What is “Sovereign Wealth” Anyway?

On Definitional Challenges of Dealing with SWFs

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During the last three years, sovereign wealth funds (SWFs) have increasingly found themselves in the spotlight. Their rapid build-up of financial power, increased risk appetite, and highly visible investment activity led to heightened concerns in the West about the potential for undue influence and possible negative impact on domestic industries and financial markets in developed economies.

Much of the anxiety surrounding SWFs had to do with certain salient aspects of their political economy and peculiarities of the global macroeconomic situation that had formed since the turn of the century. The rising power and influence of sovereign investors was directly linked to the massive build-up of macroeconomic and financial imbalances, which were widely perceived as an indication of the shift of economic balance of power from the West to the East. Rising oil prices and increasing trade deficits, viewed with alarm in the West, were feeding directly into the unrelenting asset accumulation by the governments of countries who were not always considered to be allies or friends. On the most fundamental level, existential questions were raised about the legitimacy of a system that allowed governments from foreign countries, with different political systems and agendas, to acquire an increasing share of the free market economies in democratic nations. On a more pragmatic level, concerns typically revolved around three policy areas:

- Lack of transparency about the funds’ objectives, structure and operations;
- Potential for non-commercially motivated investments;
- Lack of reciprocity in treatment of foreign investors.

With the broadening and deepening of the financial crisis in 2008, many of these concerns were eclipsed by the urgent need of many Western governments, banks and corporations to raise money: in a sea-change of attitudes many SWFs were openly courted, their much needed investments actively solicited and warmly welcomed. But the concerns did not go away completely. As the crisis subsides, one can expect a renewed interest among recipient countries in ways of safeguarding their economies and financial systems from the perceived threats – real or imaginary – emanating from SWFs.

Up until now, the focus of the SWF debate has been primarily on economic and policy issues. The international community so far has successfully pre-empted any new major legislation or regulation aimed specifically at these funds, by getting the International Monetary Fund to work with them on formulating and agreeing a set of best practices commonly known as the ‘Santiago Principles.’ But many observers stress that this is just the beginning. How does one measure and evaluate compliance with these principles? Is voluntary self-regulation really sufficient? Or is there a need for new rules and regulations after all?

As the discussion shifts from policy and economics to governance and regulation, we move firmly into the realm of law – legal norms, rules and statutes. But the legal profession is nothing if not careful and precise with language. Therefore, before one even considers any new rules or regulations, it is absolutely imperative to make sure that all of the terms and definitions used to describe and frame the subject matter are clear, unambiguous and universally accepted.

So far, the required clarity and commonality of definitions and terms have been elusive. There does not seem to be a universal agreement about the precise meanings of even the most fundamental of terms in the SWF debate. What exactly is a 'sovereign wealth fund'? What do we mean when we talk about transparency and reciprocity? Are all forms of non-commercially motivated investments always and necessarily bad by definition, or should we be much more nuanced and granular in our analysis?

This paper focuses on the various definitional challenges that come into the SWF debate. The proverbial devil is in the linguistic details. As someone who is widely credited in the industry for coining the term 'sovereign wealth fund', the author felt compelled to make this modest contribution to help frame and facilitate this important discussion on governance and regulation of SWFs.

Sovereign Wealth Funds: What does it mean?

When this author introduced the term 'sovereign wealth funds' more than four years ago, he fully expected to see these institutions grow in number, size and market presence.[1] What he did not expect, however, was the sheer level of controversy and the divergence of opinions surrounding SWFs that emerged in the subsequent debate, often precluding a calm and rational analysis of the benefits and risks presented by these entities. One particular reason for this was the confusion about the term: different commentators meant different things when they talked about SWFs and there was no universally accepted definition.[2] This led to inconsistencies as to which funds were being included in the analysis and why. There was also no consensus on how much money they managed: even the very rough estimates one found in the public domain would vary by up to a trillion US dollars. Growth projections for these funds were even more suspect, based on very arbitrary assumptions and containing huge estimation errors.

Of course, the funds themselves were and continue to be far from homogenous. There is no such thing as a 'typical' sovereign wealth fund, as they differ in structure, governance, policy objectives, risk-return profiles, investment horizons, eligible asset classes and instruments, not to mention levels of transparency and accessibility. In order to make the debate meaningful and the policy response fair, it is important to get the basics right and to develop a shared analytical framework that would be as inclusive and comprehensive as possible, while at the same time being objective and rule-based. It is in this spirit that the author tried to define and describe sovereign wealth funds back in May 2005. Below we revisit the original definition and then contrast it to several alternative approaches. We then consider the current definition of a sovereign wealth fund, as formulated in the Generally Accepted Principles and Practices (GAPP), also know as the 'Santiago Principles.' We consider the pros and cons of this definition and ways of further improving it.

