw the taxation–SWF linkage as critical. For example: "How SWF activities should/will be taxed is an important issue, especially as time goes on, especially the notion/concept of the *Sovereign Immunity Card*. Undoubtedly, taxation will be a key dynamic in how SWFs choose to structure themselves and their activities." For example, Australia with its resource-rich corporate entities is potentially a "juicy" target for

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49 US Department of the Treasury, "Committee on Foreign Investment in the United States (CFIUS), s. 721 of The Defense Production Act of 1950", notice, October 2007, http://cfius.us/modules/news/.

50 F Cheng, "Sovereign funds' war chests alarm G7", *The Australian*, 16 October 2007.

51 J M Barroso, "Statement by Jose Manuel Barroso President of the European Commission on sovereign wealth funds", press release, Oslo, 2008, http://ec.europa.eu/commission_barroso/president/press/releases/index_en.htm

52 For example, the Australian Treasury released a discussion paper in June 2010: *Greater Certainty for Sovereign investment: The framework rules*, Australian Government Consultation Paper, www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1842.

many state-related pools of capital and also may become a potential SWF-aggressive investor itself through the Future Fund. So what may be the taxation revenue implications of such developments? These are the thorny types of issues that have prompted some hostility in certain quarters towards SWFs, raising the spectre of trade protectionism and/or conflict and consideration as to how these might be avoided or mediated.[53]

As one respondent cautioned, a major tension about SWFs is that many of the largest ones are in the most protectionist countries that to an extent do not trust foreigners and this concern compounds the lack of transparency around SWFs, as indeed do issues of regional harmonisation. Where SWFs are based does matter, as illustrated in the discussion above about political tensions and SWFs. The SWFI evaluated the geographical origins of SWFs and estimated that, based on total SWF funds held: 38 per cent are in Asia; 37 per cent in the Middle East; 18 per cent in Europe; 3 per cent in Africa; 2 per cent in the Americas; and 2 per cent in other areas of the world.[54] These geo-political realities matter to Western jurisdictions such as the US and the political element in debates about SWFs is unlikely to go away, just as SWFs are likely to continue increasing in size and influence.

Most respondents agreed that the activities of SWFs had become politicised to some extent, but there was disagreement as to how much, and as one respondent stressed there is often "a sunken national interest" in some policy responses to SWFs. Also, the debate around SWFs is permeated by contrasting historical and cultural perspectives. As one Chinese respondent who worked for an organisation owned by an SWF noted, many SWFs face difficulties regarding related-party transaction obligations/expectations in many recipient jurisdictions because in their home jurisdiction (for example, China or Abu Dhabi), Western-standard conflicts of interest are almost unavoidable because so many enterprises are state-owned. Another respondent made the point that:

> The West has a very blinkered view of its own past – for example, the East India Company was essentially a Sovereign Wealth Fund. The British and Dutch went on to merge their respective East India Companies in order to increase their domination of the region.[55]

So, there would seem to be vestiges of colonialism intertwined with SWFs and their ongoing evolution and, of course, these relationships are crucially affected by prevailing economic conditions. This can be seen in action as the impacts of the credit crunch and subsequent GFC have deepened during 2008, 2009 and 2010, driving both major and less developed economies around the world into recession, so there has been a softening in the rhetoric of criticism directed towards SWFs and other state-related pools of capital. For the most part, this has been due to the large totals of liquid capital that SWFs injected into international financial markets during 2007 and 2008. Deutsche Bank aggregates that SWF investment into financial assets between 1995 and 2008 was US$109.8 billion, with two-thirds of that investment occurring in 2007 and 2008.[56] Some of that more recent investment was terrible in terms of its timing due to the GFC and incurred significant

53 See, for example: E Chalamish, *Protectionism and Sovereign Investment Post Global Recession*, OECD Global Forum on International Investment, 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1554618; M Plotkin, "Foreign direct investment by sovereign wealth funds: using the market and the Committee on Foreign Investment in the United States together to make the United States more secure" (2008) 118 *Yale LJ Pocket Part* 88.

