

## **Sovereign Wealth and Governance in International Finance**

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### **I. Introduction: Unfinished Business**

The financial crisis has created an opening for reform in national financial regulation and global economic governance on a scale not seen in a generation. The G-20 has seamlessly edged out the G-7 as the indispensable forum for economic policy coordination. Long-defeated ideas, from regulating derivatives to a global reserve currency, are surfacing in polite conversation and even the occasional communiqué. The International Monetary Fund (IMF) struggles to reinvent itself after a near-death experience and fight off competition from new regulatory fora and regional power groupings. Yet at the heart of reform is an unfinished task that preoccupied those who designed the Bretton Woods system: getting countries with more capital than they can use today, and those with not enough, to cooperate to prevent the next Great Depression.

Both John Maynard Keynes and Harry Dexter White, the leading architects of the post-World War II economic order, realized that stability and growth depended on getting both deficit (debtor) and surplus (creditor) countries to act in the common interest; “symmetry” of obligations was the original ideal.<sup>1</sup> Keynes advocated an international institution with the power to print money, force deficit countries to adjust, but also to tax countries that accumulated excess reserves, pressuring them to revalue.<sup>2</sup> Because everyone expected the United States to be the biggest creditor of all, White and other U.S. negotiators opposed aspects of the Keynes proposal that would discipline surplus

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<sup>1</sup> JOSEPH GOLD, *LEGAL AND INSTITUTIONAL ASPECTS OF THE INTERNATIONAL MONETARY SYSTEM* 1981), at 259-260.

<sup>2</sup> *Id.* at 260. According to Keynes, “[t]he object is that the creditor should not be allowed to remain entirely passive. For if he is, and intolerably heavy task may be laid on the debtor country, which is already for that very reason in the weaker position.” J. M. Keynes, *quoted in Id.*

countries. The result was Articles of Agreement that empowered the IMF to require deficit countries to adjust in exchange for balance-of-payments support, even as it could only reprimand the egregious capital hoarder.<sup>3</sup>

Sixty years later, the United States was the world's biggest debtor. As states in the global financial center spent at a growing pace, those that had long been on the periphery—such as China, Russia, and the oil-producing states in the Middle East—were accumulating trillions of dollars from export revenues and keeping down the value of their currencies. The accumulation initially took the form of central bank purchases of U.S. Treasury and agency securities, but then began to shift on the margins to riskier, less liquid investments, such as U.S. and European equities, and infrastructure and extraction assets in Africa. Portfolio investments that were part of this trend increasingly came from separately-managed vehicles called sovereign wealth funds (SWFs).

This Article explores the role that SWFs play in the current reform moment. I argue that SWFs, which began as an artificial, externally imposed category in search of a coherent definition, remain surprisingly salient because they so starkly embody today's particular incarnation of the surplus-deficit country dilemma described by Keynes and others. In contrast to the world in 1944, many of today's capital exporting states are poor, and most are relative newcomers to governing international finance, while the world's biggest debtor continues to dominate international institutions and issue the leading reserve currency. Yet SWFs also strike a cord with the public in their home and investment host states, because they reflect domestic anxieties about financial globalization in both populations. Moreover, recent initiatives to diffuse controversy over SWFs mirror the evolving legal and institutional regime to govern international finance: stressing informal coordination, sharing expertise, borrowing private governance tools, and eschewing formal treaties and institutions in favor of norms and fora. Studying SWFs in the different settings where they operate and through the eyes of their disparate constituencies—at home, in the host countries, in the financial markets and in the public

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<sup>3</sup> Id.; BARRY J. EICHENGREEN, *GOLDEN FETTERS: THE GOLD STANDARD AND THE GREAT DEPRESSION, 1919-1939* (1995), at 398.

international realm—should reveal much about the state of international financial integration, and the shape of international law and institutions to come.

After this Introduction, Part II of the Article describes the political context for the emergence of the SWF phenomenon. The term originated in the investment host states and, until recently, was almost entirely a reflection of their take on financial globalization. Part III focuses on the efforts to define SWFs, and argues that these are best understood as expressions of their proponents' views on governing cross-border capital flows. Part IV considers the competing demands on SWFs among their different constituents, and groups them along four dimensions of accountability. Part V describes recent efforts to address these demands at the international level. Part VI concludes with implications for governing global finance.

## **II. Political Context: Between Fears**

The term “sovereign wealth fund” first appeared in a central banking journal in 2005,<sup>4</sup> roughly midway between the attacks of September 11, 2001 and the financial collapse of September 2008. Introduced to describe a shift in reserve management strategies among surplus countries, the phrase entered mainstream vocabulary as a rolling reflection of host country fears: the fear of foreign invasion, the fear of state control, the fear of indebtedness, and the fear of big money.

Perhaps the most curious thing about this turn of events was that few of the early public anxieties about SWFs were triggered by entities now defined as SWFs. In the United States, the SWF debate erupted on the heels of mishandled attempts by state-owned enterprises (SOEs), operating companies from the Persian Gulf and China, to buy into U.S. oil and port facilities, which raised the specter of strategic takeover by un-democratic, anti-market, and vaguely hostile states.<sup>5</sup> Media reports of the Dubai Ports

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<sup>4</sup> *From Reserves to Sovereign Wealth Management*, 15 *Central Banking* \_\_ (Feb. 2005); Andrew Rozanov, *Who Holds the Wealth of Nations?* 15 *Central Banking* \_\_ (May 2005)

<sup>5</sup> Press Release, Office of Pub. Affairs, U.S. Dep't of the Treasury, CFIUS and the Protection of the National Security in the Dubai Ports World Bid for Port Operations (Feb. 24, 2006), *available at*

bid highlighted the fact that two of the 9/11 hijackers came from the United Arab Emirates.<sup>6</sup> And even those who said there was no reason to oppose CNOOC's acquisition of Unocal noted China's state-run economy and its status as the United States' preeminent creditor.<sup>7</sup> In the United States and Europe, SWF controversy also coincided with an inflection of concern with "private pools of capital" (hedge funds and private equity).<sup>8</sup> These were large, fast-growing privately owned investment vehicles that often had short time horizons, profited from market volatility,<sup>9</sup> and took an increasingly active role in managing their investments, yet seemed impervious to regulation.