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[1] A. Rozanov. *Who Holds the Wealth of Nations?* Central Banking, Volume 15 No. 4, May 2005. The author also predicted that growth of SWF assets would come not only from commodity exports, but increasingly from carving out and separately managing 'excess' central bank reserves. Since then, we have seen Korea and China go down this path, establishing well-capitalized government investment corporations. We are also witnessing debates about the potential merits and challenges of setting up reserve-funded SWFs in other parts of Asia – from Japan to India.

[2] The most obvious misuse of the term was evident whenever it was wrongly applied to describe the foreign bidders in the CNOOC-Unocal and the Dubai Ports transactions. Equally misguided were references to SWFs when discussing Russia's state-owned resource companies and banks, or China's state lending banks and state-owned enterprises.

The Original Definition[3]

In the original article sovereign wealth funds were defined as sovereign-owned asset pools, which are neither traditional public-pension funds nor reserve assets supporting national currencies. There are three key components to this definition, two of which help us define the broad sovereign wealth fund universe by specifying what these funds are *not*, rather than what they are.

• Sovereign ownership and management;

• Assets which are NOT prudential monetary reserves;

• Assets with are NOT traditional pension funds.

The first component is fairly straightforward. The only point to add is that there are minor exceptions: some sub-sovereign funds are sometimes included on SWF lists. Usually these are the resource-based funds in Alaska, Wyoming and Alberta. As they are policy-driven, funded by excess commodity revenues and owned by local taxpayers, they have more in common with commodity-based sovereign wealth funds than with their sub-sovereign brethren, such as public pension funds.

The second and third points allow us to broaden the universe to cover all sources of sovereign wealth. Central banks and monetary authorities maintain a certain amount of foreign exchange reserves for prudential policy purposes. Such reserves cannot and should not be viewed as sovereign wealth. However, if they end up accumulating considerable excess reserves – substantially above what might reasonably be required for traditional policy purposes – then this excess portion constitutes sovereign wealth, whether or not the authorities choose to acknowledge and manage it as such. It may not represent "net sovereign wealth", insofar as assets are supported by local-currency debt on the liability side of the national balance sheet, but it is sovereign wealth nonetheless.

Some commentators have suggested a separate, if overlapping, category of sovereign pension funds. It may, in fact, be more helpful to distinguish between various national

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[3] This section draws from two previous publications by this author:
A. Rozanov. *Who Holds the Wealth of Nations?* Central Banking, Volume 15 No. 4, May 2005
A. Rozanov. *A Liability-Based Approach to Sovereign Wealth.* Central Banking, Volume 18 No. 3, February 2008

pension schemes in terms of sources and ownership of the underlying pension money. If the main source of the fund is individual and employer contributions on behalf of current and future retirees and if the underlying beneficiaries are effectively the legal owners of the fund, then the entity cannot under any circumstances be considered a sovereign wealth fund. The fact that a sovereign institution happens to be the agent entrusted with managing the fund does not make it meaningfully different from similar sub-sovereign public or private pension plans. If, on the other hand, the source of the money is not pension contributions, but taxes, privatisation proceeds and other payments out of the general budget, and if the fund is effectively owned not by the underlying beneficiaries, but by the taxpayers – then it can legitimately be considered a sovereign wealth fund, which just happens to be managed to meet a particular future pension liability on behalf of the sovereign state.[4]

The above definition defines sovereign wealth in the broadest possible way. As long as the assets in question are sovereign-owned and do not represent either prudential monetary reserves or classic public pension money, they must be sovereign wealth – regardless of whether they are domestic or foreign, equity-like or debt-financed, earmarked for current or future generations, highly liquid and broadly diversified or relatively illiquid and concentrated.

The broad and universal nature of this definition is its biggest strength, but it is also its most serious weakness: while it captures all sovereign investment vehicles in whichever shape or form they might exist, it fails to elucidate the key features and distinct characteristics of the funds in question. In other words, it is just too vague to be applied on its own. Therefore, to make this definition more structured and analytically robust, one needs to augment it with a simple, rule-based classification system to clearly describe the different types of SWFs within its universe. In a subsequent article this author proposed to use liability profiles of sovereign wealth funds as the basis for their classification.[5]

Liability profiling essentially requires asking two questions: first, what are the sources of funds, and second, what are the intended uses of funds? On the former question, a fund can

[4] The importance of this distinction was clearly demonstrated during the current financial crisis. While a government cannot direct a 'genuine' pension fund to invest in any asset for any policy purpose other than fulfilling its fiduciary duty to beneficiaries, it can certainly do so with an SWF. Consider the case of Ireland, where legislation was amended so that the government could direct NPRF to invest almost half of its assets to recapitalize local banks.