54 SWFI, *SWF Rankings*, n. 37 above.

55 For a discussion of how various interest groups interacted in shaping the policy priorities of the East India Company, see HV Bowen, *The Business of Empire: The East India Company and imperial Britain, 1756–1833* (Cambridge: CUP 2006).

56 S Kern, *SWFs and Foreign Investment Policies: An update* (Frankfurt: Deutsche Bank Research 2008), p. 7.

short-term losses, especially some of the high-profile financial acquisitions. One respondent (an international banker) believes that in several of these instances: "SWFs were the final option in terms of a source of capital. US investment banks chose SWFs because if they had gone to US Insurance Funds the latter would have sacked the senior management of these poorly-performing firms." Whether this is a pervasive view across the market one cannot know, but one can be more certain of the massive losses to date that these SWF investments have incurred. For example, in February 2008, the SWFI estimates that the Abu Dhabi Mubadala (ADIA) fund had a -49.2 per cent return in only three months on its US$700 million investment in Advanced Micro Devices and China's CIC suffered a -52.1 per cent return in eight months on its US$3 billion investment in the Blackstone Group and a -15 per cent return in only two months on its US$5 billion investment into the global investment bank Morgan Stanley.[57] Current debates about multilateral regulation of financial markets and policy development to date regarding SWFs have to take account of the valuable liquidity that they can bring to capital markets as the GFC's effects continue to unfurl across the global economy.

Multilateral regulation and SWFs

The gathering global recession of 2008 coincided with some interesting multilateral developments regarding SWFs and how they chose to present themselves as a grouping to the world. In May 2008, in Washington DC, 25 SWFs from jurisdictions as varied as Australia, Botswana, Chile, China, Norway, Russia, Singapore, Trinidad and Tobago, the United Arab Emirates and the US formed the International Working Group (IWG) in cooperation with the IMF, but also the World Bank, and as a partial response to some of the criticism about their investment activities and motivations. Composition of the IWG has been largely finance industries and central banks. The IWG established a small secretariat and gave it the task of developing a set of principles that reflected the investment practices and objectives of SWFs. The IMF's role was as a facilitator of the process and recipient countries were involved all the way. Only five months later, at a meeting in Santiago, Chile, in October 2008, the IWG formally declared the GAPP – also known as the Santiago Principles. IWG members committed to operate by the GAPP, which have as their core 24 voluntary principles emphasising good governance, accountability, transparency and a commitment to financially motivated investment strategies.[58]

Most of those interviewed felt that the Santiago Principles are a fairly impressive achievement considering that 25 very different countries were involved. A range of highly technical complex issues were covered in a short space of time and several respondents believe that the principles will come to be seen as more comprehensive than first thought. For example, they will view transparency more widely than has been reported, e.g: clarity of purpose; who is making investments and for what purposes; and clear division of responsibilities. One respondent summarised in this way:

> The Santiago Principles has been and will continue to be a living document and reflect perceptions of what constitutes best practice. So, they can act as a guide for other countries that will establish SWFs in the future and they will have to be reviewed at various intervals. There has to be a transitional phase and there has to be flexibility in the rules because for some countries the Principles will be aspirational. It is something that the SWFs have done by themselves for

57 SWFI, "Do SWFs make smart equity purchases?", 19 February 2008, www.swfinstitute.org/swf-research/do-swfs-make-smart-equity-purchases/.

58 IWG, GAPP, n. 29 above.

themselves. They are not an IMF process of the IMF setting standards for SWFs but rather an "Industry Standard".

Some of those interviewed who were closely involved with the Santiago Principles felt that the Santiago Principles project had been one of the most challenging that they had been associated with over the last 20 years and emphasised that peer pressure had been a significant factor in establishing the principles. One commented that: "the process has worked really well so far and given that initially many of the SWFS were against any interventions, it has been one of the brightest moments in multi-lateral regulation in recent years".

Several respondents noted the key role played behind the scenes by the IMF in moderating media perceptions of SWFs, especially in calming anxieties surrounding China's "carve-out of sovereign wealth" that had put much of the intensity into contemporary debates about SWFs. In their view, the most important decisions were taken at the May 2008 Washington meeting in relation to the terms of reference,[59] and, although it was inevitable that the end product of the principles themselves would not be legally binding, it was the only basis on which there could be progress now in relation to SWF oversight in multilateral contexts.

