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Sovereign Wealth Funds in the Making - Assessing the Economic Feasibility and Regulatory Strategies

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Emerging Sovereign Wealth Funds in the Making: Assessing the Economic Feasibility and Regulatory Strategies

Julien CHAISSE, Debashis CHAKRABORTY and Jaydeep MUKHERJEE*

The recent emergence of Sovereign Wealth Funds (SWFs) as active and important players in international financial markets has raised a host of questions about their likely effect on markets and states. This trend is further reinforced in 2010/2011 by the fact that despite the fears and turbulences that spread all over the world in reason of the global economic and financial crisis, SWFs have blatantly retained their influence. SWFs create a regulatory and theoretical challenge because they serve two masters with very different agendas. This article is the first to explore the challenges governments face when they wish to set up an SWF. It explores determinants and policy options governments have to set up an SWF by analysing the fiscal and monetary parameters while simultaneously focusing on the regulatory determinants funds may and should comply with in order to be better accepted as international investors. The challenges are important since SWF are expected to grow in the future and might emerge as decisive investors throughout a world in crisis.

1. Introduction: The Dynamic Scene of Sovereign Wealth Funds (SWFs)

Investments through Sovereign Wealth Fund (SWF) route is clearly not a recent phenomenon, since it is in operation for around five decades. However, despite increasing inclination towards market liberalization and privatization observed over the last decade,[1] the role of the States has, in this period of time, arguably grown in importance on some particular aspects of investment. Notably, investments from emerging economies increased, a large proportion of which was executed by State-Owned Enterprises (SOEs) and SWFs.[2] This trend was further reinforced in 2010 by the fact that despite the fears

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[1] The recent economic crisis is, however, underlining the role to be played by the national governments in no uncertain terms.

[2] Both forms of investments originate from State ownership and State activity and are, thus, regularly referred to as investments by 'State-Controlled Entities' (SCEs).

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and turbulences that spread all over the world in the wake of the global economic and financial crisis, SWFs have blatantly retained their influence.[3]

SWFs can be defined as pools of investment capital (whatever may be the legal form of the SWF: private or public) controlled by a government or central bank and invested in economic activities in other countries. The source of this capital is Foreign Exchange (FOREX) reserves, which all governments keep (typically in widely traded currencies such as the Dollar, Euro, or Yen). When there is a surplus current account balance, those reserves can be put into an investment fund and used to increase national wealth or diversify sources of revenue. Existing research demonstrates that SWFs are usually set up in order to serve a basic purpose, that is to invest surplus State reserves in foreign currency to yield higher returns. The funds improve the liquidity of the financial markets, create long-term growth and jobs, and ensure stability for the companies they invest in. These responsible and reliable investors have pursued a long-term, stable policy that has certainly stood the test during the recent turmoil in the financial markets.[4]

Because of the financial crisis, the US market remains an attractive option for the emerging economy SWFs (especially China), which is a matter of concern there, the most prominent being the fear of foreign government investment for the wrong reasons (threatening national security). The concerns expressed in the United States are known and shared by the European Union (EU). Owing to the geographic proximity, however, Europeans are perhaps more concerned about Russia. This explains, to some extent, the different perceptions on both sides of the Atlantic and the differences in terms of regulatory approach. Four issues are particularly important in relation with SWFs. First, the role of investing governments is often called into question.[5] Second, the lack of operational transparency of SWFs is another area of concern.[6] Third, the alleged political and geostrategic motivations behind SWF operations constitute a major debate.[7] Finally, from a political economic standpoint, there is certainly an uneasiness in developed countries in accepting a shift in the balance of power in world economy towards newly emerging market giants.[8]

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[3] The picture is striking: in 2010, *Preqin Special Report on Sovereign Wealth Funds* gave an updated assessment of SWF growth. The start of a global economic recovery has helped the aggregate assets under management of all SWFs to reach USD 3.59 trillion, which represents an 11% increase from last year. See Preqin, 'Special Report on Sovereign Wealth Funds' (New York, 2010), 190. See also J. Slawotsky, 'Sovereign Wealth Funds as Emerging Financial Superpowers: How US Regulations Should Respond', *Georgetown Journal of International Law* 40 (2009): 1239.

[4] B.J. Reed, 'Sovereign Wealth Funds: The New Barbarians at the Gate? An Analysis of the Legal and Business Implications of Their Ascendancy', *Virginia Law & Business Review* 4 (2009): 110–112. See also P. Rose, 'Sovereign Wealth Funds – Active or Passive Investors', *Yale Law Journal Company* 118 (2008): 104.

[5] See P.J. Keenan, 'Sovereign Wealth Funds and Social Arrears: Should Debts to Citizens Be Treated Differently than Debts to Other Creditors', *Virginia Journal of International Law* 49 (2009): 440–442.

[6] Slawotsky, 1239. See also J.O' Brien, 'Barriers to Entry: Foreign Direct Investment and the Regulation of Sovereign Wealth Funds', *The International Lawyer* 42 (2008): 1231.

[7] See M. Saxon, 'It's Just Business, or Is It?: How Business and Politics Collide with Sovereign Wealth Funds', *Hastings International and Comparative Law Review* 32 (2009): 693. See also A. Wong, 'Sovereign Wealth Funds and the Problem of Asymmetric Information: The Santiago Principles and International Regulations', *Brooklyn Journal of International Law* 34 (2009): 2081.

[8] See Yvonne C.L. Lee, 'A Reversal of Neo-colonialism: The Pitfalls and Prospects of Sovereign Wealth Funds', *Georgetown Journal of International Law* 40 (2009): 1116–1118. See also G. Lyons, 'State Capitalism: The Rise of Sovereign Wealth Funds', *Law and Business Review of the Americas* 14 (2008).

SWFs have come into the spotlight, especially since 2007 when China declared its intention to invest USD 3 billion of its fund reserves in private holding companies. The wide coverage of this event by print media caused policymakers to draw their attention on this class of investors. The SWFs have raised concerns about financial stability, corporate governance, political interference, and protectionism.[9] Interestingly, it is observed that the funds for many Merger and Acquisition (M&A) transactions originate from potential geopolitical rivals. There exist a rich literature on these issues and the risk of protectionist reaction from developed countries. In order to address this, the Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF) have been engaged in negotiations in order to draw some guidelines that may help advert protectionism. The level of acceptance of the SWFs on these initiatives will bear considerable influences on their structure, governance, and operations.

Few SWFs publish regular and timely information on their assets, liabilities, and investment strategies, notably those in developing countries. In that context, a whole set of motives, some quite alarming, have been ascribed to them including not only long-term investments focused on yield or on stabilizing the effects of resource volatility but also attempts to promote their government's economic and political agenda abroad, business espionage, and national security issues. Some of these SWFs are well established and experienced and can make adjustments in response to demands for changes in governance and disclosure. Others are relatively new and caught up in a web of pressures with outcomes still unclear. The latter group of newly established funds deserve deeper attention for policy research. This article attempts to analyse the trends in SWF investment and the main obstacles faced by them. In particular, the analysis focuses on the major impending challenges for SWFs originating from emerging economies, both existing and potential ones.

The analysis is arranged along the following lines. First, the global SWF experience is briefly reviewed, followed by the external and internal macroeconomic sustainability conditions for the emerging economy SWFs. The subsequent analysis intends to identify the main regulations in the EU and the US market that such SWFs might face. These regulations might emerge as potential obstacles in the sense that they incorporate conditionality for any investment entering their domestic markets. The analysis will then focus on the multilateral (IMF) guidelines on SWFs, which apparently again might be perceived as an obstacle by the emerging economies.[10] However, complying with these multilateral guidelines could be advantageous for such SWFs, if these regulations help

[9] It should be borne in mind that SWFs usually lack structures that are transparent and management processes that are domestically and internationally accountable. They work in an opaque way. SWFs do not publish statistics on their composition and size or their investments and strategies. Another concern is that management of SWFs may be motivated by 'nationalistic considerations' and not merely made in search of investment opportunities that yield optimal risk-adjusted rates of return as suggested by classical economic theories. See J. Chaisse, B. Boie & P. Gugler. 'The Regulatory Framework of International Investment: The Challenge of Fragmentation in a Changing World Economy', in *The Fragmentation of International Trade Regulation*, ed. T. Cottierat al. (London: Cambridge University Press, 2011), 417–451.

[10] From a factual standpoint, the IMF principles detailed below are not regulations in the strict sense of the term but rather they offer guidelines covering governance, accountability, transparency, and conduct of investments for SWFs.

them to avoid the EU and US obstacles to investment. On the basis of the analyses with respect to legal perspective, the policy conclusions are drawn.

It is observed from the analysis that external and internal macroeconomic stability is extremely important for a country for creating a successful SWF. This lesson is of cardinal importance for many countries nurturing the idea to set up such an investment route. However, they must also anticipate regulatory hurdles on foreign markets such as the United States and the EU. As they only expect limited respite from bilateral investment treaties (BITs) and the World Trade Organization (WTO) General Agreement on Trade in Services (GATS) commitments, advantage of the recently released IMF 'Santiago Principles' must be accessed by considering that as an important first step in the creation of a new international norm.

2. Recipes for Sustainable SWFs: Lessons from a Cross-Country Analysis

Currently, SWFs and central banks with a large SWF function manage an estimated USD 3.2 trillion of assets. It is, however, important to put SWFs into perspective vis-à-vis other existing investment options. In 2006, by comparison, global stock market capitalization was USD 42 trillion, while the market value of private debt securities was USD 23 billion. The importance of SWFs in global capital markets is expected to grow further, mainly because of high oil prices and the positive repercussions on Gulf States, the relative weakness of the US Dollar, and persistent current account surpluses in China and certain other Asian countries.[11] As stated earlier, the idea here is that a country can establish its SWF only if it is having surplus foreign currency. FOREX reserve surplus in a country brings forward the question of channelizing these savings into the best possible investment route.[12] Financial engagements via SWF route depicts an option that would allow a country to profit from worldwide economic growth and to mitigate the risk that grows when large reserves are invested one-sidedly in US Dollars. Thus, the prime goal behind establishing an SWF seems to be to make profitable use of the FOREX it has accumulated as the result of trade imbalances or FOREX intervention.

Table 1 reports the FOREX scenario for selected countries, including several emerging economies that are capable of running successful SWF operations. It is observed that all the countries have presently accumulated considerable amount of FOREX reserve, which can be utilized for the purpose of creating and successfully managing the SWF. In fact, countries like China and Singapore are already engaged in doing so.

Looking at the data on SWFs from Sovereign Wealth Fund Institute, it is observed that the FOREX surplus can mainly be generated through two channels.[13] On the one hand, United Arab Emirates (UAE), Saudi Arabia, Kuwait, Norway, Russia, and so on set up SWFs from their oil export revenue. On the other hand, the SWFs of China,

[11] A. Blundell-Wignall, Y. Hu & J. Yermo, 'Sovereign Wealth and Pension Fund Issues', OECD Working Papers on Insurance and Private Pensions, No. 14 (OECD Publishing, 2008), 6–7.