[5] A. Rozanov. *A Liability-Based Approach to Sovereign Wealth.* Central Banking, Volume 18 No. 3, February 2008

represent an equity-like claim by the sovereign on the underlying assets. This is typical of commodity-based SWFs, such as those in Norway, Russia and most of the Middle East, which represent net national savings by their respective governments. On the other hand, an SWF may be funded through the issuance of local currency-denominated debt, which is more typical of entities created from excess foreign exchange reserves of respective central banks, with Korea and China being classic examples. On the latter question, one can think of four different types of profiles:

- Contingent liabilities, typical of stabilization funds;
- Fixed future liabilities, typical of national pension reserve funds;
- Mixed or endowment-type liabilities (i.e. perpetual capital with interim outflows);
- Open-ended liabilities (i.e. effectively no contractually attached liabilities).

Contingent liability funds are typically set up to smooth budget revenues and expenditures, sterilize excess liquidity and protect the economy from overheating, “Dutch disease” and boom-bust cycles. Their liabilities are contingent on volatile and unpredictable commodity prices, and as such these funds will typically be managed with objectives similar to central bank reserves: safety, liquidity and return. The focus of these funds is on nominal returns denominated in foreign currency.

Fixed liability funds refer to entities such as France’s Fonds de Réserve pour les Retraites (FRR), Ireland’s National Pension Reserve Fund (NPRF), Australia’s Future Fund and New Zealand’s Superannuation Fund. These SWFs were set up to meet a fixed liability of the sovereign 20 to 30 years out into the future, which happens to be a projected shortfall in the public pension system. These funds resemble a large pension plan with a very young workforce and very few, if any, current retirees. At inception, it is extremely flexible in what it can do on the asset side of the balance sheet, but as it matures, it becomes much more constrained.

Mixed liability funds are essentially endowment-type future generation funds, like the ones in Norway and Russia. Their liabilities are mixed in a sense that they have a contractually fixed obligation to make regular payments into the budget – the so-called “fiscal rule” or “spending rule”, but at the same time they are open-ended funds with no targeted terminal value. They may not have quite the same degree of freedom on the asset side compared to a newly launched fixed liability fund, but as time goes by, they maintain their relatively high degree of freedom, while the fixed liability fund is increasingly constrained.

Finally, open-ended liability funds are essentially the various investment authorities and government investment corporations. These funds do not have readily identifiable or contractually defined obligations: they have neither formal spending rules nor liability shortfall targets. In theory, these funds have the longest investment horizon, the maximum capacity for risk taking, and the broadest possible latitude and degree of freedom on the asset side of their balance sheets. Quite simply, they can afford to do with their money whatever they want.

To summarize, the main benefits of the above approach to defining and describing sovereign wealth funds are two-fold. First, it allows for the broadest possible demarcation of the SWF universe – there is no risk of leaving any fund behind simply because the definition happened to be too narrow. Secondly, by introducing a classification system based on fund liability profiles, the universe can be broken down into logical and internally consistent segments, which makes the analysis of SWFs tractable.[6] The downside, however, is that this approach to defining sovereign wealth funds is 'messy', in that it does not produce a short, snappy, universally applicable and simple-to-use definition. As we shall see in the examples below, alternative approaches to defining SWFs tried to achieve better precision at the expense of narrowing the universe.

Alternative Definitions

In a speech in June 2007, Clay Lowery, in his capacity as Acting Under Secretary for International Affairs at the US Treasury, offered the following definition of a sovereign wealth fund:

"I will use the term [sovereign wealth fund] to mean a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from official reserves."[7]

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[6] For details of such two-dimensional classification – by sources and uses of funds – and the impact of respective liability profiles on investment preferences of SWFs, see the table in the appendix.

[7] Lowery, C. Sovereign Wealth Funds and the International Financial System, remarks at the Federal Reserve Bank of San Francisco's Conference on the Asian Financial Crisis Revisited, 21 June 2007.

While this definition is reasonably succinct and precise, it is open to interpretation and manipulation. For example, a fund like Temasek Holdings of Singapore is not funded by foreign exchange assets, so technically – according to this definition – it is not an SWF. Or consider Korea Investment Corporation (KIC): while operationally it is separate and independent from the central bank, the latter maintains a call option on the reserve assets it contributed to KIC at the time of its formation in 2005. So technically, one could argue that the bulk of KIC's assets are not entirely separate from the Bank of Korea's official reserves and hence may not constitute sovereign wealth according to this definition.