Confronted with the public outcry, SWFs and their supporters seemed flummoxed. From their perspective, host country opponents were being willfully ignorant at best, protectionist and bigoted at worst; regardless, they "had the wrong guy." To be sure, SWFs were large and state-owned. But SWFs, unlike SOEs, refrained from active management of their targets. In contrast to hedge funds and private equity, SWFs were "patient capital". Their long investment horizons promised to stabilize volatile markets even where their strategies were more aggressive than those of traditional reserve managers.<sup>10</sup> By 2008, opponents of sovereign investment also stood accused of biting

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<http://www.treas.gov/press/releases/js4071.htm>. See also Katharina Pistor, *Global Network Finance* 2-8 (Am. Law & Econ. Ass'n. 18th Annual Meeting, Working Paper No. 54, 2008), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=2611&context=alea>.

<sup>6</sup> *Documents Show Conditions for Dubai Deal*, MSNBC (Feb. 22, 2006), at <http://www.msnbc.msn.com/id/11494815>.

<sup>7</sup> *Is CNOOC's Bid for Unocal a Threat to America?* Knowledge @ Wharton (Nov. 21, 2005) at <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1240>.

<sup>8</sup> *President's Working Group Releases Common Approach to Private Pools of Capital*, U.S. Treasury Press Release, Feb. 22, 2007, at <http://www.ustreas.gov/press/releases/hp272.htm>; Ashley Sieger, *Germany Pledges Code to Regulate Hedge Fund 'Locusts'*, THE GUARDIAN, May 19, 2007, at <http://www.guardian.co.uk/business/2007/may/19/germany.internationalnews>.

<sup>9</sup> *Id.* See also *Interview with Rob Johnson*, Frontline, "The Crash" (1999), at <http://www.pbs.org/wgbh/pages/frontline/shows/crash/interviews/johnson.html> (describing "currency attacks" that drew attention to hedge fund investment strategies in the late 1990s).

<sup>10</sup> See e.g., Mohamed A. El-Erian, *Towards a Better Understanding of Sovereign Wealth Funds*, Presentation at the Peterson Institute for International Economics 7, Oct. 19, 2007, at <http://www.petersoninstitute.org/publications/papers/el-erian-on-truman.pdf>. SWFs' long time horizons also distinguish them from traditional central bank reserve managers, for whom liquidity is paramount.

the hand that fed them: SWFs were among the scarce few sources of funding for the tottering financial sector in New York and London.<sup>11</sup>

Despite such protests, SWFs struck a raw nerve in host states. Chameleon-like, they had the capacity to reflect all the scary news of the day: the color-coded security alerts, Wall Street's desperate hunt for capital, the failure of financial regulation, the inefficacy of 20<sup>th</sup> century international institutions, and massive concentration of wealth in the hands of governments that the hosts had long regarded with deep suspicion. Calls for foreign investment restrictions came naturally, framed in terms of sovereignty and national security,<sup>12</sup> in tandem with the equally predictable protests against protectionism.<sup>13</sup> Two years later, policy middle ground was well-settled. In the United States, a new law made minor tweaks to the open investment framework established in the 1980s,<sup>14</sup> while officials preached transparency and made SWFs promise to act commercially.<sup>15</sup> Other hosts went through similar debates.<sup>16</sup>

Law reform did not lay controversy to rest. SWFs turned out to be bigger than the national security-open investment quarrel that had trapped them, and seemed to fit uneasily in the existing regulatory paradigm, premised on the existence of an ascertainable boundary between public and private activity. The funds and the debate they begat reflected the power shifts and culture clashes of financial integration, which,

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<sup>11</sup> See e.g., Steven Schwartzman, *Reject Sovereign Wealth Funds at Your Peril*, Fin. Times (London), Jun. 20, 2008, available at <http://www.ft.com/cms/s/0/405b8888-3dff-11dd-b16d-0000779fd2ac.html>.

<sup>12</sup> Evan Bayh, Time for Sovereign Wealth Rules, WALL STREET J., Feb. 13, 2008, at A26.

<sup>13</sup> DAVID M. MARCHICK & MATTHEW J. SLAUGHTER, COUNCIL ON FOREIGN RELATIONS, GLOBAL FDI POLICY: CORRECTING A PROTECTIONIST DRIFT 10 (2008), available at <http://www.cfr.org/publication/16503/>.

<sup>14</sup> Foreign Investment and National Security Act of 2007 ("FINSA"), Pub. L. No. 110-49, 121 Stat. 246 (2007) (amending § 721 of the Defense Production Act of 1950 ("DPA")). The amendment included stricter requirements for state-controlled investments.