[12] Reed, 112. See also Wong, 2081.

[13] The data are obtained from Sovereign Wealth Fund Institute, <www.swfinstitute.org/funds.php>, 26 Jan. 2011.

Table 1. FOREX Reserves Scenario for Selected Countries

Country	**Current Size (Billions of US Dollars)**	**Country**	**Current Size (Billions of US Dollars)**
China	1,202–2,447	Brazil	109–252
Japan	888–990	Malaysia	89–96
Russia	330–458	Algeria	83–149
Korea	243–278	Mexico	75–100
India	192–273	Thailand	69–150
Singapore	137–203	Turkey	67–71
Hong Kong	135–259	Libya	64–100

From 2007 to December 2010 (*some are updated to February, March, or April*).

Singapore, Australia, New Zealand, and so on depend on their non-commodity export earnings.

Although the countries involved in the process of creating SWFs began accumulating large FOREX reserves in order to cushion their economies from future economic shocks, there could be several reasons to create SWFs,[14] which may include, for example:

- protecting and stabilizing the host country budget and economy from excess volatility in revenues/exports;
- creating a diversified fund of holdings generated by non-renewable commodity exports;
- earning greater returns than on FOREX reserves;
- increasing savings for future generations;
- funding social and economical development;
- exercising increased political influence by making strategic foreign investments.

The present analysis, however, focuses only on the Economic Feasibility and Regulatory Strategies towards successful creation and long-term sustainability of the SWFs. Hence, the following section first deals with the key question of identifying the preconditions for SWF creation (section 2.1) and then details the importance of stability in open economy macroeconomic framework (section 2.2)

2.1. Preconditions for SWF creation: Are they always fulfilled?

Table 2 in the following reports several SWFs currently in place, hosted by both developed and emerging economies. It is observed from the table that several countries having

[14] See Slawotsky, 1239.

similar development profile vis-à-vis emerging economies, like India, Brazil, and so on,[15] have adopted the SWF route for promoting strategic investments.

Table 2. Estimated Assets under Management over 2007–2010 in Recent SWFs (Set Up Since 2005)

Country	**Inception Year**	**Fund Name**	**Source of Funds**	**Assets (Billions of US Dollars)**
China	2007	China Investment Corporation	Non-commodity	200–280
Libya	2006	Libya Investment Authority	Oil	70
Qatar	2005	Qatar Investment Authority	Oil	50–65
Australia	2006	Australian Future Fund	Non-commodity	54–49.3
France	2008	Strategic Investment Fund	Non-commodity	28
South Korea	2005	Korean Investment Corporation	Non-commodity	20–27
Venezuela	2005	National Development Fund	Oil	15
Russia	2008	National Welfare Fund	Oil	142.5[16]
UAE – Dubai	2006	Investment Corporation of Dubai	Oil	19.6
Bahrain	2006	Mumtalakat Holding Company	Oil	9.1
Brazil	2009	Sovereign Fund of Brazil	Non-commodity	8.6
East Timor	2005	Timor-Leste Petroleum Fund	Oil and gas	5.0
China	2007	China-Africa Development Fund	Non-commodity	5.0
Saudi Arabia	2008	Public Investment Fund	Oil	5.3
Vietnam	2006	State Capital Investment Corporation	Non-commodity	0.5
Indonesia	2006	Government Investment Unit	Non-commodity	0.3
Mauritania	2006	National Fund for Hydrocarbon Reserves	Oil and gas	0.3
UAE – Ras Al Khaimah	2005	RAK Investment Authority	Oil	1.2
UAE – Federal	2007	Emirates Investment Authority	Oil	N
Oman	2006	Oman Investment Fund	Oil	N
UAE – Abu Dhabi	2007	Abu Dhabi Investment Council	Oil	N

Source: Compiled by authors from IMF Global Financial Stability Report (2007), Financial Time (2007–2010), and SWF Institute (2010).

[15] The central banks of countries like India, Brazil, and so on have accumulated reserves to the tune of approximately USD 300 million as of end 2010 and are ranked 6th and 7th, respectively, in the list of countries by FOREX reserves (source: <http://en.wikipedia.org/wiki/List_of_countries_by_foreign_exchange_reserves>).

[16] This includes the oil stabilization fund of Russia.

A first major study by *Morgan Stanley* predicted that SWFs may manage USD 12 trillion by 2015.[17] *Global Insight*, announced in 2008, noted that SWFs have been growing by 24% annually for the past three years.[18] Projecting from this annual growth rate, Global Insight forecasted that SWFs will surpass the entire current economic output of the United States by 2015 and that of the EU by 2016. In 2010, *Preqin Special Report on Sovereign Wealth Funds* provided an updated assessment of SWF growth. The initiation of the global economic recovery process has helped the aggregate assets under management of all SWFs to reach USD 3.59 trillion, which represents an 11% increase over last year's figure. The conclusion is striking: despite the global economic and financial crisis, SWFs have retained their influence.[19]

However, which macroeconomic characteristics should encourage a country to go for SWF route? For understanding this question, the current analysis has classified the nine selected countries into three categories: (a) countries with successful SWF, namely China, Saudi Arabia, and UAE; (b) countries that are experiencing recent SWF tryst, namely Vietnam, Indonesia, Malaysia, and Botswana; and (c) countries that possess the potential to create successful SWF in near future, namely India and Brazil. Analysing the trade balance scenario of the selected sample, it is observed that all countries under the first two categories, with the exception of Vietnam, had current account surplus in 2009. On the other hand, under the third category classified here, while Brazil has a marginal current account surplus of USD 1.712 billion in 2009,[20] India during the corresponding period suffered a high current account deficit of USD 15.5 billion.[21] A closer look at the trade balance components reveals that, while most of these countries are having a deficit in case of trade in commercial services, the surplus in case of merchandise exports are covering the gap.[22] It needs to be mentioned here that energy products feature significantly in the export basket of only some of the selected countries having trade surplus, for example, UAE, Saudi Arabia, Malaysia, and Indonesia. In other words, the creation of SWF is not found to be conditional on the presence of energy export sources alone; the Balance of Payments (BOP) surplus through merchandise/service trade route might play an equally important role in this regard.

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[17] S. Jen, *How Big Could Sovereign Wealth Funds Be by 2015?* (Morgan Stanley, 4 May 2007).

[18] The details can be obtained from <www.globalinsight.com/>, 26 Jan. 2011.

[19] See Preqin, 190.

[20] The Brazilian trade surplus in the first week of December 2010 stood at USD 15.5 billion, which is 33.37% less than the figure of USD 23.5 billion during the corresponding period a year ago. Given the world scenario, there is speculation that the country may run into a (trade) deficit in 2011.

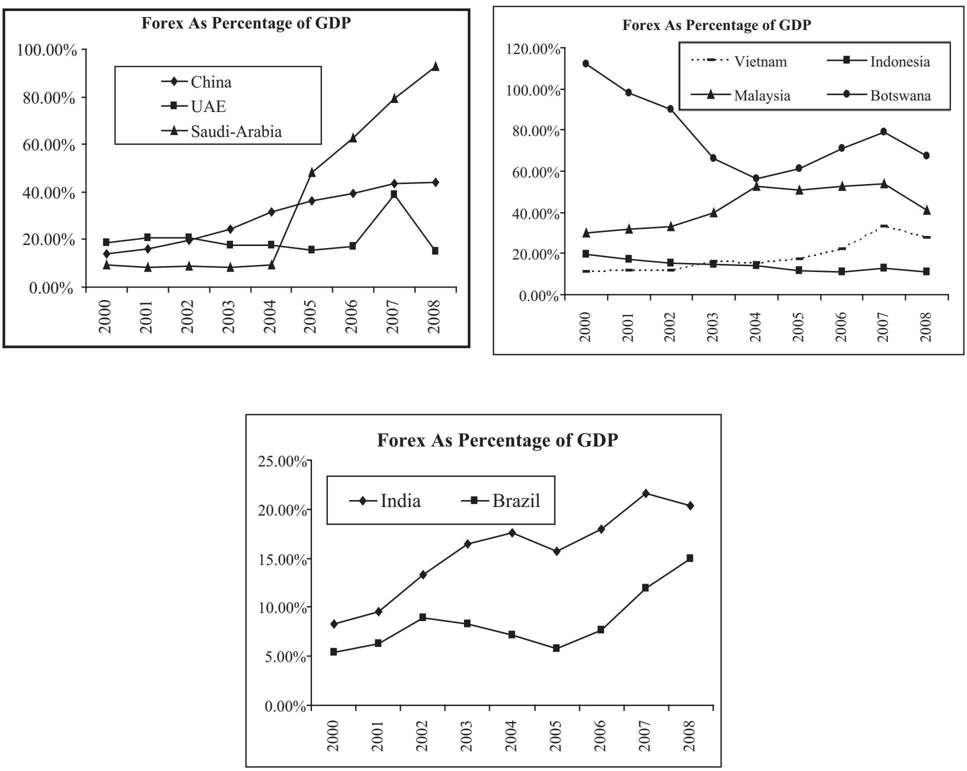
[21] World Trade Organization, *International Trade Statistics 2010* (Geneva, 2010).

[22] An opposite scenario is observed in India: a surplus under invisibles – trade in services – in the current account but a high trade deficit. However, it may be noted that while the trade deficit declined from USD 39.2 billion in July–September 2008 to USD 32.2 billion in July–September 2009, the net invisibles surplus, reflecting activity in services and transfers, declined from USD 26.54 billion in the second quarter of last year to USD 19.57 billion in July–September 2009. Reserve Bank of India, *Q2 Estimate of Balance of Payments* (Mumbai, 2009).

2.1.1. *Variations around the FOREX Reserve*

To understand the macroeconomic ability of the selected countries to create and sustain SWF in the long run, the key role played by several macroeconomic factors are considered here.[23] In the current context, the FOREX reserves expressed as a percentage of Gross Domestic Product (GDP) of the sample are analysed first.[24] The trends in the three sets of countries can be observed from Figure 1.

Figure 1. Foreign Exchange Reserve as Percentage of GDP



Source: Constructed by the authors from the IMF database.

[23] Z. Yang, 'Issues in the Long-Term Development of Sovereign Wealth Funds', *Asia-Pacific Trade and Investment Review* 4 (2008): 158–180.

[24] The data for the analysis are obtained from IMF, 'World Economic Outlook Database', <www.imf.org/external/pubs/ft/weo/2010/02/weodata/index.aspx>, 26 Jan. 2011.

It is observed that the percentage is highest for Saudi Arabia and Botswana, though the latter has witnessed a decline in its FOREX reserves by around 16% at the end of 2009.[25]

Emerging economies like China, Brazil, and India, on the other hand, has witnessed a steady increase on this front over the last decade, due to a surging capital account surplus in all these countries through Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) flows and, in addition, a huge and growing current account surplus for China. The fluctuating trend in the remaining countries, on the other hand, indicates towards more complex dynamics on this front. The lower FOREX ratio for Indonesia is indicative of its economic size.