In October 2007, the IMF made its first attempt to define sovereign wealth funds in the Global Financial Stability Report:

"SWFs can generally be defined as special investment funds created or owned by governments to hold foreign assets for long-term purposes."[8]

This is an improvement on the US Treasury's definition, in that separation from official reserves is no longer a limiting condition. However, the focus on foreign assets potentially leaves out any sovereign fund that happens to be invested exclusively or primarily in local markets. However, it is well known that during the first two decades of its existence Singapore's Temasek invested almost exclusively in domestic assets. Many sovereign funds in Asia and the Middle East continue to do so today.

Stephen Jen, a widely quoted financial analyst and a knowledgeable authority on SWFs, offered this take on what constitutes a sovereign wealth fund in one of his research reports:

"In my view, a SWF needs to have five characteristics:

1. *Sovereign;*
2. *High foreign currency exposure;*
3. *No explicit liabilities;*
4. *High risk tolerance;*
5. *Long investment horizon."* [9]

[8] *Global Financial Stability Report*, International Monetary Fund, October 2007 (p. 45)
[9] S. Jen. *The Definition of a Sovereign Wealth Fund*, Morgan Stanley research, 25 October 2007

While this definition is very precise, it severely limits the universe of sovereign funds by excluding all conservatively run stabilization funds with low risk tolerance and short investment horizon and all sovereign funds that are invested primarily in domestic assets. It also effectively excludes all national pension reserve funds, since they have explicit future liabilities.

In and of themselves, none of these limitations necessarily invalidate the proposed alternative definitions. As long as the analysts using the terms are fully aware of these limitations and make sure to choose the correct interpretation for their needs, such differences need not present a problem. However, once we move into the realm of legal definitions and statutes, one has to be extra careful in how one defines a sovereign wealth fund.

The IWG-SWF Definition (a.k.a. the 'Santiago Principles' definition)

In October 2008, a group of sovereign wealth funds, working closely with the IMF, formulated and agreed an SWF definition which then formed the basis of the 'Santiago Principles' and related official documents. This has now become the consensus definition, for at least two reasons. First, it was developed and affirmed by the International Working Group of Sovereign Wealth Funds (IWG-SWF): in other words, it was produced by a forum of SWFs working on a set of principles for SWFs. It cannot get more genuine and authoritative than this. Secondly, the definition strikes a reasonably good balance between precision and breadth. It also explicitly offers a fund classification by sources of capital.

"SWFs are defined as special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports."[10]

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[10] Sovereign Wealth Funds: Generally Accepted Principles and Practices – "Santiago Principles." *Appendix I. Defining Sovereign Wealth Funds.* October 2008

The ‘Santiago Principles’ further provide three key specifications that must be in place for a fund to be legitimately classified as an SWF.

“Three key elements define an SWF:

- *Ownership: SWFs are owned by the general government, which includes both central government and sub-national governments.*
- *Investments: The investment strategies include investments in foreign financial assets, so it excludes those funds that solely invest in domestic assets.*
- *Purposes and Objectives: Established by the general government for macroeconomic purposes, SWFs are created to invest government funds to achieve financial objectives, and (may) have liabilities that are only broadly defined, thus allowing SWFs to employ a wide range of investment strategies with a medium- to long-term timescale. SWFs are created to serve a different objective than, for example, reserve portfolios held only for traditional balance of payments purposes. While SWFs may include reserve assets, the intention is not to regard all reserve assets as SWFs.”*[11]

Interestingly, the ‘Santiago Principles’ also specify which market participants should *not* be classified as SWFs:

“This definition excludes, inter alia, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, operations of state-owned enterprises in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals.”[12]

This definition provides a clear and solid framework for any formal discussion of sovereign wealth funds. However, there are at least three specific groups of sovereign investors who are not covered by this approach, whose activities may – potentially – present similar policy and regulatory challenges that the SWF debate is trying to address.

The first group are sovereign funds that are currently outside the scope of the formal IWG-SWF definition simply because they invest exclusively or primarily in domestic markets.[13]

[11] Ibid.
[12] Ibid.
[13] Of this type of funds, only Singapore’s Temasek has been classified as an SWF within the meaning of the ‘Santiago Principles.’ While more than 70% of its portfolio is currently invested overseas, its international

Many such entities have been set up in developing countries around the world: Khazanah Nasional Berhad in Malaysia, State Capital Investment Corporation in Vietnam, Samruk-Kazyna National Wealth Fund in Kazakhstan, Mumtalakat Holding Company in Bahrain, Mubadala Development Company in Abu Dhabi, Oman Investment Fund, to name just a few. Some of these sovereign funds are already active investors overseas, while others can be expected to follow this trend in the future. The explicit exclusion of such funds from the 'Santiago Principles' framework looks artificial.