At the media conference formally announcing the Santiago Principles, the IWG drafting chair Mr David Murray (chair of Australia's Future Fund) stated that the key task was to establish trust in recipient countries based on notions of openness and legitimacy. His sentiments were echoed by Joaquin Almunia, European Commissioner for Economic and Monetary Affairs, who also added that the long-term investment horizons of state-related pools of capital like SWFs would be extremely important in preserving mutual trust across international financial markets and their associated regulatory environments.[60]

Unfortunately, however, in respect of SWFs, and despite the positive developments associated with the IWG and the proclamation of the Santiago Principles, the comments in 2007 of the IMF still carry weight: "there's a lot we don't know about sovereign funds. Very few of them publish information about their assets, liabilities, or investment strategies."[61] One of the more cynical (pragmatic?) respondents predicted in mid-2008 that: "A relatively informal protocol will be agreed to by the SWFs and international organisations, but it will never be policed in any real sense." In reality, where national self-interest and international trade collide, as they do with SWFs, can we expect much more than this? It will always be a series of fluctuating scenarios that seek to balance a range of forces and interests. As one international regulator summarised in response to Question 11: "Sovereigns are always sovereigns and so can deny access or discriminate, but there are only limited opportunities for anyone to do so repeatedly." This response reflects the realities of international trade and regulatory interaction.

On the issue of where to locate regulatory responsibility for SWF activity in multilateral contexts, amongst the respondents there was an overwhelming view that such responsibility should lie not with any international regulatory body, but rather with the recipient jurisdictions and the domestic regulation that inevitably impacts upon an SWF. This pragmatic response is to be expected given how investment norms are shaped and operationalised on international financial markets. Past attempts by international organisations to embed a top-down multilateral regulatory infrastructure to shape behaviour

59 IWG of SWFs, "International Working Group of Sovereign Wealth Funds is established to facilitate work on voluntary principles", press release, 1 May 2008, www.iwg-swf.org/pr/swfpr0801.htm.

60 S Willson, "Wealth funds group publishes 24-point voluntary principles", http://www.imf.org/external/pubs/ft/survey/so/2008/new101508b.htm.

61 S Johnson, "The rise of sovereign wealth funds", n. 39 above.

by investment actors have not been successful. This was demonstrated by the Organisation for Economic Co-operation and Development's (OECD) failure regarding its proposed Multilateral Agreement on Investment (MAI) in the late 1990s.[62] The key reason why the MAI failed was its lack of process legitimacy and, if international regulatory mechanisms are to emerge for SWFs, then inherent process legitimacy will be essential.[63] If further SWF-related regulatory initiatives are to follow the Santiago Principles then it is unlikely to be through a specialist regulatory agency, but rather, initially, through codes of best practice, such as the GAPP, and perhaps, ultimately, instruments such as the OECD Convention on Corruption to which jurisdictions could become signatories and give binding commitments if appropriate. However, there was general opposition to the notion that treaty law should be used to regulate companies or asset managers. As one respondent commented: "Innovation is not really required as the necessary regulatory mechanisms are already there. As always the 'rub' of jurisdiction versus sovereignty is there, especially if there is a Memorandum of Understanding (MOU)." The emphasis should be on intermediation rather than new regulatory institutions. This gradual approach was viewed as not only congruent with market realities but also as a legitimate exercising of regulatory power. For example, in response to Question 9 about what regulatory innovations, if any, there should be regarding SWFs one respondent suggested that:

> If adequate disclosure is not there then that actor should be disqualified from the capital markets of the recipient jurisdiction of that actor's investments. However, it is incumbent on the recipient jurisdiction to articulate its position and seek to influence SWFs to change their practices if necessary. There are some industries (e.g. utilities, ports) where there are real national security issues and these may merit some protection from the investment strategies of SWFs. There may be increasing reluctance by many jurisdictions to open their doors to SWF investment due to some not having sufficient levels of disclosure.