2.1.2. *How to Determine SWF Viability?*

How can one determine whether a country is presently ready to float its own SWF? Park and Estrada have proposed two measures of reserve adequacy for analysing whether a country has 'too much' reserve build-up and, hence, 'surplus' reserves.[26] Following their approach, the readiness of a country to go for the SWF route can be appreciated by considering its ratio of reserves to short-term external debt. According to the so-called Greenspan-Guidotti rule,[27] the critical value of this ratio is one, with a value below one signalling danger. The underlying logic is that countries should at least possess enough reserves to overcome a massive withdrawal of short-term foreign capital at any given point.

Figure 2 shows the value of the above-mentioned ratio for the selected countries under each category.

It is observed from the figure that all the countries included in the sample have a value higher than unity for the period under consideration. The ratio has increased gradually for all the countries, though a noticeable declining trend has been witnessed in 2008 – with the exception of China and Saudi Arabia, due to the recession effect. UAE has been worst affected by the recent turn of events, largely as a result of falling real estate prices in Dubai and liquidity pressures.[28] On the other hand, the ratio has

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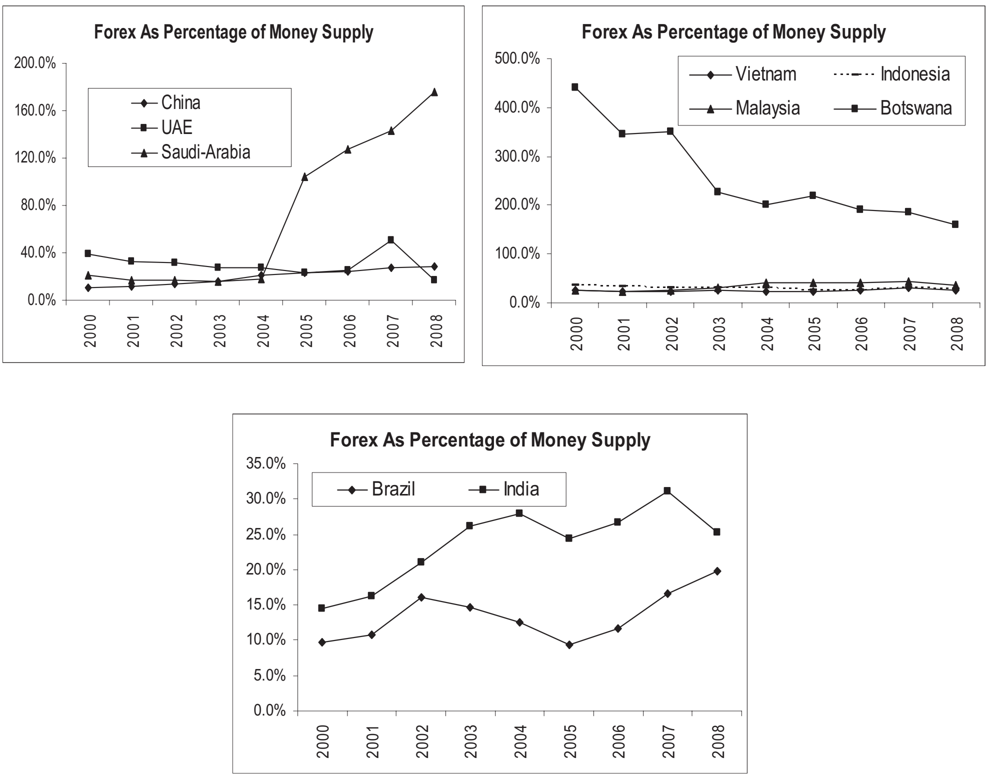
[25] The global economic crisis has had a devastating impact on Botswana's economy, mainly because of the latter's heavy dependence on the mining sector, which accounts for more than a third of GDP, and particularly on diamond exports. International Monetary Fund, *Impact of the Global Financial Crisis on the Gulf Cooperation Council Countries and Challenges Ahead* (Washington, DC: Middle East and Central Asia Department, 2010), <www.imf.org/external/pubs/ft/dp/2010/dp1001.pdf>, 26 Jan. 2011.

[26] D. Park & G. Estrada, 'Developing Asia's Sovereign Wealth Funds and Outward Foreign Direct Investment', *Asian Development Review* 26, no. 2 (2009): 57–85.

[27] The rule is named after Pablo Guidotti – Argentine former Deputy Minister of Finance – and Alan Greenspan – former Chairman of the Federal Reserve Board of the United States. Guidotti first stated the rule in a G-33 seminar in 1999, while Greenspan widely publicized it in a speech at the World Bank. Guzman Calafell and Padilla del Bosque found that the ratio of reserves to external debt is a relevant predictor of an external crisis, <http://en.wikipedia.org/wiki/Guidotti-Greenspan_rule>, 26 Jan. 2011.

[28] For UAE, the problem worsened further with the consequences of Dubai World – a holding company owned by the Government of Dubai – seeking a debt. Support provided by the Government of Abu Dhabi has helped calm down markets, but uncertainties remain. As the impact of the debt event will depend on the eventual scope and modalities of the

Figure 2. FOREX Reserve as a Percentage of External Debt



Source: Constructed by the authors from the IMF database.

improved considerably for India since 2004 and Brazil since 2006, riding mostly on high capital inflows through FDI and FPI vis-à-vis a moderate volume of external debt.

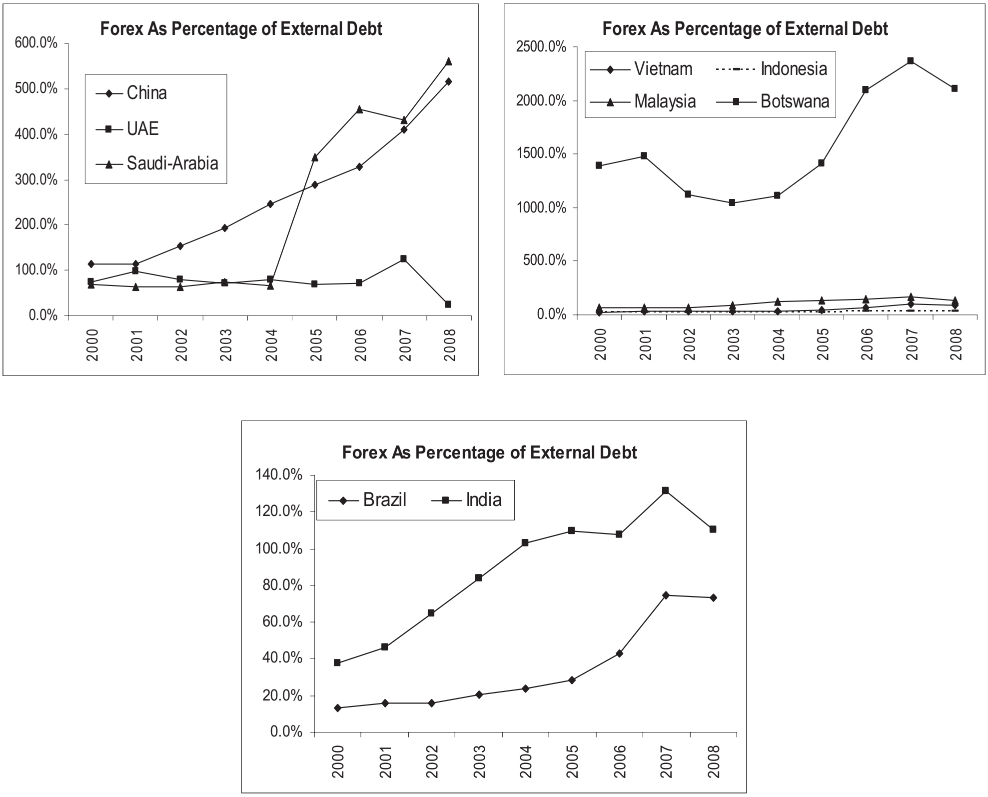
The second indicator of reserve adequacy proposed by Park and Estrada measures the ratio of reserves to M3 or broad money, which proposes a critical value in the range of 5% to 20%. The higher the ratio, the greater is considered to be the confidence of the general public in the value of the local currency and, hence, the lower the risk of capital flight from the country.

Figure 3 reports the value of the above index for the selected countries.

It is observed that Saudi Arabia and Botswana fulfils the condition in a perfect manner, with both countries having a ratio above 100% in recent years. The countries like

debt restructuring, it could have a significant effect on the repricing of sovereign risk throughout the region and beyond (IMF, 2010).

Figure 3. FOREX Reserve as a Percentage of Money Supply



Source: Constructed by the authors from the IMF database.

China, Vietnam, Indonesia, Malaysia, and India are marginally above the critical range with some short-run fluctuations in line with business cycles. On the other hand, the value of the ratio for Brazil and UAE has been noticed within the critical range during the period under consideration. In fact for UAE, the ratio has dropped drastically mostly for reasons cited earlier, which puts the viability of their SWF in the borderline case. On the other hand, the corresponding figure for Brazil has remained beyond the critical level for the last five years.

2.2. Importance of stability in open economy macroeconomic framework

In addition to the external conditions, the domestic macroeconomic stability scenario may also significantly influence the ability of a country to float its own SWF. According to the macroeconomic theory as the government steps up its borrowing in the domestic market, the savings left for lending to firms go down by the same amount, so that the rise in debt-financed government spending is exactly offset by a fall in private investment. Thus, the net expansionary effect is much smaller than the expectation level of the government. In other words, *government borrowing crowds out private investment*. In addition, the increased borrowing needs by the government cause interest rates to increase, which leads to an inflow of funds from abroad. This leads to a sharp appreciation in the value of the domestic currency, making domestic goods less competitive on world markets. The result is a trade imbalance. Thus, *government borrowing crowds out net exports as well.*

If, for the private sector, saving is equal to investment, then the government's fiscal deficit is reflected in an equal external deficit. If national saving (both private and public savings) is not enough to finance domestic investment, then funds have to be borrowed from abroad, causing net exports to decline and increasing the burden of external debt. Thus, an increase in the fiscal deficit (unless accompanied by an equal increase in private domestic saving) will lead to the crowding out of private domestic investment and/or net exports. This in turn would affect the economic growth.

The open economy national income equation can be written as

$$Y = C + I + G + \mathrm{NX}, \tag{1}$$

where Y represents the country's GDP; C represents the private consumption expenditure of the households; I represents the private investment or gross domestic capital formation; G represents the government purchase of goods and services; and NX represents the net exports, that is, exports - imports.

Subsequently, the government transactions can be written in the following form:

$$\mathrm{YD} = Y + \mathrm{TR} - \mathrm{TA} \tag{2}$$

and

$$\mathrm{YD} = C + S, \tag{3}$$

where YD represents the disposable income; TR represents the transfer payments by government; TA represents the taxes; and S represents the private saving by consumers.