The second group are central banks and monetary authorities with excess foreign exchange reserves. The core of these assets will be managed as liquidity, not sovereign wealth, to facilitate any balance-of-payments problems and to effect currency interventions. However, there is a strong possibility that the excess portion of reserves, however defined and measured, will be increasingly viewed and managed as sovereign wealth. Indeed, central banks and monetary authorities in Saudi Arabia, Hong Kong, Switzerland and some other countries have already been managing a portion of their overall assets along these lines.[14]

The third group are investment funds owned by sovereign rulers, primarily in the Middle East. They may run into perception problems when investing overseas and might therefore benefit by being included in the category of SWFs. While in theory the 'Santiago Principles' are correct to explicitly exclude assets managed for the benefit of individuals, in practice the line between sovereign wealth and private wealth of the sovereign can be quite blurry.[15]

If policymakers and regulators around the world considering SWF-related matters want to avoid any misunderstandings and unintentional mistakes, let alone potential regulatory arbitrage or intentional abuse of the system, they would do well to consider working with the SWF community on improving and further sharpening the focus and scope of definitions and qualifications contained in the 'Santiago Principles.'

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presence is a relatively recent phenomenon for this fund. Temasek was originally established and continued to operate for at least two decades as a sovereign fund investing exclusively in domestic assets.

[14] A. Newton, senior political analyst at Nomura International, calls such central banks 'Diversified Monetary Authorities' or DMAs, emphasizing the return-oriented, broadly diversified, multi-asset-class nature of their portfolios, not that dissimilar in their philosophy and structure to SWFs.

[15] A classic example is Dubai International Capital (DIC), the investment vehicle managing private assets of the emirate's ruler, Sheikh Mohammed bin Rashid Al Maktoum. Initially, its Chief Executive Sameer Al-Ansari emphatically protested every time DIC was labelled an SWF, but many commentators in the West remained sceptical: in November 2007, the Times of London wryly noted that there was "not much difference between a sovereign wealth fund and the sovereign's wealth fund." In an interview in January 2009, when asked if SWFs such as DIC (sic!) were still planning to invest, the CEO replied without challenging the interviewer's explicit assumption of DIC being an SWF.

Specifically, they may want to suggest that the recently established International Forum of Sovereign Wealth Funds[16], together with the IMF, consider inviting the first group of institutions to sign up to the Principles and join the SWF community formally. As for the other two groups, it may be constructive to establish ongoing consultations, with a view of potentially inviting these entities to participate in the work of the Forum as 'affiliated members.'

Definitional Challenges with Transparency[17]

The biggest issue that most policymakers and commentators seem to take with many sovereign wealth funds is their perceived lack of transparency. Coupled with the recent string of high-profile private-equity-style transactions, this has led to increased pressure on SWFs to become more open and transparent and to subscribe to a code of best practices. In fact, this push for transparency was the major impetus behind the 'Santiago Principles' initiative. Given the increased size and market presence of SWFs, and their expected growth trajectory, it is not surprising that many countries on the receiving end of sovereign wealth flows feel the need to understand and get more comfortable with these funds. A meaningful increase in transparency and the amount and quality of information disclosed by SWFs will go a long way towards accommodating this need. However, the issue of transparency and public disclosure is much more nuanced and complex than may appear at first glance.

While there is considerable room for SWFs to increase their overall levels of transparency, utmost care must be exercised when determining exactly what information can and should be disclosed. When the political establishment in the West demands more transparency from the SWF community, the latter should respond by requesting that these demands be couched in much more detailed and concrete terms. Exactly what information would be required and why? At what level of detail? What would be the frequency and timing of such disclosure? Who are the intended recipients of this information and how do they propose to use it?

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[16] For more information on the Forum, see the contents of the Kuwait Declaration at the following link: http://www.iwg-swf.org/mis/kuwaitdec.htm

[17] This section draws from the following publication by this author: A. Rozanov, "The Transparency of Sovereign Wealth Funds," *The Gulf Region: a New Hub of Global Financial Power*. Chatham House. 2008

Once the discussion gets down to this level of detail, some interesting – and much more fundamental – questions will emerge, starting from the most basic one: how exactly should we define transparency when dealing with SWFs? Can there be one common set of rules that would equally apply to funds which are very different in nature? And what happens if the level of transparency of a particular fund is perfectly adequate for domestic purposes, but is found lacking by international standards? Can such a fund "square the circle" by opening up to international organisations and national regulators in recipient countries on a confidential basis, thus avoiding full public disclosure?