Across the respondent cohort there was a sense that a market evolutionary approach is probably best and a pervading sense of resigned acceptance that multilateral regulatory activity would and should be pretty limited.[64] Several respondents commented that perhaps the most important questions for citizens to ask of their SWFs are not ones of regulatory strategy but rather: "are costs of investment rising", "are you making good investment decisions" and "are you wasting my money"? In the words of one respondent: "Is SWF money the people's money or the state's money?" Speaking in mid-2008 before the GFC broke, one banker respondent stated that:

> The financial bubble in markets has been partly caused by excess liquidity leading to interest rates being lower than they should have been and SWFs cannot invest all the money that they have, never mind leveraging these funds, so they are stable

62 OECD, Multilateral Agreement on Investment, 1998, www.oecd.org/document/22/0,3343,en_2649_33783766_1894819_1_1_1_1,00.html. For an examination of the MAI and why it failed, see K Tieleman, (2005), *The Failure of the Multilateral Agreement on Investment (MAI) and the Absence of a Global Policy Network*, Case Study for the UN Vision Project on Global Public Policy Networks, www.gppi.net/fileadmin/gppi/Tieleman_MAI_GPP_Network.pdf.

63 For a critical analysis of the paramount importance of legitimacy in multilateral regulatory activity in the financial sector, see G Gilligan, "Multi-lateral regulatory initiatives: a legitimation-based approach", in J O'Brien (ed.), *Governing the Corporation: Regulation and corporate governance in an age of scandal and global markets* (Chichester: John Wiley & Sons 2005), ch. 7, pp. 121–39.

64 This pragmatic stance reflects economic and political realities. For a discussion of this issue with a particular emphasis on the rising importance of China as a state investor, see LC Backer, "Sovereign investing in times of crisis: global regulation of sovereign wealth funds, state owned enterprises and the Chinese experience" (2009) 19(1) *Transnational Law and Contemporary Problems*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1444190.

> investors just when they are going to be most needed by financial markets. The coming financial crisis will be very bad, so most of the current objections to SWFs will dissipate.

These words have indeed been prescient as the GFC unfolded through 2009 and 2010. Regulatory hostility from national governments and regional actors such as the EU has not been directed at SWFs but rather towards other elements of the finance investment sector such as over-the-counter derivative products,[65] credit ratings agencies,[66] and hedge funds and private equity funds.[67] These moves reinforce again that pragmatic commercial and political realities help both national and regional parliaments and regulatory organisations frame what may be deemed desirable and achievable in terms of multilateral regulatory contexts, whether in the finance sector or elsewhere in the global economy.

Conclusion

All respondents saw little that was inherently wrong in jurisdictions setting up and running SWFs, indeed, the IMF published its own "operational roadmap" for policymakers who were considering establishing an SWF.[68] As one China-based corporate governance specialist summarised:

> Essentially it is investing national savings in a fiduciary capacity and SWFs are too indirect an approach to be gaining political advantage. If so, they would be buying into defence companies and not more conventional arrangements. It would be pretty obvious if governments were utilising SWFs in a heavily political manner.

That same respondent in reflecting on the political debates about SWFs feels that there has been an over-reaction to SWFs and outside China there has been a lack of appreciation of the sophistication of China's financial markets. In some ways, this is not surprising given the relative opacity of China's financial markets in comparison to their Western counterparts and, similarly, SWFs will inevitably be affected by broader political developments. However, in terms of whether SWFs merit special regulatory scrutiny, there was overwhelming consensus amongst respondents that they do not and perhaps *the real evil* as it were is not SWFs, but the conflicts of interest within financial conglomerates. This begs the question that, if it is sensible for there to be more disclosure regarding SWFs, the same could be said for major conglomerates. Should all fund managers be made to disclose more and how can such developments be reconciled with the market reality that fund managers can perform better if their movements are more opaque, so that they can gain advantage over competitors? This is typical of the conundrum facing governments in fora such as the G20 and regulators everywhere as they seek to balance nurturing competitive self-interest with the promotion of market integrity. So, on an ongoing basis, there needs to be careful thought about how much disclosure SWFs and fund managers should be subject to.