It follows from the combinations of the above equations that

$$S = Y + \mathrm{TR} - \mathrm{TA} - C \tag{4}$$

or

$$\mathrm{S} = [C + I + G + \mathrm{NX}] + \mathrm{TR} - \mathrm{TA} - C \text{ [from Equation (1)]}$$

or

$$S = I + G + \mathrm{NX} + \mathrm{TR} - \mathrm{TA}$$

or

$$S - I = (G + \mathrm{TR} - \mathrm{TA}) + \mathrm{NX}. \tag{5}$$

The left-hand side of Equation (5) represents the excess of savings over investment of the private sector. The right-hand side portrays the government budget deficit plus the trade surplus. In other words, the difference between private domestic saving and investment is equal to the difference between the budget deficit and the trade deficit, that is, $S - I = \mathrm{BD} - \mathrm{TD}$. An increase in the budget deficit (unless accompanied by an equal increase in private domestic saving) will lead to the crowding out of private domestic investment and/or net exports.

Now from the balance of payment identity, Equation (5) can be rewritten as

$$S - I = (G + \mathrm{TR} - \mathrm{TA}) + \Delta R - K, \tag{6}$$

where K represents all net capital inflows and ΔR represents net increase in official reserves.

Otherwise,

$$I - (S + S_G) = K - \Delta R, \tag{7}$$

where $S_G = \mathrm{TA} - (G + \mathrm{TR})$, which denotes public savings.

Thus, if combined domestic savings fall short of domestic investment – a phenomenon observed when a country has high fiscal deficit – either capital inflows or decummulation of reserves or a combination thereof will have to fill the gap. In other words, the existence of a current account surplus is, therefore, critical. If there is no surplus – or, even worse, there is actually a current account deficit – the accumulation of FOREX assets (a positive ΔR) can only be seen as the counterpart of capital flows – they are merely 'borrowed reserves'.[29]

2.2.1. *The Fiscal Stability Condition*

As explained in the earlier section, domestic macroeconomic stability condition bears significant influences on the SWF decision of a country. Therefore, Figure 4 looks into the fiscal surplus/deficit scenario of the selected countries.

[29] S. Griffith-Jones & J. Antonio Ocampo, 'Sovereign Wealth Funds: A Developing Country Perspective (2008)', <www.g24.org/sowf0308.pdf>, 26 Jan. 2011.

It is observed that while China, UAE, Saudi Arabia (the countries under the category of successful SWF), and Brazil (under the potential countries) are enjoying a positive Government cash surplus to GDP over the period under observation, the remaining countries are having fiscal deficits. This finding has a critical bearing on the future ability of the countries to engage in SWF activities. For instance, Vietnam fulfils the Park and Estrada conditions for creating SWFs. However, the ability of the country, which is having fiscal deficit for all the years in the recent period, to support the SWF becomes weaker, if the domestic scenario is taken under consideration. This is also precisely the case for India. Following the fiscal reforms in early 1990s, India's combined fiscal deficit of the Centre and the States declined from 9.3% of GDP in the crisis year of 1990–1991 to 6.3% in 1996–1997. Between 1997–1998 and 2001–2002, on account of fifth pay commission report implementation, the fiscal deficit, once again, increased to over 9.0% of GDP, thereby raising concern about macroeconomic sustainability and stability. The impact of increasing fiscal deficit got manifested in the debt-GDP ratio of the Centre and States combined, which increased from 64.75% in 1990–1991 to 81.35% in 2004–2005. It is against this background that the operationalization of Fiscal Responsibility and Budget Management Act of 2003 (FRBMA) assumed urgency in India.[30] On the other hand, the concern over UAE's recent modest performance in FOREX reserve expressed as a percentage of M3 is partially compensated by its strong performance on domestic stability front.

2.2.2. *Into the Future: Assessing the SWF Viability*

From the above analysis, the following conclusion on SWF viability can be drawn. While a mixed picture emerges from the first three figures, the domestic macroeconomic stability scenario depicted in Figure 4 clearly distinguishes between the three categories considered here. It is observed that the first set of countries that are presently owning the successful SWFs is witnessing a comfortable fiscal surplus scenario, thereby providing a strong theoretic support to their decision to float the SWF. On the other hand, all the countries within the second and third categories, barring the exception of Brazil, are experiencing a fiscal deficit.

It has already been noted that the countries in the second and third categories are either newcomers in the SWF field or are contemplating creation of the same in the recent period. In other words, they are yet to reach the level attained by the first category countries. In a sense, it can be argued that the fiscal comfort level of the domestic government is considerably influencing the performance of the SWF.

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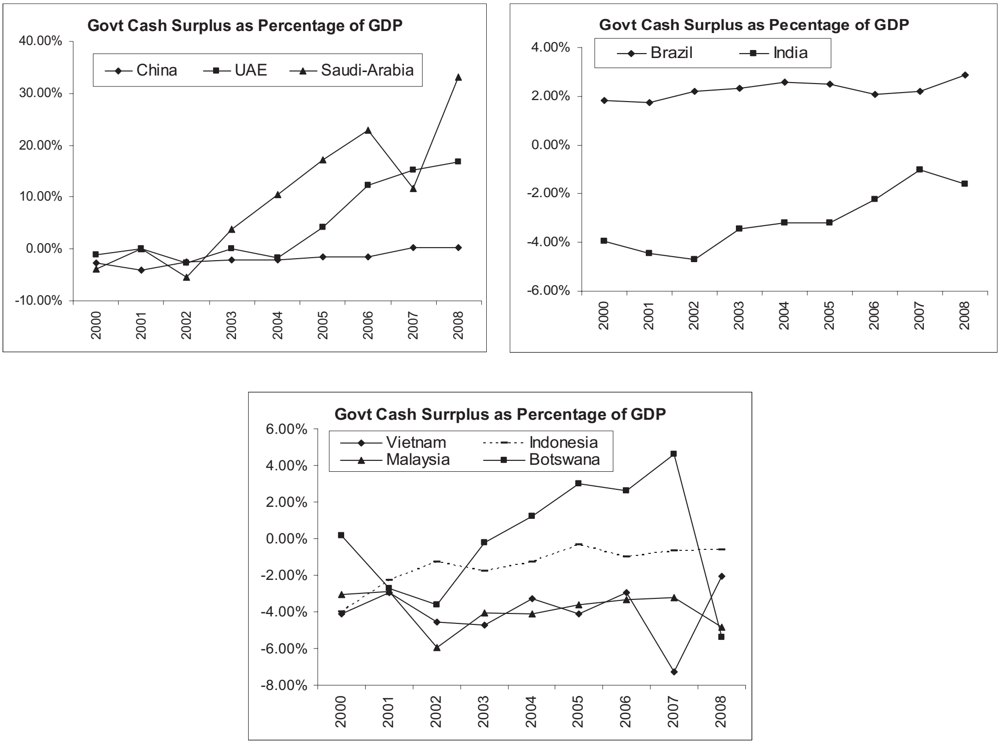
[30] S. Raju & M. Jaydeep, 'Fiscal Deficit, Crowding out, and the Sustainability of Economic Growth: The Case of the Indian Economy', Centre for Asian Studies Working Paper No. 31 (Paris, France: Institut Français des Relations Internationales (IFRI), July 2010).

Figure 4. Government Cash Surplus as a Percentage of GDP



Source: Constructed by the authors from the IMF database.

Therefore, it can be concluded that a combination of external and internal macroeconomic conditions is equally and critically important for a country to successfully explore strategic investment options through SWF routes.

3. Designing Legal Strategies for SWFs Operations

Albeit the growing activities of SWF, there are few, if any, examples of SWFs that have caused damage to Multi National Enterprises (MNEs) or the international financial system. Nevertheless, the newly established SWFs such as China Investment Corporation (CIC) from China have led to considerable concerns among experts in international economics and finance. The perceived concerns are, therefore, mostly based on a threat perception of political interference by the Chinese government (or other emerging economies) in economic exchange and business activities rather than actual incidence of it.[31] Among the potential entrants, the recent outward investment drive from India is geared more towards securing crucial access to natural resources, which could be understood as more important consideration than the sole economic profitability of the investment.

From a macroeconomic perspective, major shifts in SWF investments could potentially disrupt global financial markets. On a national level, politically driven investments in a country could raise national security concerns. Furthermore, there is a possibility that China could use the CIC as a mechanism to pursue geopolitical objectives. For example, a strategic investment in natural resources with means that exceed those of (Western) MNEs could be a step towards controlling resources in times of future shortages. One may doubt the neutrality of the behaviour of State actors in a landscape dominated by private business.

The controversy over SWFs is essentially about the interaction of two very different concepts of the role of government in a capitalist economy, state capitalism as opposed to market capitalism. Where elements of state capitalism interfere in a tradition of market capitalism, a potential for abuse or corruption may arguably be created by the greater proximity an SWF creates between governments and the private sector. Particularly with regard to banks and the financial sector, in which the CIC has already strongly invested, a growing network of interlinked investments between banks and other financial firms within China and overseas can be assumed. In practice, CIC's investment in companies such as Morgan Stanley may provide them with unfair preferential access to China's domestic financial markets, or, in return, overseas financial firms may be put under pressure to treat Chinese companies in global business preferentially compared to others. Neutrality of the business sector and a level playing field for MNEs worldwide is at stake.

It needs to be mentioned here that North-to-South SWF investment is quite common. The BRIC (Brazil, Russia, India, and China) countries are currently witnessing 14% of global SWF inward investments. For instance, among the major global investors, Temasek is currently holding stakes in ICICI Bank in India.[32] Likewise, the Norwegian Pension Fund, the world's third largest SWF, is keen to invest USD 2 billion in Indian

[31] The prime goal for China in establishing an SWF seems to be to make profitable use of the FOREX it has accumulated as a result of trade imbalances or FOREX intervention. Yet, other reasons may also play an important role. Essentially, China is saving today to consume even more in the future when China will be richer. This poses a puzzling behaviour. China is, after all, a relatively poor but rapidly growing country and would possibly be better off with a higher consumption rate today. The ultimate outcome is that the Chinese government exchanges its own bonds for foreign assets. Howeve, this mechanical explanation fails to answer the question on why China accumulates foreign assets rather than consuming more or even investing more in domestic physical assets. It follows from such argumentation that the activities of the Chinese SWF must be assumed to be being used also for other, strategic goals: Chinese economists have argued that the available savings could support the economic development of China best if used as means to acquire international technologies, brands, and resources and to smoothen access to international markets. See P. Gugler & B. Boie, 'The Rise of Chinese Multinational Enterprises', in *Expansion of Trade and FDI in Asia: Strategic and Policy Challenges, Contemporary Asia Series*, ed. J. Chaisse & P. Gugler (London: Routledge, 2009), 25–57.