The SWF debate is happening at a time when regulators and market commentators are pondering very similar issues as they relate to other parts of the financial system, namely, private equity and hedge funds. There are indeed some interesting parallels. Consider, for example, the following quote from George Soros's testimony to the US Congress back in 1994, in which he deliberates on the question of transparency and disclosure by hedge funds:

"I should like to draw a distinction between supervision and regulation. I am for maximum supervision and minimum regulation. I should also like to draw a distinction between information gathering and disclosure. I think the authorities need a lot more information than the general public. In fact, information we are legally obliged to disclose has, on occasion, caused unwarranted price movements."[18]

These two distinctions – between supervision and regulation and between information gathering and disclosure – go to the heart of the matter not only in the hedge fund debate, but also with regard to SWF transparency. There are two reasons for this.

First, each SWF operates in its own country under a set of rules which are considered optimal by domestic standards. Whatever level of transparency and disclosure these funds maintain vis-à-vis local constituents is a matter of sovereign choice in each individual country. However, once these funds expand their investment activity overseas, they may face legitimate concerns from international organisations and national regulators in recipient countries. Arguably, all SWFs would be sympathetic and sensitive to such

[18] George Soros, "Hedge Funds and Dynamic Hedging", Evaluating and Implementing Hedge Fund Strategies, 3rd edition, Ronald Lake (editor), Chapter 35, p. 426.

concerns and would be prepared to engage and work with their counterparts in recipient countries in a meaningful and productive way. It is when increased transparency is automatically equated to increased disclosure of information to the general public – above and beyond what may be considered optimal for domestic purposes – that these funds might find it politically difficult to accommodate such demands.

Secondly, increased transparency and public disclosure may carry with it a real economic cost. This is what George Soros alluded to when he referred to 'unwarranted price movements'. Whatever one might think of hedge funds and their role in the financial system, the one sin of which nobody can accuse them is harbouring a political agenda or being motivated by non-economic considerations in their investments. In terms of their goals and objectives, hedge funds are the ultimate money-making machines: seeking maximum return with minimum risk, preferably within the shortest possible time horizon. If these institutions find it advantageous to operate with minimum levels of transparency and public disclosure, then surely they do it for no other reason than to maximise profits and protect their economic interests.

Of course, SWFs are different from hedge funds in many respects, and one should be careful not to draw too many direct parallels when it comes to formulating a policy response. But the point still stands: if some SWFs appear reluctant to embrace full transparency and public disclosure, it may have less to do with their political agendas or any strategic considerations, and more to do with legitimate economic and financial concerns.

Some people might argue that what is natural and appropriate for a private sector agent may not be the case for a public institution: if a fund is managed by the government in the interests of the general public, then surely full transparency is always and unequivocally a good thing. But consider the following counter-arguments.

First of all, sovereign wealth funds are typically set up to provide better investment returns, broader diversification of national wealth and more efficient management of public finances. In fact, it is one of the key tenets espoused by the Western critics of SWFs, who advocate – in no uncertain terms – that any sovereign fund should be run on purely commercial terms and market-based principles. If that indeed is the case, then it would be perfectly natural and appropriate to apply to SWFs the same principles that govern investment behaviour of private sector agents.

Secondly, even in the non-profit-orientated part of the official sector transparency can sometimes be harmful or even potentially lethal. Consider the Northern Rock debacle of 2007, which produced the first run on a British bank in 140 years. While the lessons of this incident are still being digested by both the authorities and the general public, one particular point made by Mervyn King, the Governor of the Bank of England, in his statement to the House of Commons Treasury Select Committee is especially relevant to this discussion. Specifically, he said that he would have preferred to offer covert aid to the troubled bank. However, according to Mr. King, the EU Market Abuse Directive prevented the Bank from doing so, as it would have required public disclosure of any such covert support.[19] Instead, the authorities were forced to act overtly, which sparked worries about Northern Rock's solvency and led customers to line up to withdraw deposits, thus precipitating the crisis and arguably increasing the eventual fiscal costs to the taxpayer.

The lesson contained herein for all proponents of more transparency and tighter regulations in financial markets is that sometimes it may be more efficient and beneficial to all parties involved to have less transparency. Therefore, in designing regulations and putting together codes of best practice for SWFs, it is important to recognise that increased transparency may come at a cost, both to the funds themselves and to the financial system overall. At the very least, this calls for thinking long and hard about the exact definition and scope of the term "transparency" when applied to sovereign wealth funds.