<sup>15</sup> See e.g., Robert M. Kimmitt, *Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy*, FOREIGN AFFAIRS (Jan./Feb. 2008), available at <http://www.foreignaffairs.org/20080101faessay87109/robert-m-kimmitt/public-footprints-in-private-markets.html> [hereinafter "Kimmitt *Public Footprints*"]; Clay Lowery, U.S. Dept. of the Treasury Assistant Secretary for International Affairs, *The Role of Sovereign Wealth Funds in the Global Economy*, Remarks at Barclays Capital's 12th Annual Global Inflation-Linked Conference (Feb. 12, 2008), available at <http://www.ustreas.gov/press/releases/hp836.htm>; U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS, U.S. FACT SHEET: FOURTH CABINET-LEVEL MEETING OF THE U.S.-CHINA STRATEGIC ECONOMIC DIALOGUE 2-3 (June 18, 2008), available at <http://www.treas.gov/press/releases/reports/sedusfactsheet.pdf>.

<sup>16</sup> MARCHICK & SLAUGHTER, *supra* note 13, at 7-12.

thanks to capital flow reversals, no longer looked like a simple exercise to reshape the world in the Anglo-American image. And they both embodied, and recast, the old conundrum of disciplining surplus states, with the U.S.-designed and dominated system lacking robust tools to pursue the changed U.S. interests.

Political scientists were among the first to highlight the SWF phenomenon as a step in the erosion of the boundary between states and markets, and the further erosion of national boundaries in financial flows and their regulation.<sup>17</sup> Governing transnational hybrids was becoming the central organizing challenge of financial globalization.<sup>18</sup> SWFs were a perfect fit for the emerging regulatory paradigm; they stood at the intersection of public and private, domestic and external demands for accountability. On the one hand, they were state entities, accountable both to the domestic and the international public through traditional channels of public law. On the other hand, to the extent SWFs committed to act as private market actors, they were accountable to stakeholders at home and abroad under contract and corporate law, and subject themselves to market and institutional regulation. In sum, the SWFs' hybrid character had political, legal and institutional implications at home and abroad. But before it could be regulated, the hybrid had to be defined.

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<sup>17</sup> See, e.g., Giselle Datz, *Governments as Market Players: New Forms of State Competition, Adaptation and Innovation in the Global Economy* (Oct. 2007) (unpublished manuscript, on file with author); Eric Helleiner & Troy Lundblad, *States Markets and Sovereign Wealth Funds*, GERMAN POLICY STUDIES (Fall 2008). [Cerny on organized capital.] These articles continue a long-running debate about financial globalization and the evolution of the state in political science. See e.g., Philip G. Cerny, *Power, Markets and Authority: The Development of Multi-Level Governance in International Finance*, in GOVERNING FINANCIAL GLOBALIZATION (Andrew Baker, Alan Hudson and Richard Woodward, eds., 2005).

<sup>18</sup> Larry Backer was among the first in the law literature to engage with this challenge. Larry Catá Backer, *Economic Globalization and the Rise of Efficient Systems of Global Private Law Making: Wal-Mart as Global Legislator*, 39 Conn. L. Rev. 1739 (2007) and Larry Catá Backer, *The Private Law of Public Law: Public Authorities as Shareholders, Golden Shares, Sovereign Wealth Funds, and the Public Law Element in Private Choice of Law*, 82 Tulane L. Rev. \_\_\_\_ (2008), draft available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1135798](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1135798).

### III. Constructing the Construct

At one of the many recent conferences devoted to SWFs, an international official observed that the term “sovereign wealth fund” is offensive in its artificiality.<sup>19</sup> It purports to describe entities with little in common, most of which had not interacted (much less collaborated) until they became the target of host country hostility. SWFs come from rich European states like Norway, and new, impoverished, conflict-ridden ones like Timor Leste, with the likes of Abu Dhabi, Alaska, Azerbaijan, Botswana, Chile, China, Russia and Singapore in between. Every continent and every political system is represented, though relatively few SWF home states conform to Western notions of representative democracy.<sup>20</sup> Some funds have decades of investment experience, but more than half are brand new.<sup>21</sup> Some seek to offset commodity price swings, some save for future generations, others are essentially pension funds, yet others want to boost returns on their governments’ hard currency reserves. Some invest at home, others abroad; many do both.<sup>22</sup> Sources of funds range from commodity or manufacturing export revenues to foreign aid inflows.<sup>23</sup> Some SWFs invest net government savings, others borrow from their central banks; most do not borrow from the markets.

Such diversity makes for very different policy constraints, funding and investment profiles. The diversity is relevant in two ways. First, the SWFs may find it difficult to coordinate among themselves. Second, it is hard to devise a unified policy response for something that is not a unified phenomenon. Thus each definition of SWF that claims to unify the category also expresses a view on who should regulate them, and how.

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<sup>19</sup> Remarks of Wouter Bossu at the Georgetown University Law School Conference on Sovereign Wealth Funds, *available at* [link to podcast].

<sup>20</sup> See e.g., Ashby H.B. Monk, *Recasting the Sovereign Wealth Fund Debate: Trust, Legitimacy, and Governance*, Draft Working Paper [available on SSRN] (Jul. 2009).

<sup>21</sup> See e.g., John Lipsky, First Deputy Managing Director of the International Monetary Fund at the seminar, *Sovereign Funds: Responsibility with Our Future* organized by the Ministry of Finance of Chile (Sept. 3, 2008), *text as prepared for delivery available at* <http://www.imf.org/external/np/speeches/2008/090308.htm>. This figure is somewhat misleading, since many of the new funds are small. The large funds tend to be older.

<sup>22</sup> See e.g., Arina Popova [Study of Russian SWFs], Georgetown J.I.L. (*forthcoming* 2009).