[32] M. Zhang & F. He, 'China's Sovereign Wealth Fund: Weakness and Challenges', *China and World Economy* 17, no. 1 (2009): 101–116.

bonds and equities.[33] India currently does not restrict the inflow of the SWF investments in any discriminatory manner vis-à-vis any comparable investment made by other agencies. The Ministry of Finance has noted in 2008 that foreign SWFs do not pose any threat to India's economic interests.[34]

However, the decisions to allow firms in India may sometimes be influenced by the SWF-related provisions elsewhere. For instance, Reiche has noted that the operation of the British metal and mining firm Vedanta Resources Ltd and its subsidiaries Sterlite Industries Ltd and Madras Aluminum Company Ltd have been banned in India because of their environmental and human right violation records. Interestingly, however, the ban was introduced after Vedanta's exclusion from the Norwegian SWF.[35]

The firms in the developing countries (e.g., Brazil and India) are recently moving up the value chain fast and strategic acquisition of European and American firms in sectors like iron and steel, banking and finance, and so on can provide considerable leverage to them in the sphere of international business. A number of South-to-North M&A activities have been reported over the last couples of years, which would receive tremendous boost, if such bids are tacitly supported by government-backed SWFs. The ventures would ensure strategic presence and command over the concerned sector of the recipient economy, on the one hand, and ensure higher profitability, on the other hand. In response to the global stream of events, the United States maintain the option of screening investments made on their territory. The considerable flows of international investments occurring in Europe reflect their freer policy regime regarding movement of capital. Because of the concerns existing in Europe, the European institutions decided in 2008 to agree on the basic principles that should shape the EU approach towards SWFs. A consensus emerged towards a common approach. It has been decided not to create *ex nihilo* a new mechanism of control but to rely on the existing rules of the common market that enable Member States to derogate to the principle of freedom of movement of capital. The following section of this article focuses on the regulatory mechanisms in the United States (section 3.1.1) and the EU (section 3.1.2).

3.1. Domestic regulation and screening mechanisms: united states and EU

It is the broadening of investments by SWFs and especially the possible motives that have raised concerns. There were a series of well-publicized cases involving SWF attempts to enter, for example, the energy and mining sectors (Canada and the United States) and, in the United States, a network technology company, ports management, and banking and finance. Two of these initiatives involved SWFs from Singapore and Abu Dhabi, while

[33] Government of India, *Economic News* 6, no. 10 (2008).

[34] S. Sankaran, 'No Threat from Sovereign Wealth Funds, Says Finmin (22 Jul. 2008)', <www.livemint.com/2008/07/22005327/No-threat-from-sovereign-wealt.html>, 26 Jan. 2011.

[35] D. Reiche, 'Sovereign Wealth Funds as a New Instrument of Climate Protection Policy? Study of Norway as a Pioneer of Ethical Guidelines of Investment Policy', Working Paper No. 173e (Wuppertal Institute for Climate, Environment and Energy, December 2008), <www.wupperinst.org/en/info/entwd/uploads/tx_wibeitrag/WP173e.pdf>, 26 Jan. 2011.

the rest were from China. These proposals were all withdrawn in the face of widespread criticism from private and public sources. In Europe, proposed FDI by SWFs or other firms, in strategic sectors or national champions, is resisted, as noted below.

A 2007 study by the Economist Intelligence Unit cited the United States, China, and France, in that order, as most likely to block M&As for strategic or political concerns.[36] Significant but minority Chinese SWF stakes were allowed in major US banks and investment banks experiencing difficulties but on the understanding that the investment was passive, that is, below 10% ownership and without a director on the board or voting rights. Nevertheless, in 2005–2007, there were large FDIs by acquisition or establishment from the Near East and Singapore in a variety of developing and developed countries.[37]

As of 2010, there are over twenty-two entities widely accepted as SWFs. The seven largest ones are known as the 'Super Seven',[38] and each has over USD 100 billion in assets and has been very active in the recent months. The table below shows the most important transaction realized by the five top SWFs. Most of these investments are in the United States and another part in EU. Only one investment is reported to have occurred in Indonesia. The United States and EU are considered here since they are both significant economies in which SWFs seek to invest (see Table 3 below).

In terms of national security, most states have long retained the power to prevent international M&As usually under national laws and sometimes under international investment treaties. The exception to national treatment that is involved here may be explicit in reference to national security or even to listing particular military sectors and infrastructure or it may come under some broader heading such as public order.

Given the recent economic scenario, it is important to contemplate whether SWFs could, in the long run, decide to shift investment targets from slow-growth economies like the United States and EU countries to rapidly growing economies such as India, China, and Southeast Asian economies.[39] As reported by Matthew Saxon, Lou Jiwei, Head of China's investment fund, 'recently said that his fund would not invest in some European countries because he felt extremely unwelcome there'.[40] It might be added that from pure profitability point of view, this may reveal new trends in the future: why investing in 2% growth economies when one can invest in 8% growth economies?

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[36] Cited by Karl P. Sauvant, 'Driving and Countervailing Forces: A Rebalancing of National FDI Policies', in *Yearbook on International Investment Law and Policy 2008–2009*, ed. Karl P. Sauvant (Oxford: Oxford University Press, 2009), 243.

[37] UNCTAD, 'World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge' (Geneva: UNCTAD, 2008), 24.

[38] The Super Seven includes Abu Dhabi Investment Authority, the Government of Singapore Investment Corporation, the Government Pension Fund of Norway, KIA, CIC, Russia National Wealth Fund, and Temasek Holdings. Of the listed owners, UAE's Abu Dhabi Investment Authority possesses the largest SWF, with assets estimated to be somewhere between USD 250 billion and USD 1 trillion. Another player of note in this league of large SWFs is the CIC, which has an initial endowment of USD 200 billion. While not as large as the Super Seven, the holdings of other SWFs are still quite substantial.

[39] See Julien Chaisse & Philippe Gugler, 'The ASEAN in a New Era: Unveiling the Promises', in *Competitiveness of ASEAN Countries – Corporate and Regulatory Drivers*, ed. P. Gugler & J. Chaisse (Cheltenham: Edward Elgar, New Horizons in International Business series, 2010).

[40] Saxon, 708.

Table 3. Top M&A Transactions 2007–2010 by the Top Five SWFs

SWF	Value (Millions of US Dollars)	Target	Target Nation	Year
Abu Dhabi Investment Authority	About 196.4	Gatwick	United Kingdom	2009
Abu Dhabi Investment Authority	280	Virgin Galactic	United States	2008
Abu Dhabi Investment Authority	7,500	Citigroup	United States	2007
Government Pension Fund	Unknown	Unknown	Unknown	Unknown
SAMA Foreign Holdings	Unknown	Unknown	Unknown	Unknown
SAFE Investment Company	2,500	TPG fund	United States	2008
SAFE Investment Company	2,800	Total	France	2008
China Investment Corporation	1,900	PT. Bumi Resources Tbk	Indonesia	2009
China Investment Corporation	1,580	AES Corporation	United States	2009
China Investment Corporation	5,600	Morgan Stanley	United States	2007

Source: Compiled by authors from various sources.

3.1.1. *The Regulation of SWF Investments in the United States*

Though the earlier Bush Administration had been generally supportive of SWF investment, concerns were expressed at times. For instance, Christopher Cox, Chairman of the US Securities and Exchange Commission (SEC), raised concerns on the following issues:

– At times, foreign governments may not be fully cooperative with insider-trading investigations.
– On certain occasions, SWFs may be the beneficiaries of economic intelligence from national security services.

The US approach since 2007 has been summarized by the former Secretary of Treasury Paulson, who said that ‘money is naturally going to gravitate toward dollar-based assets because of the strength of our economy’; … Paulson further noted, however, that ‘I’d like nothing more than to get more of that money. But I understand that there’s a natural fear that they’re going to buy up America’.[41] This psychology has been strengthened in the aftermath of the global economic downturn.

[41] S.R. Weisman, ‘U.S. Fears Overseas Funds Could “Buy up America”’, *New York Times*, 21 Aug. 2007. See also Slawotsky, 1251–1254.

Federal laws already exist in the United States to protect against potential national security threats posed by FDI, including investments by SWFs; indeed, those laws were recently strengthened after the Dubai Ports World controversy cast popular doubt on their efficacy. In the United States, a specific mechanism ensures the control of SWF investments in the national economy. Indeed, since 1988, the United States has had a legal framework to forbid a foreign investment if it threatens to impair US national security. The Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee chaired by the Secretary of US Treasury, takes part in the US investment policy analysis through reviews that protect national security while maintaining the credibility of open investment policy.[42] As a committee of the US executive branch, the CFIUS takes responsibility for monitoring overseas acquisitions of 10% or more of a domestic company's total ownership. Critics argue that the 10% ownership threshold for reviewing these investments is inadequate, pointing out that investors who acquire smaller ownership shares can have a dramatic impact on a company and on an economy at large. Interestingly, no definition of national security exists in CFIUS[43] (see Table 4).

Table 4. CFIUS Covered Transactions, Withdrawals, and Presidential Decisions (2006–2010)

Year	**2006**	**2007**	**2008**	**2009**	**Total**
Number of notices	111	138	155	65	469
Notice withdrawn during review	14	10	18	5	47
Number of investigation	7	6	23	25	61
Notice withdrawn during investigation	5	5	5	2	17
Presidential decisions	2	0	0	0	2

Source: US Treasury website as of December 2010.

Filing a notice with CFIUS of a foreign acquisition is voluntary and typically done at the initiative of the parties. However, parties are motivated to file by the fact that the law empowers CFIUS and the President to dissolve the acquisition at any time in the future, even after an acquisition has been completed, if a filing was not made. After a transaction has been filed, CFIUS conducts an initial review, utilizing the full intelligence and national security infrastructure of the US government, based on detailed information from the parties, which frequently receive questions and requests for clarification from CFIUS. The scope of these reviews focus on two key thresholds:

– *Test 1*: Is there credible evidence that the foreign interest exercising control might take action that threatens national security?

[42] On CFIUS's recent activities, see S. Tariq Anwar, 'CFIUS, Chinese MNCs' Outward FDI and Globalization of Business', *Journal of World Trade* 44, no. 2 (2010): 419.

[43] See P. Rose, 'Sovereign Wealth Fund Investment in the Shadow of Regulation and Politics', *Georgetown Journal of International Law* 40 (2009): 1215.

– *Test 2*: If yes, do laws other than Exon-Florio and the International Emergency Economic Powers Act provide adequate and appropriate authority for the President to protect national security?

If consensus prevails that no credible threat to national security exists, or the threat has been mitigated, CFIUS decides, within thirty days, not to open a further investigation. If threats exist, or agencies are divided in their opinion, CFIUS conducts an investigation for an additional forty-five days, after which it is required to file a report with the President. The President will have fifteen days to make a decision whether or not to block a transaction.

It is always possible to negotiate during both initial and further reviews. It is observed that in the past, certain parties have dropped out of transactions when CFIUS's national security concerns have been insurmountable,[44] made commitments regarding the composition of the Board of Directors (adding American citizens or guaranteeing that a Board will only be composed of Americans), or even committed to maintain research and development in the United States. In other words, CFIUS can leverage the approval process to win concessions that further improve and guarantee US national security.