Definitional Challenges with Non-Commerciality and Reciprocity

The other two typical concerns surrounding SWFs are their potential for non-commercially motivated behaviour and lack of reciprocity in foreign investment regimes. As with transparency, the effectiveness of any regulatory response will depend in large part on proper understanding of definitional nuances and the appropriate use of both terms.

Non-commercial motivation – or 'extra-financial' considerations – are part and parcel of the investment management landscape. This is nothing new: we have lived with many examples of such investment behaviour for decades. For instance, trading activity of central

[19] "Mervyn King Attacked over Northern Rock Rescue," Times Online, 20 September 2007

banks and monetary authorities intervening in the foreign exchange markets has nothing to do with profit expectations or narrowly defined financial risk management. In fact, many active currency managers in the private sector openly cite such interventions as one of the many sources of alpha available to a profit-maximising agent in FX markets. Clearly, when central bankers trade in financial markets in such instances, they are making financial decisions based on non-commercial motivation related to their policy objectives.

In a similar vein, long-term institutional investors who practice 'responsible investment' or apply ethical screening, which may or may not be motivated by religious beliefs, engage in a non-commercially motivated investment practice. Some of the largest public and private pension plans, notably in the United States of America, have been known to divest from entire stock markets based on considerations of openly political nature, such as lack of democratic government or deficiencies in labour laws, for example.

How can one seek to limit, let alone outlaw, non-commercially motivated behaviour by SWFs without applying the same principle to other institutional investors? Surely, such actions would go against the key principle of equitable and non-discriminatory treatment of all investors? But even more fundamentally, non-commercially motivated investments in the majority of cases can actually be good for financial markets, because the idiosyncrasies introduced by such behaviour increase the diversity and heterogeneity of markets.

All policymakers and regulators will agree that any attribute which helps deepen and enhance the liquidity of financial markets should be considered highly desirable. Market liquidity, in turn, is a function of three attributes: size (market capitalization), activity (market turnover) and diversity (market agents with different risk / return preferences, investment horizons, liquidity needs, etc.). Any extra-financial motives that add to this diversity will actually strengthen the market, not weaken it.[20]

One of the key issues here is the exact definition of "non-commerciality": it may just be too broad in scope to be helpful in applying to SWF regulation (or self-regulation). Perhaps the best way forward would be to replace such expressions as "non-commercially motivated

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[20] There are two legitimate exceptions to this rule: genuine national security concerns and market efficiency considerations in very small and illiquid segments of global markets. As long as neither of these exceptional concerns is triggered, policymakers and legislatures would do well to preserve and nurture helpful idiosyncrasies originating from non-commercially motivated investment preferences.

investment" or "extra-financial considerations" with a much narrower and more precise term. Perhaps narrowing it down to "political motivation" would be a good start, although this would not resolve the dilemma arising from the above mentioned actions of US pension plans divesting from overseas markets for political reasons. Maybe an even narrower term like "geopolitical motivation" would be more appropriate, but it may still be a challenge to come up with a universally acceptable definition for such a nebulous notion. Whatever the case may be, one thing is certain: the legal community needs to address the definitional challenges before it can even begin to proceed to legislate and regulate SWFs.

Reciprocity is a similarly difficult concept to define precisely. Does it mean an asset swap of roughly equivalent strategic and market value? Is it a quid-pro-quo opening up of specific sectors of the economy based on bilateral agreements? Or does it mean signing up to a multilateral agreement, which sets out just the basic rules and principles for achieving a level regulatory playing field for all investors? In the public debate about reciprocity one can find references to all three different interpretations.

Positions of policymakers and commentators in recipient countries are also starkly different. The US and the UK have taken a fairly relaxed approach to reciprocity. Even as they insist on resolving matters of transparency and non-commerciality, their position on reciprocity is that while it would help, it should not be made a condition to allow SWF investments in their economies. This view was clearly articulated in the article "Public Footprints in Private Markets" by Robert Kimmitt, then Deputy Secretary of the US Treasury: "It is in the United States' interest to be open to market-driven investments – from both private and sovereign entities – even if other countries are not."[21]

But while such open and relaxed position is firmly supported by sound economic arguments, politically it may be very difficult to sell to politicians and the general public. A special report on the EU policy response to sovereign investments published by the Centre for European Reform (CER) provides a very good background on the state of the debate in continental Europe:

"Most SWFs are located in countries that themselves have rather restrictive investment environments. The United Arab Emirates, for example, confine foreign companies to minority shareholdings in all sectors of the economy. China strictly controls foreign

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

involvements in many industries, through a plethora of laws and regulations or pure political obstruction. And Russia in 2008 passed a law that limits foreign investment in 42 strategic sectors, in some cases to shares as low as 10-25 per cent.