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65 European Commission, "Making derivatives markets in Europe safer and more transparent", press release IP/10/1125, Brussels, (2010) http://europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1125&format=HTML&aged=0&language=EN&guiLanguage=en.

66 HR4173 Dodd–Frank Wall Street Reform and Consumer Protection Act 2010, www.govtrack.us/congress/bill.xpd?bill=h111-4173.

67 In November 2010, the European Parliament, by a vote of 513 to 92, passed the Directive on Investment Fund Managers introducing regulations for hedge funds, private equity funds and other alternative investment funds such as real estate funds, see: http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm.

68 U Das, Y Lu, C Mulder and ANR Sy, *Setting up a Sovereign Wealth Fund: Some policy and operational considerations*, IMF Working Paper Series No WP/09/179, 2009, www.imf.org/external/pubs/ft/wp/2009/wp09179.pdf.

It is inevitable it seems that SWFs will get bigger and become increasingly important vehicles for the recycling of global finance, namely, channelling capital from surplus (balance of payments) generating countries, to deficit countries. However, as one respondent stressed, their fundamental size, number, growth and scale will still depend at root on the corresponding size and trends in global macroeconomic imbalances themselves as their proximate cause. Exchange rate regimes, namely the prevalence or otherwise of dollar-type pegs and domestic inflation issues will also have an influence on their size, growth and number. Real and nominal rates of return on benchmark sovereign assets in the major advanced economies will also have an influence in as far as sovereign wealth portfolio shifts are affected. The public accumulation of assets by energy exporting countries is expected to continue if constraints on energy supply relative to demand remain, which does seem likely over the medium to longer term. Essential sovereign foreign exchange cash management requirements have already been met in most cases from earlier years' accumulated external surpluses, which suggests further/additional surpluses will increasingly shift to higher risk and return investment assets and their vehicles. It is highly likely that SWFs increasingly will be seen as favoured pools of available liquid capital. Continuing relatively low growth rates and subsequently low returns on investment capital can be expected in major advanced economies, so investment will be channelled increasingly into emerging markets and SWFs will be an important conduit in such processes.

In effect, recent months have seen a dramatic re-casting away from the pre-dominant philosophy that has driven financial markets development and their regulation in the last three decades, i.e. a commitment to free market ideology underpinned by light-touch regulation under the canvas of regulatory competition in order to attract increasing amounts of inward investment. Since 2008, liquidity in global markets has reduced significantly and concerns about sovereign debt have grown as appetite for risk has diminished globally. Interwoven with this, a new era of more proactive state-led investment capitalism is emerging with state-related pools of capital part of the key advance guard of this process. This drastic change has been driven by what the Australian Treasurer Wayne Swan has described as "spectacular regulatory failure" and he stresses the new prevailing international consensus that the state must be a more active investor in markets as well as a more active overseer of their design and regulation.[69] Mr Swan's comments are congruent with the views expressed by G8 leaders following their October 2008 summit meeting in the US,[70] and the Board of Governors of the IMF.[71] This is the new international financial environment and geo-political reality in which existing and future state-related pools of capital are likely to become increasingly proactive and influential, contributing to financial markets in Australia and around the world, beginning the road to economic recovery. As the GFC and its affiliated difficulties of economic management rumble on through 2010 and beyond, the dilemmas surrounding SWFs and their appropriate regulation typify many of the issues associated with financial regulation more generally in both national and international contexts.

Where should research efforts be directed on these issues? To gain some clues on this, Question 10 asked respondents what research projects about SWFs they would like to see. Overall, there was a desire for projects that had a value-added emphasis. Interesting suggestions included: how to align investment resources to notions of intergenerational

69 M Franklin, "Wayne Swan calls for new controls on free market", *The Australian*, 24 January 24.

70 IMF, "G8 leaders statement on the global economy", 2008 http://www.imf.org/external/np/cm/2008/101508a.htm.

71 IMF, *Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund*, 2008, www.imf.org/external/np/cm/2008/101108a.htm.

equity; how much liquidity is the *right* amount of liquidity; and how should SWF activities be aligned with the national budget? Looking at the need for increasingly sophisticated custodianship relationships and the corporate governance role played by SWFs, for example, what criteria should SWFs give to fund managers regarding voting policies, environmental risks or governance systems? Another respondent proposed that SWF investment patterns and decision-making be compared over time to other investment actors, especially in relation to why SWFs decide to invest and/or disinvest domestically or internationally. There should be increased comparative research between SWFs, for example: does it make a difference if an SWF is located in a large or small country, or commodity-funded SWFs in comparison to general trade-stimulated SWFs?