Since 1988,[45] foreign companies have sent CFIUS several thousand notifications of intent to purchase US companies, but CFIUS has only investigated a few, and of these, it has blocked only one.[46] That case involved the purchase by China Aviation Technology Import-Export Corporation (the import-export arm of Beijing's Ministry of Aerospace) of MAMCO, a privately owned, Seattle-based manufacturer of civilian aircraft parts.

The small number of CFIUS notifications that led to investigation, formal withdrawal, or presidential decision is actually misleading given the unknown number of decisions to withdraw after informal consultation or before investigation and given the conditions imposed. CFIUS's political impact, however, may be greater, since many firms withdraw their offers if it looks like CFIUS may investigate them.

3.1.2. *The Regulation of SWF Investments in the EU*

It is often argued that an EU committee on foreign investments is required to mirror arrangements in the United States, for an EU-wide screening mechanism or some 'golden shares'[47] mechanism for non-EU foreign investment. Such a mechanism is not

[44] Saxon, 693.

[45] In 1988–2008, there were 1,593 notifications with CFIUS or about 10% of all reported FDI. This resulted in only twenty-five investigations, thirteen notices that were withdrawn, and one actual rejection in the twelve presidential decisions.

[46] For an overview, see T.E. Crocker, 'What Banks Need to Know about the Coming Debate over CFIUS, Foreign Direct Investment, and Sovereign Wealth Funds', *Banking Law Journal* 125: 457.

[47] These are non-standard shares, the ownership of which confers special rights on the holder. Recent landmark decisions of the European Court of Justice (ECJ) regarding compatibility of 'golden shares' with EC law are a clear indication that the concept of 'golden shares' violates one of the four fundamental freedoms conferred on individuals by the EU Treaty, namely the free movement of capital. According to case law of the ECJ rules governing 'golden shares', an actual exercise of any rights attached to a 'golden share' by any public body must be based on criteria of non-discrimination and an effective legal remedy has to be guaranteed. The judgments do not present a straightforward prohibition of 'golden shares'; however, they set out strong limits on their application. See ECJ, C-282/04, *Commission v. Netherlands*, 28 Sep. 2006.

anticipated at the European level. The internal debate experienced on this area within the EU had different aims from those of the United States. There is a clear consensus of EU institutions towards a common approach.[48] The European Commission took the initiative in a communication released in February 2008, which was supported by the European Council and the European Parliament later in the year.

In February 2008, the Commission presented a communication entitled 'A common European approach to SWFs.'[49] In common with all the Commission Communication documents, this text is one with no legal significance sent by the Commission to the other European institutions. The aim of the Commission is to set out new programmes and policies. According to this 2008 Communication, new legislative measures at Community level are unnecessary. The common approach recommended by the Commission was based on five principles:

– commitment to an open investment environment;
– support of multilateral work;
– use of existing instruments;
– respect of European Community (EC) Treaty obligations and international commitments;
– and finally, proportionality and transparency.

The Commission is, thus, seeking to avoid legislative action and envisages soft measures, such as guidelines, accompanied by efforts at the international level to increase transparency of SWFs. It is important to note that the Commission Communication is recommending the common European approach as a complement to the prerogatives of Member States regarding the use of their national legislation.[50]

The Council took over the ideas set out by the Commission, clarifying, in particular, two principles out of the initial five, along the following lines:

– On the one hand, rather than expressing its support for the multilateral approach in general, it preferred to express its position specifically on the work under way in the IMF and the OECD.
– On the other hand, rather than referring to the use of the existing instruments, and once again taking a more general approach, the Council thought it more appropriate to adopt as a basic principle the use of national instruments and EU instruments, if necessary.

[48] See Saxon, 708–710.

[49] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A Common European Approach to Sovereign Wealth Funds, COM/2008/0115 Final, 27 Feb. (2008).

[50] This regime has not been affected by the entry into force of the Treaty of Lisbon on 1 Dec. 2009 amending the former EU and EC treaties, without replacing them. The TFEU provides the new Union with the legal framework and tools necessary to meet future challenges (nota bene: We use in the developments below the new numbering of the TFEU).

Article 65 stipulates that the Member States have the right to put in place restrictions on grounds of public order or public security. Under the article, a Member State is entitled to restrict Treaty freedoms on the basis of legitimate national security concerns. Free movement of capital, unlike the other freedoms of movement established by the Treaty on the Functioning of the European Union (TFEU), does not apply solely between Member States. It also prohibits restrictions on the movement of capital between Member States and third countries. This is true in respect of all investments, be they from SWFs, state-controlled companies, private companies, or others. Furthermore, a number of Member States have measures in place that, for example, restrict investments in the defence sector.

It is important to emphasize that the list of justification measures in Article 65(1)(b) TFEU is not exhaustive. Although, whatever the ground relied on, the measure in question must be suitable for the purposes of attaining the objective that it pursues and not go beyond what is necessary in order to attain it, essentially applying a proportionality test. The Court has also provided criteria to assess the proportionality: national measures must aim at the protection of a legitimate general interest and foresee strict time limits for the exercise of opposition powers; assets or management decisions targeted must be specifically listed.

Lastly, in *Test Claimants in the FII Group Litigation*, the Court stated that it may be the case that a Member State will be able to demonstrate that a restriction on capital movements to or from third countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States.[51] In analysing whether such restrictions are justified, different considerations may apply vis-à-vis the case with purely intra-Community restrictions.[52]

Article 65 has never been invoked in the context of SWFs. In other words, no Member State has ever adopted a law restricting FDI from SWFs nor has a Member State ever enforced a decision rejecting an SWF investment arguing as to the validity of the decision as an exception (Article 65) to the principal of freedom of capital movement (Article 64).

Recent experience shows that the opacity of some SWFs risks prompting defensive reactions. In October 2008, the Italian government announced first that SWFs wanting to buy shares in Italian companies should 'generally' stay below 5%, suggesting that a new law should be passed. This was a reaction to the purchase by Italy's former colony, Libya, of a 4.23% stake in the number two Italian bank UniCredit SpA.[53] However, shortly after this, Foreign Minister Franco Frattini said that there is no need for a threshold, but there

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[51] Case C-446/04, *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue* [2006] ECR I-11753, para. 171 (hereinafter *Test Claimants in the FII Group Litigation*).

[52] The reason is that the movements of capital to or from third countries take place in a different legal context from that which occurs within the Community. Particularly, the degree of legal integration that exists between EU Member States is not comparable to that of economic activities involving relations between Member States and third countries. See *Test Claimants in the FII Group Litigation*, para. 36.

[53] G. Dinmore, 'Italy Set to Curb Sovereign Wealth Funds', *Financial Times*, 21 Oct. 2008.

is a need for transparency.[54] Such a U-turn should be interpreted as abandoning any plan to pass a new law and refer to the multilateral approach supported by the EU.

However, the United Kingdom and France have already introduced legislation allowing them to fend off investments from SWFs. Germany passed a new law that entered into force in April 2009. The Cabinet of the German Ministry for the Economy took a decision on Foreign Trade and Investment Law on 20 August 2008.[55] This decision is aimed at protecting strategic German industries from unwanted foreign takeovers. Since April 2009, the law gives the German federal government the right to veto any investment from non-EU or European Free Trade Association countries (i.e., Switzerland, Norway, Liechtenstein, and Iceland) amounting to 25% or more of a company's stakes, if it deems that 'public security' or 'public order' is at risk.[56] Based on the US model, Germany's plans could lead to further attempts across the twenty-seven-Member EU aimed at blocking foreign investment incursions into sensitive industries. US inspiration is obvious in the German pre-notification procedure. Foreign investors can pre-notify the German administration, on a voluntary basis, before an intended acquisition. The administration can then clear the acquisition and provide a level of legal certainty to the investor. Under Germany's proposals, 'public order and security' are the principal criteria for triggering a review of foreign groups' investment plans.

There is a risk of witnessing a different strategy being implemented in each of the Member States rather than a unique policy at the EU level, which, ultimately, would not help tackle the reality. There is a need to make clear at the European level which sectors should be protected from foreign takeovers and to go beyond the existing vague criteria of public order and public security.

Such a list of EU strategic sectors should be drafted, which may isolate energy, technologies, and other relevant sectors from SWF entry. In addition, public mistrust of overseas investment and isolationist sentiment could cause an overreaction to the question of regulation. This could have far-reaching consequences not only financially but also in terms of diplomatic and economic relationships with other nations. For instance, European leaders do not have the same policy towards Russia as they do towards the United States.

As a result, there is a need to clarify the interpretation of Article 58 Energy Charter Treaty (ECT), which provides for restrictions on the free movement of capital on grounds of public order. Because it has not been applied until now in the context of SWFs, it is worthwhile ensuring that Member States will not be tempted to make extensive use of it.

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[54] Reuters Agency, 'No Need to Cap Sovereign Fund Holdings', 23 Oct. 2008.

[55] B. Benoit, 'Berlin Foreign Investors' Bill Clears Hurdle', *Financial Times*, 20 Aug. 2008, <www.ft.com/cms/s/0/ac2762d6-6eff-11dd-a80a-0000779fd18c.html?nclick_check=1>, 26 Jan. 2011.

[56] Thirteenth Act amending the Foreign Trade and Payments Act and the Foreign Trade and Payments Regulation, 18 Apr. 2009. Based on the US model, Germany's plans could lead to further attempts across the twenty-seven-Member EU aimed at blocking foreign investment incursions into sensitive industries. US inspiration is obvious as foreign investors can now pre-notify the German administration, on a voluntary basis, before an intended acquisition to obtain legal certainty. Under Germany's proposals, 'public order and security' are the principal criteria for triggering a review of foreign groups' investment plans.

This does not, however, remove the need to clarify the interpretation of Article 65, which provides for restrictions on the free movement of capital on grounds of public order. As it has not been applied until now in the context of SWFs, it is worthwhile ensuring that Member States will not be tempted to make extensive use of it. To this end, an option could be to develop, as the French government did (see below), a shortlist of sensitive sectors where 'enhanced scrutiny' is exercised over inflows of funds, whether private or SWF, leaving all other sectors with free entry. It could take the form of a paragraph added to Article 65.

3.2. The evolving international legal framework: hard law and soft law

A multiplicity of instruments serves the purpose of investment protection and promotion and illustrates a structural fragmentation.[57] Treaties (bilateral, regional, and plurilateral) have increasingly become the basic source of international investment law. The applicability and lack of prospects under BITs and free trade agreements have already been addressed by Locknie Hsu and will not be addressed.[58] We will focus on the multilateral rules, that is, the law of the WTO (section 3.2.1) that has been largely unexplored and the development of soft law principles by the IMF (section 3.2.2).