<sup>23</sup> Rozanov, *supra* note \_\_ at 1.

Definitions elevate certain commonalities and obscure differences within the proposed grouping. From the ideal type, each definition derives optimal institutional design, channels of accountability, and sanctions for noncompliance.

The following sampling of definitions and their implications is illustrative, not exhaustive. My goal is to give a range of possibilities for SWFs as legal and policy subjects, but also a flavor of the political project of constructing the subject.

StateStreet economist Andrew Rozanov, widely credited with introducing the SWF term, defined it in the negative, as “neither traditional public-pension funds nor reserve assets supporting national currencies.”<sup>24</sup> Typical SWFs were “a by-product of national budget surpluses ... trade and fiscal positions,” most but not all funded from natural resource revenues. Their objectives ranged from revenue smoothing and sterilization, to savings and development. To constitute an SWF, a pool of funds would not need to reside in a separate legal institution; however, it would have to be managed separately under guidelines distinct from those applicable to central bank reserves, to achieve “more broadly diversified and risk-tolerant sovereign wealth.”<sup>25</sup> In this (non-)definition, SWFs remain essentially public entities, an extension of foreign exchange reserves, accountable through the same channels as central bank reserve managers, albeit under less strict risk and liquidity standards. However, Rozanov suggests a diversity of potential investment strategies and policy goals that implies a broader range of constituents and performance benchmarks than a one might expect of a central bank account. For example, an aggressive investor in a wider range of fields concerns both market participants and regulators in such fields, as well as those whose supply the betting funds. And it is no longer obvious that central bank channels would provide adequate accountability, for example, where a fund is set up for domestic social development.

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<sup>24</sup> Rozanov, *supra* note \_\_ at 1.

<sup>25</sup> Rozanov, *supra* note \_\_ at 1, 4.

While not part of any formal definition of SWFs, their “sheer size and scope” drove policy and market interest.<sup>26</sup> A big reason SWFs mattered now was that they were big. “Bigness” and rapid growth became an implicit part of the SWF policy equation, much as they had earlier with hedge funds and private equity. In just a few years, SWFs grew from a few million to nearly \$3 trillion in assets under management (not including state pension funds), surpassing hedge funds; before the crisis, they were expected to triple in five years. The financial meltdown has tempered, but not reversed the trend.<sup>27</sup> As noted earlier, this growth was part of a broader pattern of capital flows. To put SWFs in perspective, despite all the growth, they still lag far behind official foreign exchange reserves.<sup>28</sup> Nevertheless, their combined size (which naturally depended on how one defined an SWF) made SWF policy a matter of global financial stability.

By 2007, SWFs became “the latest topic de jour in international finance,”<sup>29</sup> and analysis focused more sharply on the cross-border investment activities of the SWF governments. An influential early treatment by Edwin M. Truman shared with Rozanov the view of SWFs as essentially excess reserves deployed to advance a wide range of government objectives, usually under more permissive investment guidelines. However, Truman’s account situated SWFs as a subset of their governments’ international assets, excluding funds that invested solely at home. He also put more emphasis on formally separate legal identity, implicitly excluding from the definition segregated central bank accounts

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<sup>26</sup> Rozanov, *supra* note \_\_ at 1.

<sup>27</sup> Charles Roxburgh, Susan Lund, Matt Lippert, Olivia L. White, & Yue Zhao, *The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity Are Faring in the Financial Crisis* (McKinsey Global Institute, Jul. 2009) [Hereinafter McKinsey NPB 2009] (citing no decline in SWF assets under management, at \$3.2 trillion for 2008, and projecting continued albeit slower growth).

<sup>28</sup> BRAD W. SETSER, COUNCIL ON FOREIGN RELATIONS, SOVEREIGN WEALTH AND SOVEREIGN POWER 10 (2008), available at [http://www.cfr.org/publication/17074/sovereign\\_wealth\\_and\\_sovereign\\_power.html?breadcrumb=%2Fpublication%2Fby\\_type%2Fspecial\\_report](http://www.cfr.org/publication/17074/sovereign_wealth_and_sovereign_power.html?breadcrumb=%2Fpublication%2Fby_type%2Fspecial_report) [hereinafter “SETSER REPORT”]. See also Brad Setser, *It Is 2004 All Over Again: Central Banks Haven’t Shifted Away from Safe, Liquid Assets*, BRAD SETSER: FOLLOW THE MONEY, <http://blogs.cfr.org/setser/2008/06/23/it-is-2004-all-over-again-central-banks-havent-shifted-away-from-safe-liquid-assets/#more-3615> (June 23, 2008, 11:06 a.m.). At the onset of the financial crisis, they were slated to overtake reserves within five years. See John Lipsky, First Deputy Managing Director of the International Monetary Fund at the seminar, *Sovereign Funds: Responsibility with Our Future* organized by the Ministry of Finance of Chile (Sept. 3, 2008), text as prepared for delivery available at <http://www.imf.org/external/np/speeches/2008/090308.htm>.

<sup>29</sup> Edwin M. Truman, *Sovereign Wealth Funds: The Need for Greater Transparency and Accountability*, Peterson Institute for International Economics Policy Brief No. PB07-6 (Aug. 2007).

managed more aggressively than conventional reserves.<sup>30</sup> This subtle definitional shift led by implication to Truman's most under-appreciated contribution to the early SWF debate: his matrix of SWFs' stakeholders. At a minimum, these comprised home state citizens, the government, domestic and foreign market participants, and host country governments and citizens.<sup>31</sup> Home, host, and international regulation of SWFs would have to reconcile the demands of these constituencies, and maybe others.