In response to Question 11, which asked those interviewed to project how SWFs might develop over five- and 10-year time spans, there was agreement that there would be increasing finance industry professionalisation within SWFs and they would become more like private equity actors. Some respondents felt that growth rates for SWFs would slow as recessionary influences in the global economy grew, especially if this pushed down commodity prices, in particular, oil. One national regulator in an SWF jurisdiction felt that there are good ways of recycling trade surpluses (including SWFs) and that indirectly SWFs will contribute to greater stability in the petroleum sector, as keeping oil in the ground becomes a more attractive option, this may be important for international debates about climate-change policy. One respondent interviewed in mid-2008 felt that the constant variable in relation to SWFs would be trade imbalances, with two key associated elements of i) oil price; and ii) the levels of China's economic policy openness allied with how much China's inward investment increases. They projected that oil price ranges would settle for the medium term at US$80–100 a barrel, but even at those lower prices there would be substantial accumulation by many SWF jurisdictions. However, prediction can be a fraught process, as one respondent remarked: "Measurement processes in capital markets are still something of an unknown dimension and subject to change and market sentiment. For example, the Nikkei Index was 40,000+ in 1989 and constituted 40 per cent of global equity capitalism – look at it now!"[72]

As several respondents noted, another important issue for SWFs is exchange rates. Some of those jurisdictions with managed exchange rate regimes use SWFs as a relief mechanism for surplus capital to avoid overheating in their domestic economy, so SWFs perform a sterilisation bonds function. If under conditions of increasing globalisation floating exchange rates became the norm across all SWF jurisdictions, how might this change SWF strategies and structures? This in turn has broader implications for the more general issue of likely increased levels of states becoming proactive investment actors, which may well include establishing their own SWFs. Many of the respondents commented that in the future there is likely to be increased overlap of the spectrums of activity between central banks and SWFs. This in turn has implications for the likely increasing synergy between national economic well-being and the health and vitality of international finance, which in turn endows increasing strategic significance upon multilateral regulatory activity *to keep the plates spinning as it were*. As the GFC has demonstrated so graphically in recent times, this raises a host of issues on non-economic areas, sprawling across social, political and cultural boundaries.

How proactive for the "public good" SWFs might become was discussed by a number of the respondents. Norway was often referred to as a "model" citizen in terms of how its

72 At the time of writing, 23 November 2010, the current level of the Nikkei Index is 10,115, http://e.nikkei.com/e/app/fr/market/nikkeiindex.aspx.

SWF, the Government Pension Fund Global (GPFG) operates and is regulated. Of particular interest is the role of the Council of Ethics for the fund. A member of that council explained that the Council of Ethics has a very limited mandate, eliminating the worst of what it sees as the "bad" companies (for example, Rio Tinto, Walmart, Freeport) from the Fund's investment portfolios (there are approximately 7000 companies in the pension fund's investment portfolio). The key criteria for the activities of the council are: law of human rights; law of armed conflict; corruption; environmental issues. On average the council works with about 80 companies whose identity is kept secret and only the excluded companies are named (about four or five in an average year). The council is appointed by the government and not the Ministry of Finance (so in theory there may be less chance of regulatory capture) and the ministry has to publicise the council's advice even if it disagrees with it. The value of the council lies in its capacity to leverage on reputational risk. The exclusion capacities of the council give leverage to the Norges Bank to influence the governance of companies in which it invests and so there is an important synergy between the council and the central bank.[73] It will be interesting to see in the future whether other jurisdictions equip their SWFs with this "institutionalised ethical leverage" in the way that Norway has done.[74] It is already being recognised at the highest levels of government and international organisations that SWFs could promote the development of social capital and the public interest. For example, speaking on ways to promote development in Africa in particular, World Bank President Robert B Zoellik has actively argued for what he calls his one per cent solution, whereby SWFs "invest 1 percent of their funds in Africa".[75] As one respondent noted, another potential public interest pathway for SWFs is to integrate into their investment decision-making the concept of social licence – under which large plants (funded through SWF investment) should buy local products so that there is mutual benefit for local communities and the foreign firms. If these socially positive and potentially transformative investment strategies come to be construed as economically rational by investment actors and subsequently ingrained in business practice, they may help to reduce risks of trade protectionism in the future.