3.2.1. *The Applicability of the WTO GATS Rules*

Comprehensive multilateral rules governing international economies are currently limited to trade issues. Even though the WTO agreements contain major loopholes, multilateral rules on trade constitute a broad umbrella of rights and obligation under which regional, plurilateral, and bilateral agreements as well as national laws all regulate trade issues. Although FDI has increased significantly over the last two decades, outpacing the already significant expansion of trade during the same period, the current international legal framework for FDI is highly fragmented. The current framework consists of a wide variety of national and international rules and principles that differ in form, strength, and coverage. The result is an increasingly complex international setting for international investment in which governments must ensure consistency between differing sets of obligations. The WTO and its predecessor organization, the General Agreement on Tariffs and Trade (GATT), have not directly tackled the broad issue of foreign investment rules. However, the WTO GATS already covers investments by SWFs. Under the GATS,

[57] This fragmentation in the substance of the norms is confirmed by the fact that even if the network of BITs is expanding it is still heavily one-sided. They are mainly agreements between developed and developing countries. This multifaceted fragmentation does not only depict a *statu quo*. On the contrary, fragmentation has a dynamic character since it has grown over time with a continuously increasing number of treaties, actors, and fora dealing with international investment issues. These several indicators underline the increase of fragmentation in international investment regulation. See Chaisse & Gugler, 2011.

[58] L. Hsu, 'Sovereign Wealth Funds, Recent Legislative Changes, and Treaty Obligations', *Journal of World Trade* 43, no. 3 (2009): 469–474.

countries negotiate schedules of commitments, which are, in effect, legally binding promises to allow foreign investment in specific sectors subject to specific conditions.

There is little doubt that WTO GATS does apply to potential SWF investments. The GATS deals most with investment issues of all the existing WTO agreements. The GATS modes of supply are cross-border supply, consumption abroad, commercial presence, and the movement of natural persons. Although GATS does not deal officially with investment, it covers FDI through its commercial presence mode of supply. The establishment of a commercial presence relates substantially and directly to investment. As long as an SWF decides to invest in a WTO country member (United States and EU are relevant examples) and if it is in the services sector, GATS is a relevant legal instrument to look at.

Actually, it is only by reference to a country's schedule, and (where relevant) its Most Favoured Nation (MFN) exemption list, that it can be seen to which services sectors and under what conditions the basic principles of the GATS (market access, national treatment, and MFN treatment) apply within that country's jurisdiction. A specific commitment in a services schedule is an undertaking to provide market access and national treatment for the service activity in question on the terms and conditions specified in the schedule. The commitments made in the field of 'commercial presence' are important since with constitutional principle of MFN obligation, parties to GATS are committed to treating services and service providers from one Member in a no less favourable way than like services and service providers from any other as concerns measures affecting trade in services.[59]

National treatment, however, is not automatically accorded across the board. It applies only for scheduled sectors when parties agree to provide national treatment in the context of specific market access commitments. GATS also states that a Member may maintain a measure inconsistent with MFN treatment provided that such a measure is listed in, and meets the conditions of, the Annex on Article II Exemptions.

The GATS does not set out any operational conditions directly. The host countries continue regulating foreign investment through their domestic legislation (as discussed above) and not by directly imposing obligations on foreign investors in International Investment Agreements (IIAs). Nevertheless, there are some general obligations within GATS that certainly affect the investment operational conditions.

Such obligations are domestic regulation, recognition, monopolies and exclusive service suppliers, and business practice obligations. The domestic regulation affects the operation of investment mostly through an authorization process, qualification requirements, technical standards, and licensing requirements, where these conditions and procedures are required for the supply of a service. The obligations of recognition affect investment in the supply of a service, where service suppliers need to meet standards or

[59] The wording of MFN treatment in GATS is the same as in the North American Free Trade Agreement and the US BITs, using the negative list approach, once it states that with respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.

criteria for the authorization, licensing, or certification of their services, or they need to achieve special education or experience. The obligation on monopolies and exclusive service suppliers within the Agreement states that each Member shall ensure that any monopoly supplier of a service in its territory does not act in a manner inconsistent with the MFN treatment principle. If a supplier fulfils the condition on monopoly and exclusive service supplier, then this Agreement will certainly affect the operation of his/her investment in order not to allow such a supplier to abuse its monopoly position. Regarding the obligations on business practices, the Agreement appeals the Members to eliminate certain business practices of service suppliers that may restrain competition and thereby restrict trade in services.

This brings us to the issue of national investment legislation based on national security, which may block, impede, undo, or, in some other way, affect adversely investments made by SWFs. Such a domestic action would not be in itself a violation of its GATS Mode 3 commitments. The country may indeed rely on Article XIV*bis* GATS in order to benefit of the 'security exception'.

It is true that one of the most critical concerns regarding foreign acquisitions is national security. The problem with national security issues is that there is no way to clearly define what types of investment invoke these concerns and what types of investments do not. While it may be clear that foreign investment in a country's defence industries would raise national security concerns, there are many other industries that do not fall within the traditional notion of defence but are, nonetheless, essential to a country's security.[60]

If any action taken under such legislation violates the recipient country's GATS obligations, would the Article XIV*bis* security exception apply? This provision was never invoked and does not give much clue on its applicability[61] and the capacity of governments to prohibit SWF investment on this ground.[62] The prospects are, however, very limited and not encouraging.

It is indeed clear from the wording that the GATS (Article XIV, chapeau) introduce a requirement that such measures shall not constitute, or be applied in a manner which would constitute, arbitrary or unjustifiable discrimination. In addition, the measures may not serve as 'disguised restrictions'. However, the GATS qualification noted above is not carried over to the security provisions of the GATS per se (Article XIV*bis*), so that as concerns national security, the measures remain entirely self-judging.

The security exception is to preserve Members' freedom of action in areas relating to national defence and security. Trade liberalization and international regulation do not prevail over Members' vital interests in maintaining the core of sovereignty and cannot

[60] See Wong, 1096.

[61] A. Emmerson, 'Conceptualizing Security Exceptions: Legal Doctrine or Political Excuse?', *Journal of International Economic Law* 11, no. 1 (2008): 135–154.

[62] T. Cottier & P. Delimatsis, 'Art. XIV*bis* GATS: Security Exceptions', in *Max Planck Commentaries on World Trade Law, WTO – Trade in Services*, vol. 6, ed. R. Wolfrum, P.-T. Stoll & C. Feinäugle (Leiden/Boston: Martinus Nijhoff Publishers, 2008), 329–348.

Box 1. Article XIVbis (Security Exceptions)

(1) Nothing in this Agreement shall be construed:

(a) to require any Member to furnish any information, the disclosure of which it considers contrary to its essential security interests; or

(b) to prevent any Member from taking any action that it considers necessary for the protection of its essential security interests:

(i) relating to the supply of services as carried out directly or indirectly for the purpose of provisioning a military establishment;

(ii) relating to fissionable and fusionable materials or the materials from which they are derived;

(iii) taken in time of war or other emergency in international relations; or

(c) to prevent any Member from taking any action in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security.

(2) The Council for Trade in Services shall be informed to the fullest extent possible of measures taken under paragraphs 1(b) and (c) and of their termination.

restrain Members' freedom to preserve, and defend, their very existence. Moreover, it should be recalled that the GATS only provides for state-to-state dispute settlement and that as concerns investment matters what is probably another limit to the possibility to control national protectionism towards SWFs on the basis of the GATS.

3.2.2. *Multilateral Guidelines: Obstacles or Opportunities?*

In October 2007, the G7 Finance Ministers invited major multilateral organizations, such as the IMF and the OECD,[63] to launch a reflection on the role of SWFs and on the mechanisms to address the challenges they pose. Since the G7 summit, the activities in the IMF and OECD have been running in parallel, but they are not dealing with exactly the same themes. They are, however, generally described as complementary. OECD has finished its work in 2009, and the playing field has not been changed. The IMF agreed on a set of twenty-four voluntary principles for the funds to follow and to ensure their competitiveness in global financial markets. These Generally Accepted Principles

[63] On the latter organization work, see O'Brien, 1231.

and Practices (GAPP) or 'Santiago Principles' were released on 11 October 2008 and appeared in Annex 1.[64]

A bit earlier, the pioneering work of Edwin Truman, which provides a basis for evaluating the results of the IMF-sponsored dialogue, chalked out a blueprint for SWF best practices.[65] The drive by the United States and the EU to draw up the code of best practices, including a renunciation of political motives, has stirred resentment among some of the investors responsible for the funds, particularly in China and some Gulf States. The challenge for IMF in delivering this difficult task was known from the beginning, but it became even more complex in the context of the financial crisis.

The GAPP seeks to establish a framework for SWFs that promotes operational independence in investment decisions, transparency, and accountability. They were designed largely to appease recipient country regulators and largely focus on state-level concerns: accountability, transparency, and economic investment purpose.[66] To achieve this, it covers practices and principles in three key areas:

– legal framework, objectives, and coordination with macroeconomic policies;
– institutional framework and governance structure;
– investment and risk management framework.

The GAPP encourage the funds to explain their investment criteria and recommend that they avoid buying stakes in sensitive companies, such as Western defence contractors. They also vote on setting up a standing committee that will update the guidelines and liaise with Western governments and institutions such as the World Bank and IMF on issues of concern. Endorsement of, and adherence to, the GAPP is a completely voluntary matter, which must be ratified by the competent authority in each participating country.[67]

The principles make repeated mention of the need for greater transparency. It is true that SWFs differ in management and levels of transparency.[68] Norway's and Qatar's funds are directly managed through the central bank or the finance ministry, while the UAE's funds are incorporated as private companies with some degree of independence.

[64] On the negotiations process, see J.J. Norton, 'The "Santiago Principles" for Sovereign Wealth Funds: A case Study on International Financial Standard setting Processes', *Journal of International Economic Law* 13, no. 3 (2010): 648–655.

[65] It is important to note that SWFs, like state-owned firms, vary widely on the issues of disclosure, governance, structure, accountability, and transparency, which have attracted criticism. Truman's study of forty-four pension and non-pension SWFs that focused on these issues gave New Zealand's Superannuation Fund and the Canada Pension Plan ninety-five out of a possible 100% for best practices with China's National Security Fund at seventy-seven among the ten pension funds studies. By contrast, Norway's Global Fund was rated at ninety two, the Hong Kong Exchange Fund at fifty-one, the CIC at twenty-one, and two Abu Dhabi Funds at fifteen and nine. Of the top non-pension funds, three were in developing countries, while of the twenty-four next funds fully eighteen were in developing countries. See Edwin Truman, 'A Blueprint for SWF Best Practices', Peterson Institute for Economics, No. PB08-3 (Washington, April 2008), 21.

[66] Rose, 2009, 1214.

[67] As the International Working Group (IWG) noted in its release of the Principles, 'The GAPP is a voluntary set of principles and practices that the members of the IWG support and either have implemented or aspire to implement. The GAPP denotes general practices and principles, which are potentially achievable by countries at all levels of economic development. The GAPP is subject to provisions of intergovernmental agreements, and legal and regulatory requirements. Thus, the implementation of each principle of the GAPP is subject to applicable home country laws'.