Definitions proliferated into the fall of 2007, when the U.S. Treasury waded into the mix with its own pithy entry that continued the view of SWFs as an evolved variation on central bank reserves: "a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities ... ."<sup>32</sup> Official speeches and testimony at the time elaborated the regulatory understanding that underpinned the formal definition: SWFs as a group had a history of "responsible" investing and long investment horizons; they were insulated from daily market pressures.<sup>33</sup> Here "sovereign" seemed to suggest patience and responsibility, a public mindedness of sorts combined with insulation from market demands. But the funds were also prone to flaws common among corrupt governments: opacity and mismanagement. The proposed domestic response was a minimal adjustment to the foreign investment framework to create a presumption of scrutiny for public acquirers. The broader rhetorical focus on voluntary disclosure and professionalization was in line with international "best practices" for managing government finances.<sup>34</sup>

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<sup>30</sup> Id. at 2 (Observing that nothing prevents central banks "from managing their reserves as sovereign wealth funds are managed" ... "without having formally set up a sovereign wealth fund or its equivalent." Truman does not include such reserve pools in his list of SWFs.)

<sup>31</sup> Id. at 6.

<sup>32</sup> "Report to Congress on International Economic and Exchange Rate Policies," U.S. Dept. of the Treas. Dec. 2007 at [www.treas.gov/offices/international-affairs/economic-exchange-rates/](http://www.treas.gov/offices/international-affairs/economic-exchange-rates/).

<sup>33</sup> See e.g., Remarks by Acting Under Secretary for International Affairs Clay Lowery on Sovereign Wealth Funds and the International Financial System, U.S. Dept. of the Treasury, Jun. 21, 2007, at <http://www.ustreas.gov/press/releases/hp471.htm>. (Lowery reprised this formal definition and elaboration several times in the fall of 2007.)

<sup>34</sup> See e.g., International Monetary Fund, *Code of Good Practices on Transparency in Monetary and Financial Policies* (Aug. 3, 2000) at <http://www.imf.org/external/np/mae/mft/index.htm>.

The Treasury definition was part of the U.S. Administration's campaign to preserve the open investment status quo;<sup>35</sup> it was meant to communicate that SWF risks, such as they were, could be managed easily with existing tools. With the same goal in mind, private market participants advanced a more complicated "formally public, functionally private"<sup>36</sup> construct of SWFs. By 2007, Wall Street saw in them potential clients, funders, counterparties, and market movers. Trillions of dollars in "excess" official reserves in search of investments presented a big new business opportunity for the private financial industry. Analysts thus focused on understanding SWFs as market participants: their asset and liability profiles, investment horizons, and other attributes to which Wall Street could respond—as distinct from the more "public" dimensions of public money, such as security and foreign policy.<sup>37</sup> One influential investment bank analysis highlighted five factors that defined an SWF, where only one—sovereignty—was uniquely public. Here "sovereign" appeared less as a constraint on private behavior than as evidence of investment autonomy.<sup>38</sup> In a similar vein, McKinsey consulting described SWFs as functionally private, having "the objective of maximizing financial returns within certain risk boundaries."<sup>39</sup> Market definitions underpinned the argument that SWFs should be regulated (or left alone) like private institutional investors; they were special in name only and should not be singled out for persecution.

Most of the popular definitions excluded public pension funds, which had explicit liabilities to pensioners. Truman made a forceful case for including pension funds in a

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<sup>35</sup> FINSA, *supra* note \_\_.

<sup>36</sup> See generally, Larry Cata Backer, *Sovereign Wealth Funds as Regulatory Chameleons: The Norwegian Sovereign Wealth Funds and Public Global Governance Through Private Global Investment*, \_\_ Georgetown J.I.L. \_\_ (forthcoming 2009).

<sup>37</sup> One influential analysis highlighted this perspective: "For example, I am mostly interested in SWFs' impact on risky assets, not on [sic] the regulatory or policy implications." Stephen Jen, *Currencies: The Definition of Sovereign Wealth Fund*, Morgan Stanley (Oct. 25, 2007), at <http://sovereignwealthfunds.files.wordpress.com/2008/01/the-definition-of-a-sovereign-wealth-fund-morgan-stanley-october-2007.pdf>.

<sup>38</sup> Jen's SWF characteristics are: "(1) sovereign, (2) high foreign currency exposure; (3) no explicit liabilities; (4) high risk tolerance; and (5) long investment horizon." *Id.* Risk tolerance is quite different from responsible investing in the preceding paragraph. A risk tolerant investor can wait to maximize returns; a responsible investor may sacrifice financial returns for a higher purpose.

<sup>39</sup> McKinsey Global Institute, *The New Power Brokers* (Oct. 2007) [Hereinafter, McKinsey NPB 2007]

2008 policy brief proposing “Best Practices” for SWFs.<sup>40</sup> These sought to bind “government-owned or government-controlled” vehicles to a set of norms already adhered to by some of the would-be group. Like the rest, this definition of the category had normative potential: all funds should act as if they were directly accountable to a group of passive beneficiaries. “Sovereign” in this SWF was the people’s fiduciary.

Truman’s “Best Practices” reflected a new stage in the SWFs’ evolution as a policy and governance phenomenon, and a new stage in the academic debate. The passage of U.S. investment legislation in late 2007 was a victory for free capital movement—but also for soft law. The U.S. Congress was convinced to leave most substantive regulation of SWFs to informal transnational coordination, on the understanding that the Administration would help broker a set of robust guidelines to preserve and fortify the underlying behavior expectations.<sup>41</sup> Through the efforts of host states (still its dominant shareholders), the IMF was tasked with bringing about a code of conduct for SWFs at its Annual Meeting in the fall of 2007. At this code/best practice phase of the debate, definitions became a hotter political potato: producing a group constitution required agreement on who was in the group and why.