Many Europeans ask why they should welcome investments from Asian, Arab or former Soviet countries if European companies do not enjoy the same welcome there. Demands for equal access, or reciprocity, have therefore become an integral part of the debate about SWFs… A report on SWFs commissioned by the French government in 2008 states [that] European regulation on foreign investment should be founded on the principle of reciprocity."[22]

The CER publication then proceeds to argue that such hard conditioning of SWF access on reciprocity can be very difficult to define, implement and measure; that it may create more problems than it would resolve; and that a logical and internally consistent view on reciprocity needs to be formed within the EU before it can be applied meaningfully outside the Union. Unlike policy discussions around transparency and non-commerciality, there doesn't seem to be much consensus among the recipient nations in their debate about reciprocity. However, in many respects the root cause of this disagreement might be similar to the policy risks associated with the transparency and non-commerciality: the lack of clear and universally accepted definition of what exactly is meant by these terms can lead to policy mistakes in all three cases.

Dealing with sovereign wealth funds is clearly a challenging task for the current generation of politicians, policymakers and market commentators. The current financial crisis, which has shaken the logic and tested some of the core assumptions on which we base our understanding of financial markets, has not helped. Amidst genuine concerns and worries there are also many irrational fears and prejudices. In order to design and implement a well thought out, responsible and equitable policy response, one needs to be very careful with many aspects of such response, not least the quality and meaning of the legal language. In this context, it is imperative that fundamental terms describing sovereign wealth funds and their activity as it relates to transparency, non-commerciality and reciprocity are defined in a way that makes them clear, unambiguous and universally accepted.

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[22] K. Barysch, S. Tilford and P. Whyte. "State, Money and Rules: An EU Policy for Sovereign Investments." *Centre for European Reform Essays*. December 2008.

Appendix. Theoretical impact of liability profiles on investment preferences and styles

	DEBT FUNDED	EQUITY-LIKE
CONTINGENT	*(e.g. excess monetary reserves)*	*(e.g. stabilization fund)*
	Return target: nominal, in foreign currency	Return target: nominal, in foreign currency
	Definition of risk: absolute loss	Definition of risk: absolute loss
	Risk-taking capacity: lowest	Risk-taking capacity: lowest
	Liquidity: highest (user of liquidity)	Liquidity: highest (user of liquidity)
	Investment horizon: very short	Investment horizon: very short
	Investment constraints: policy-driven	Investment constraints: policy-driven
FIXED	*(e.g. national reserve fund in a deficit country)*	*(e.g. national reserve fund in a surplus country)*
	Return target: real, in domestic currency	Return target: real, in domestic currency
	Secondary return target: beat the funding rate	
	Risk 1: failure to meet target liability	Risk: failure to meet target liability
	Risk 2: underperforming nominal funding rate	
	Risk-taking capacity: high, but time-decaying	Risk-taking capacity: high, but time-decaying
	Liquidity: low (liquidity provider), but time-decaying	Liquidity: low (liquidity provider), but time-decaying
	Investment horizon: long, but time-decaying	Investment horizon: long, but time-decaying
	Investment constraints: funding and market-based	Investment constraints: market-based
MIXED	*(e.g. future generation fund in a deficit country)*	*(e.g. future generation fund in a surplus country)*
	Return target: real, in domestic currency	Return target: real, in domestic currency
	Secondary return target: beat the funding rate	
	Risk 1: failure to maintain target spending rate	Risk 1: failure to maintain target spending rate
	Risk 2: failure to preserve capital in real terms	Risk 2: failure to preserve capital in real terms
	Risk 3: underperforming nominal funding rate	
	Risk-taking capacity: relatively high and constant	Risk-taking capacity: relatively high and constant
	Liquidity: low to medium (liquidity provider); constant	Liquidity: low to medium (liquidity provider); constant
	Investment horizon: long, effectively perpetuity	Investment horizon: long, effectively perpetuity
	Investment constraints: funding and market-based	Investment constraints: market-based
OPEN-ENDED	*(e.g. reserve-funded investment corporation)*	*(e.g. commodity export-funded investment authority)*
	Return target: real, in domestic currency	Return target: real, in domestic currency
	Secondary return target: beat the funding rate	
	Risk 1: failure to meet stated objective	Risk: failure to meet stated objective
	Risk 2: underperforming nominal funding rate	
	Risk-taking capacity: relatively high and constant	Risk-taking capacity: very high and constant
	Liquidity: low to medium (liquidity provider); constant	Liquidity: low (liquidity provider); constant
	Investment horizon: longest, effectively perpetuity	Investment horizon: longest, effectively perpetuity
	Investment constraints: funding and market-based	Investment constraints: market-based