[68] See Wong, 2081.

However, funds' management structure does not necessarily speak of their transparency level. The funds of Norway, New Zealand, Alaska, and Canada are highly transparent in their investment criteria and financial accounting. They conventionally invest in a wide range of investments, including bonds, equities, commodities, and FDI. Malaysia's SWF and Singapore's Temasek Holdings, while also transparent, pursue more strategic holdings, targeting industries that are of sovereign interest. Funds controlled by the UAE, Qatar, Kuwait, and China are among those that disclose the least information about their activities and are most likely to consider sovereign interests in their investing activities.

The full list of principles includes recommendations that sovereign funds coordinate their activities with their respective governments and central banks to avoid interfering with domestic economic policy. The members have committed that funds should disclose their sources of funding and the conditions under which their owners can withdraw them. They have committed to make disclosures as applicable under local laws and regulations. The legal framework basically reflects the 'concern that SWFs be both predictable and accountable with respect to both domestic and recipient country regulators'.[69] Of key significance in this regard are Principles 11, 12, and 22. Further, sovereign fund managers should be independent of the fund owners but fully accountable, publishing annual reports and undergoing annual audits.

To address criticism among some economists that the funds' secrecy contributes to volatility in capital markets, the principles call for funds to disclose 'relevant financial information' to 'contribute to stability in international financial markets and enhance trust in recipient countries'. Each funds' investment policy should be made public, including the extent to which they employ outside managers. The principles also address concerns about conflicts of interest arising between the funds and their government owners, calling for funds to avoid taking advantage of privileged information or influence when investing.

However, the principles stop short of requiring an explicit pledge not to invest for political ends. The principles include a call for funds to abide by local rules and regulations and base their investments on financial and economic grounds. They even call on funds to disclose any investment decisions 'subject to other than economic and financial considerations'.

The third section, Investment and Risk Management, more directly addresses recipient country concerns. GAPP 19 states that 'the SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds'. However, subprinciple 19.1 also states that '[i]f investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed'. The use of informational advantages is also proscribed: '[t]he SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities'.

[69] Rose, 2009, 1215.

The Santiago Principles offer important guidelines for the structure, governance, and management of SWFs; however, they have several flaws that will constrain their effectiveness in achieving their stated objectives. First, the GAPP is too focused on SWFs as entities and not enough on their relationship with recipient countries.[70] Second, there are no standards to measure compliance with or achievement of the Principles. Third, the Santiago Principles do not address the asymmetric information problems faced by recipient countries. Finally, there are no sanctions or rewards available to ensure compliance. Above all, the IMF guidelines are based on a standard definition of SWFs. They do not cover SOEs as made clear by a footnote. Consequently, they could find themselves in the pointless situation of being rigorously adhered to by, for example, Norway's Government Pension Fund – Global, while Russia's Gazprom felt no need to take any notice of them. If so, the SWF guidelines will serve little more than a public relations purpose if they encourage sovereign investment to flow through other investment vehicles not covered by the guidelines. It might then make sense to go on to redefine SWFs along broader lines. Robert Kimmit, the current Deputy Secretary of the Department of the US Treasury, suggests that SWFs could be conceived as 'large pools of capital controlled by a government and invested in private markets abroad' rather than as the funds that serve exclusively as investment vehicles for these pools. With 'SWF' defined in this way, a code of conduct for SWFs would cover sovereign wealth at its source, regardless of the route it then took to reach any foreign investment target.[71]

Edwin Truman made a preliminary assessment of the GAPP using the thirty-three elements in the '2008 Blueprint for SWF Best Practices'. The GAPP receives a satisfactory 'score' of 74. The GAPP rank within the top group of twenty-two pension and non-pension SWFs out of forty-six such funds. It means that should each SWF complies completely with the GAPP, they would all move into that top group. As emphasized by Truman, 'the fact that the GAPP does not score 100 on my rating system reflects reality. It is a compromise, a negotiated document'.[72] The weakest area is with respect to accountability and transparency. Disturbingly, many of the principles are silent about disclosure to the general public or only call for disclosure to the fund's owner. That approach does not promote the needed accountability to citizens of the country with the SWF or of other countries.

It seems then that it would be in the interest of governments to make use of the multilateral code of Santiago Principles rather than being subjected to the EU or the US mechanisms. A robust implementation of the 'Santiago Principles' should go far towards resolving questions about the transparency, accountability, and operations of SWFs. The issue for the International Working Group (IWG) is 'voluntary' compliance with the GAPP. However,

[70] For instance, it is not necessary for SWFs to disclose every piece of financial data or every strategy; however, it would be insufficient for the funds to merely release a statement containing only publicly available information. Excessive disclosure requirements are also problematic, because they would inhibit the SWFs' daily management and goal of maximizing returns, since every strategy decision would be public information.

[71] See R.M. Kimmitt, 'Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy', *Foreign Affairs*, January/February 2008.

[72] E. Truman, *Making the World Safe for Sovereign Wealth Funds* (13 Oct. 2008).

some signals are encouraging, since Abu Dhabi Investment Authority (ADIA) had expressed support for the Santiago Principles. Additionally, 'To underline its commitment to full compliance, ADIA has established an inter-departmental committee to oversee compliance with the GAPP. Furthermore, ADIA is analysing the feasibility of establishing a mechanism that would provide independent verification of its compliance with the GAPP.'[73]

The implementation process will take some time, and different SWFs will be at differing levels of observance of the Principles for the near and, probably, middle term.[74] What can be seen at first sight as a burden could be turned into an advantage. Indeed, complying with the Santiago Principles will mean accepting the multilateral rules accepted by all. Any SWF that would comply with such rules could expect a good treatment from both US and European authorities and will not be subject to the uncertainties resulting from their procedures.

4. Concluding Remarks: Lessons and Prospects

The recent emergence of SWFs as active and important players in international financial markets has raised a host of questions, which are focused in the current analysis. SWFs create a regulatory and theoretical challenge because they serve two masters with very different agendas. As the current financial turmoil demonstrates, financial liquidity is vital for Western economies. Recently, firms on both sides of the Atlantic – for example, Barclays and Citibank, seek out sovereign funds for fulfilling their strategic aims. Even Russian sovereign funds have not attempted to buy into any strategic assets; they are taking very limited stakes in some companies and the European Commission and the national governments are watching this activity. However, there is no evidence at the moment that these sovereign funds are being used for any nefarious purpose. Open investment policies bring about global prosperity. Open policies should be espoused by governments without compromising national security and transparency.

SWFs as a class of investor would considerably grow in importance over the next decade: both by number and volume. The objective of this article has been to understand the macroeconomic determinants of the SWF formation and depict the existing regulatory framework applicable to these investments in order to identify the main regulatory challenges they might face abroad. The analysis first identifies the importance of external and internal macroeconomic conditions for a country for successfully managing SWF. However, even when a theoretical case exists for a successful SWF, the regulatory barriers in the North might considerably impede its functioning.

Why do the regulatory strategies come into existence? The answer lies in the fact that SWFs constitute an important element in the policy dimension of many countries that have decided to set up such a fund so far. For instance, China provides a key example of the interference of the Chinese government in business transactions and the

[73] Available at <www.adia.ae/ADIA_AE_press.asp>, 26 Jan. 2011.
[74] See Norton, 660.

private sector, which may not be present in the Indian case. However, there may exist a commonality of interest between the public and private sectors in India in terms of outward investment (e.g., energy). It needs to be noted that acquisition attempts in strategic sectors like steel by Indian private players have already been criticized in Europe (e.g., Arcelor-Mittal takeover in 2006) and any SWF operation in similar spheres might also be viewed in that light.

Therefore, how can the SWFs thrive while complying with the regulatory policies? As indicated earlier, the Santiago Principles are intended as a 'framework of GAPP that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis'. Owing to the backlash against SWFs discussed earlier, the Principles are intended to be of particular value in promoting acceptance of cross-border investments.

While there are severe limitations to the Santiago Principles, they still remain an important first step in the creation of a new international norm. GAPP 24 says that 'A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.' It can be observed that there is a necessity to respect all the Santiago Principles when setting up SWF for the emerging economies so as to take advantage of these minimal standards. Respecting each Santiago Principle will put SWFs of such countries in the category of 'good SWF' and then limit regulatory obstacles it could face in the US market or the multiplicity of regulations in the EU market. Interestingly, the use of mere guidelines as opposed to hard regulation may *in fine* mark a milestone in rationalizing the integration of SWFs into the global capital markets. Complying officially with IMF guidelines should not require a lot of concessions by the emerging economies willing to set up new SWFs. Since the Santiago Principles remain quite loosely defined and minimal, a good strategy for a developing country would be to respect them and use these standards as a tool to ensure that Western countries will not create obstacles that run again the philosophy of this core of multilateral principles.

5. Annex 1. A Summary of the Twenty-Four GAPP

- GAPP 1. Principle. The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).
  - GAPP 1.1. Subprinciple. The legal framework for the SWF should ensure the legal soundness of the SWF and its transactions.
  - GAPP 1.2. Subprinciple. The key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and the other state bodies, should be publicly disclosed.
- GAPP 2. Principle. The policy purpose of the SWF should be clearly defined and publicly disclosed.
- GAPP 3. Principle. Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated

with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.

- GAPP 4. Principle. There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations.
  - GAPP 4.1. Subprinciple. The source of SWF funding should be publicly disclosed.
  - GAPP 4.2. Subprinciple. The general approach to withdrawals from the SWF and spending on behalf of the government should be publicly disclosed.
- GAPP 5. Principle. The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.
- GAPP 6. Principle. The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives.
- GAPP 7. Principle. The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations.
- GAPP 8. Principle. The governing body(ies) should act in the best interests of the SWF and have a clear mandate and adequate authority and competency to carry out its functions.
- GAPP 9. Principle. The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities.
- GAPP 10. Principle. The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.
- GAPP 11. Principle. An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.
- GAPP 12. Principle. The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner.
- GAPP 13. Principle. Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff.
- GAPP 14. Principle. Dealing with third parties for the purpose of the SWF's operational management should be based on economic and financial grounds and follow clear rules and procedures.

- GAPP 15. Principle. SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.
- GAPP 16. Principle. The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.
- GAPP 17. Principle. Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.
- GAPP 18. Principle. The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.
  - GAPP 18.1. Subprinciple. The investment policy should guide the SWF's financial risk exposures and the possible use of leverage.
  - GAPP 18.2. Subprinciple. The investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored.
  - GAPP 18.3. Subprinciple. A description of the investment policy of the SWF should be publicly disclosed.
- GAPP 19. Principle. The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy and based on economic and financial grounds.
  - GAPP 19.1. Subprinciple. If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.
  - GAPP 19.2. Subprinciple. The management of an SWF's assets should be consistent with what is generally accepted as sound asset management principles.
- GAPP 20. Principle. The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.
- GAPP 21. Principle. SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.

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

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