The IMF’s first major public product dedicated to the SWFs<sup>42</sup> had an appendix-full of formal definitions, highlighting the magnitude (or futility) of the classification challenge.<sup>43</sup> The IMF’s work program similarly emphasized the SWFs’ heterogeneity.<sup>44</sup> Universally shared SWF characteristics were limited to state ownership and

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<sup>40</sup> Edwin M. Truman, *A Blueprint for Sovereign Wealth Fund Best Practices*, Policy Brief (Peterson Institute for International Economics), Apr. 2008, available at <http://www.petersoninstitute.org/publications/pb/pb08-3.pdf>.

<sup>41</sup> See e.g., Lowery, *supra* note \_\_; Robert M. Kimmitt, *Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy*, FOREIGN AFFAIRS (Jan./Feb. 2008), available at <http://www.foreignaffairs.org/20080101faessay87109/robert-m-kimmitt/public-footprints-in-private-markets.html>.

<sup>42</sup> The Fund had previously included analysis of SWFs in its macroeconomic and country surveillance work. See, e.g., generally, INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT (Apr. 2007).

<sup>43</sup> INTERNATIONAL MONETARY FUND, SOVEREIGN WEALTH FUNDS—A WORK AGENDA 37-38. (Feb. 29, 2008) available at <http://www.imf.org/external/np/pp/eng/2008/022908.pdf>.

<sup>44</sup> *Id.* at 5-10. The description, which is not formulated as a definition, includes all the elements discussed earlier—size, long-term orientation, stabilizing influence.

macroeconomic purpose.<sup>45</sup> The IMF's character as a global membership institution, its task of herding skeptical surplus states into a code, and its lack of legal or economic power over those that had no need for its financial support, helped frame its analysis, which stressed the macroeconomic impact of the funds on the home country.<sup>46</sup> This was the first external analysis apart from Truman to consider at length how the SWFs looked to their home constituencies. The SWF category was launched in 2005 entirely as seen from the outside, and developed generally unconstrained by the self-perceptions of the funds' owners and managers.<sup>47</sup>

The struggle to define what looked like an incoherent, unstable category ended for all practical purposes in the fall of 2008, when a group of SWFs facilitated by the IMF released their own "soft code," the Generally Applicable Principles and Practices (the Santiago Principles).<sup>48</sup> Discussed at greater length in Part V below, this initiative is often interpreted as preemptive—a way for SWF states to buy peace with their hosts' security hawks.<sup>49</sup> More importantly, the Santiago Principles became a way for major SWFs and their states to take ownership of the SWF category, and make it the vehicle for the nascent political alliance of capital exporters. Their definition of SWFs adopted elements of those that came before:

*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.*<sup>50</sup>

This category specifically excluded traditional reserves, SOEs, purely domestic funds, and pension funds. It retained for SWF states the flexibility to organize the funds as they

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<sup>45</sup> Id. at 4, defining SWFs as "government-owned investment funds, set up for a variety of macroeconomic purposes."

<sup>46</sup> Id. at 10.

<sup>47</sup> Matthew Goldstein, *Putin-No Sovereign Wealth Fund in Russia Yet*, Reuters (Jun. 30, 2008) at <http://www.reuters.com/article/etfNews/idUSL3028241920080630> (describing a misunderstanding between Russian President Vladimir Putin and U.S. Treasury Secretary Henry Paulson surrounding Russia's definition of SWF.)

<sup>48</sup> The Generally Accepted Principles and Practices (GAPP), at [www.iwg-swf.org](http://www.iwg-swf.org).

<sup>49</sup> McKinsey NPB 2009, *supra* note \_\_ at \_\_.

<sup>50</sup> GAPP, *supra* note \_\_ at 27.

saw fit under domestic laws, and left unaddressed the tension between “macroeconomic [=public policy] purposes” and “financial [=apolitical] objectives”.<sup>51</sup>

Thus in its own authoritative view, the regulatory subject was a distinct category of state-owned participants in the international financial markets, accountable to the domestic population in general but no one in particular, which could take a range of legal forms and pursue a range of economic, or at least not overtly political, objectives. The next Part examines the implications of this definition for legal and institutional design.

Before concluding this short history of the SWF construct, it is worth noting the relative dearth of legal voices in the definition debates. For example, much of the U.S. law scholarship on SWFs had initially adopted the formulation of the problem from the policy debate, as open investment against sovereignty/national security, and took the SWF definition from the policy sources that posed the problem.<sup>52</sup> A small minority of authors framed the SWF phenomenon more broadly in governance terms, some pointing out the essential incoherence of singling out SWFs in the emerging regulatory regime, which obviated the need for definition.<sup>53</sup> For purposes of this Article, the search for definition is interesting as a matter of law and institutions, precisely because most thoughtful participants in the policy and academic debates acknowledged the inevitable artificiality and incoherence, yet continued to see SWFs as a useful vehicle to advance or restrain the regulation of certain international financial activities.

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<sup>51</sup> Id.