So, how should one sum up the activities of SWFs to date and their likely future influence? One respondent (a national financial regulator) summarised in this way:

> On balance SWFs have been a positive. They are symptomatic of broader developments in cross-border investment. The increasing numbers of stakeholders in financial markets is a positive development. SWFs can be a force for geo-political stability and global inter-dependence, thereby acting as a mitigating factor regarding potential conflicts.

This view may well be borne out in the future. On the issue of the rise and rise of state capitalism, another respondent (a European banker) noted that it tends to be the US that defines what capitalism is or what it should be, especially about whether the state should be an investment actor. In a post-GFC world, as the twenty-first century progresses and the economic power of Asian countries in particular grow, market perceptions about appropriate levels of activity by the state as an investor in capital markets may well change.

73 This notion is not as fanciful as might first appear because the GPFG has revealed that it holds around 1 per cent of the world's listed equities, so it is very much a player on global financial markets, see: Norges Bank, "Management of the Government Pension Fund Global", 18 May 2010, www.norges-bank.no/templates/article____76831.aspx.

74 See S Chesterman, "The turn to ethics: disinvestment from multinational corporations for human rights violations: the case of Norway's sovereign wealth fund" (2008) 23 *American University International Law Review* 577–615; C Ochoa and P Keenan, *The Human Rights Potential of Sovereign Wealth Funds,* Illinois Public Law Research Paper No 08-27, 2010, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1374880.

75 "Zoellick wants wealth funds to invest 1 per cent in Africa", World Bank, press review, 3 April 2008.

Much of the post-GFC global financial reform agenda has been about leverage and increasing the capability of jurisdictions to know what levels of investment and leverage are in their markets. In terms of SWF and other state-related pools of investment activity, there remains considerable ambiguity about their levels of investment but, in general, they tend to be less leveraged than many of their private sector counterparts and therefore less of a threat to market stability. However, the limited reach and impact of the GAPP post-Santiago illustrate that multilateral regulation of the financial sector will continue to be on the soft side of the soft law continuum. Any regulatory advances are likely to be in the area of increased cross-border surveillance rather than the production of binding agreements upon sovereign states.

Appendix: Questions used to guide the semi-structured interviews

TOPICS FOR DISCUSSION

"The implications for Australia of the growing influence of Sovereign Wealth Funds"

(Dr George Gilligan, Senior Research Fellow)

Q1 How would you evaluate the impact of Sovereign Wealth Funds over the last five years?

Q2 What has been the influence, if any, of Sovereign Wealth Funds upon your jurisdiction?

Q3 What has been the influence, if any, of Sovereign Wealth Funds upon your organisation?

Q4 Do you think the impacts of Sovereign Wealth Funds can be classified and measured, and if so, what measurement processes should be applied?

Q5 Do you think that the activities of Sovereign Wealth Funds have been presented in an overtly political way in the media?

Q6 Who, if anybody, should be responsible for the regulation of Sovereign Wealth Funds?

Q7 If Sovereign Wealth Funds should be regulated, are they regulated appropriately in your jurisdiction?

Q8 If Sovereign Wealth Funds should be regulated, are they regulated appropriately in international contexts?

Q9 What regulatory innovations, if any, should there be regarding Sovereign Wealth Funds?

Q10 What research projects, if any, would you like to see regarding Sovereign Wealth Funds?

Q11 How do you perceive Sovereign Wealth Funds developing during the following periods:

i) Five years;

ii) Ten years.