<sup>52</sup> See e.g., Ronald J. Gilson & Curtis J. Milhaupt, 60 STAN. L. REV. 1345, 1352 (2008), available at <http://lawreview.stanford.edu/content/vol60/issue5/GilsonMilhaupt.pdf>; Symposium on Sovereign Wealth Funds, 118 YALE L. J. POCKET PART (2008) [with the exception of the Popova contribution]; Richard A. Epstein & Amanda M. Rose, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, 76 U. CHI. L. REV. 111 (Winter 2009).

<sup>53</sup> See generally, Backer, *supra* note \_\_; Katharina Pistor, *Global Network Finance* (Am. Law & Econ. Ass’n. 18th Annual Meeting, Working Paper No. 54, 2008), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=2611&context=alea>.

#### IV. Axes of Accountability

The definition debates revealed SWFs to be a jumble of contradictions: public money that pledges to act as if it were private, vast pools of capital that promise not to move markets, non-controlling investors that run centrally controlled economies; and public fiduciaries that balk at corporate governance of their investment targets. Situating SWFs in a governance framework must begin by understanding to whom they answer, deciding to whom they should answer, and finding ways to resolve the inevitable conflicts among SWFs' constituencies at home and abroad.

SWFs are not unique for juggling conflicting demands. Public-private hybrids like government-sponsored enterprises (for example, Fannie Mae, R.I.P. 1968-2008) must reconcile duties to their shareholders with duties to the public.<sup>54</sup> Transnational hybrids, such as SWFs, have another dimension with which to contend: they must answer to constituencies both at home and abroad.<sup>55</sup> In all, SWFs face a four-fold accountability challenge.

First, there is *public internal accountability*, which must be achieved within the political system of the capital-exporting state. As government institutions, SWFs must further domestic public purpose. The state may be democratic, in which case SWFs answer to elected officials, or not, in which case they might answer to the monarch and her five cousins. The China Investment corporation (CIC), established in September 2007 with \$200 billion from central bank reserves, reports directly to the State Council of the People's Republic of China. Its board is made up of officials from powerful government agencies.<sup>56</sup> CIC appears to have at least two public missions: to reform the Chinese

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<sup>54</sup> See A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543, 562-574 (1995).

<sup>55</sup> See Ashby H.B. Monk, *Recasting the Sovereign Wealth Fund Debate: Organizational Legitimacy, Institutional Governance and Geopolitics* 4-6 (Centre for Employment, Work & Finance, Oxford University Centre for the Environment Working Paper, 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1134862](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862).

<sup>56</sup> Brad W. Setser, *What to Do With Over Half a Trillion a Year? Understanding the Changes in the Management of China's Foreign Assets*, RGE MONITOR, Jan. 18, 2008, available at

banking sector and to boost returns on foreign exchange reserves.<sup>57</sup> Influential observers in the Chinese press debate other public goals, including fiscal stabilization and growing export markets.<sup>58</sup> Each potentially implies a very different investment strategy; reconciling them is a matter for the Chinese political system, with critical implications for the rest of the world.<sup>59</sup>

Second, *private internal accountability* refers to SWFs' duties to narrower constituencies, such as shareholders, derived from their charters. Public and private internal accountability may conflict where, for example, a fund established to save for old age is used to advance unrelated strategic goals.<sup>60</sup> Transparency can expose internal accountability tensions. A transparent SWF set up to maximize return on investment may have to forego opportunities in politically unpopular sectors or countries to secure domestic legitimacy.<sup>61</sup>

Third, *public external accountability* implies a duty of state-owned funds to adhere to international norms. Acting as a market participant should not absolve the state of its

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[http://www.cfr.org/publication/15294/what\\_to\\_do\\_with\\_over\\_a\\_half\\_a\\_trillion\\_a\\_year\\_understanding\\_the\\_changes\\_in\\_the\\_management\\_of\\_chinas\\_foreign\\_assets.html?breadcrumb=%2Fbios%2F8937%2Fbrad\\_w\\_setser%3Fgroupby%3D3%26hide%3D1%26id%3D8937%26filter%3D2008](http://www.cfr.org/publication/15294/what_to_do_with_over_a_half_a_trillion_a_year_understanding_the_changes_in_the_management_of_chinas_foreign_assets.html?breadcrumb=%2Fbios%2F8937%2Fbrad_w_setser%3Fgroupby%3D3%26hide%3D1%26id%3D8937%26filter%3D2008); see also MICHAEL F. MARTIN, CRS REPORT FOR CONGRESS: CHINA'S SOVEREIGN WEALTH FUND 26 (2008), available at <http://www.fas.org/sgp/crs/row/RL34337.pdf>.

<sup>57</sup> China's state-owned bank holding company was recently made a subsidiary of CIC, further confusing the mission. ChinaStakes.com, *A Simmering CIC-Huijin Separation*, July 8, 2008, <http://www.chinastakes.com/story.aspx?id=495> (last visited Sept. 14, 2008).

<sup>58</sup> Ashby H.B. Monk, Scott Moore & Xunyi 'Jane' Xu, *A Review of Chinese Language Literature on Sovereign Wealth Funds* 11-12 (Oxford International Review Sovereign Wealth Funds Team Working Paper No. SWF001, 2008), available at <http://oxfordir.files.wordpress.com/2008/07/swf001.pdf>. For similar debates on the public mandate of Russia's SWFs, see Arina V. Popova, *Sovereign Wealth Funds: To Be or Not To Be Is Not the Question; Which One to Choose, Is, \_Geo. J.I.L.\_* (forthcoming 2009).

<sup>59</sup> Recent administrative restructuring brought a number of Chinese banks under CIC control. This raised prudential concerns in the United States when several of the banks sought to establish operations in New York. Scott G. Alvarez, General Counsel for the Board of Governors of the Federal Reserve System, Testimony Before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives (Mar. 5, 2008), available at <http://www.federalreserve.gov/newsevents/testimony/alvarez20080305a.htm>; Jamil Anderlini & Geoff Dyer, *US Delays Licenses to Top Chinese Banks*, FT.com, Jun. 16, 2008, available at <http://www.ft.com/cms/s/0/4dc9a06c-3bcb-11dd-9cb2-0000779fd2ac.html> (last visited Sept. 17, 2008).

<sup>60</sup> In what is likely a more common scenario, Norway's SWF has financed the government beyond the limits established by its internal guidelines. Truman, *supra* note 8, at 9.

<sup>61</sup> Steven Schwarzman, *Reject Sovereign Wealth Funds at Your Peril*, FT.com, Jun. 20, 2008, available at <http://www.ft.com/cms/s/0/405b8888-3dff-11dd-b16d-0000779fd2ac.html> (last visited Sept. 16, 2008).

basic public duties:<sup>62</sup> for example, not to fund genocide. Although public international law increasingly seeks to bind private parties directly, states remain its principal subjects. Norwegian officials point to public international norms, such as the U.N. Global Compact, as well as domestic procedural safeguards, to defend their SWF's ethical guidelines and its shunning of Wal-Mart.<sup>63</sup> Recognizing the greater pull of public duties for public institutions, scholars have recently proposed using SWFs as vehicles to advance human rights in host countries.<sup>64</sup>

But how far does this duty to the system run? When observers extol SWFs' role as "patient capital" serving financial stability, does it follow that SWFs must refrain from aggressive trading? When the United States asks China to invest commercially,<sup>65</sup> does it expect CIC to hold U.S. financial stocks in a credit crunch? Iceland thought so when it caught Norway short-selling its bank shares in 2006.<sup>66</sup> Here too transparency is a bone of contention: failure to disclose SWF positions can impede macroeconomic surveillance and potentially unsettle the markets; disclosure can put SWFs at a disadvantage to wholly private competitors, such as hedge funds, and other SWFs.<sup>67</sup>

Fourth, *private external accountability* refers to SWFs' duties as creditors and shareholders, which they may owe their investment targets under host country laws. For the most part, SWFs are already bound by these laws simply by virtue of the investment: for example, they may not engage in insider trading or self-dealing. The worry is that SWFs might simply flout the laws when it becomes expedient, on the assumption that being sovereign, they can escape sanction. In this context, extracting SWF promises to

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<sup>62</sup> Cf. *Lebron v. Nat'l R. R. Passenger Corp.*, 513 U.S. 374 (1995) (making a similar argument in the U.S. domestic context).

<sup>63</sup> Kristin Halvorsen, Norwegian Minister of Finance, speech at the 2008 OECD Forum on Climate Change, Growth, Stability, *Sovereign Wealth Funds* (June 3-4, 2008), transcript available at <http://www.oecd.org/dataoecd/24/57/40760305.pdf>, at 2-3.

<sup>64</sup> See Patrick J. Keenan & Christiana Ochoa, *The Human Rights Potential of Sovereign Wealth Funds* (Apr. 8, 2009). Illinois Public Law Research Paper No. 08-27; Indiana Legal Studies Research Paper No. 132. Available at SSRN: <http://ssrn.com/abstract=1374880>.

<sup>65</sup> See *supra* note 15. Similar agreements were reached with Singapore and Abu Dhabi.

<sup>66</sup> *Asset-Backed Insecurity*, THE ECONOMIST, Jan. 17, 2008, at 386, available at [http://www.economist.com/finance/displaystory.cfm?story\\_id=10533428](http://www.economist.com/finance/displaystory.cfm?story_id=10533428).

<sup>67</sup> Press Conference Call Transcript No. 08/01, International Working group of Sovereign Wealth Funds (Sept. 2, 2008), available at <http://www.iwg-swf.org/tr.htm>; see also Halvorsen, *supra* note 26, at 1-2.

abide by the laws<sup>68</sup> seems feckless: such promises hardly solve the underlying commitment problem. Proposals to deprive SWFs of shareholder voting rights<sup>69</sup> do address commitment, but may have little practical impact: votes matter less when you can phone the CEO, or when all else fails, the Finance Minister. Governments' capacity to exert influence and get information through private channels is a central concern with sovereign investments; modifying formal voting rules avoids the issue. The normative assumptions behind voting proposals also merit a closer look. Is disenfranchising public shareholders (and thereby empowering the rest) good for corporate governance?<sup>70</sup> Does it serve government accountability in the home country? More cynically, is depriving Russia of a formal shareholder vote worth giving up Norway's or California pension funds' leverage on human rights?

This four-part typology is simplified. It is also descriptive. Reconciling tensions among the four basic categories requires agreement on norms.

## V. Meet Me in Santiago

Two years ago, there was no obvious forum to negotiate norms to govern SWFs. Domestic debates in host states were stuck in the sovereignty-protectionism rut. With its power to block transactions that threaten national security, the Committee on Foreign Investment in the United States (CFIUS) had gone from obscurity to celebrity, became an emblem of the controversy over sovereign investment, and inspired imitators around the world.<sup>71</sup> SWF sponsors saw this trend as both an economic and a political threat. To the people at home, SWFs stood variously for economic security, political autonomy and global prestige. Even in states where the masses had little knowledge and no influence over how public money was invested, governments could lose face by making too many concessions to host country fears.

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<sup>68</sup> See Lowery, *supra* note 15; Kimmitt *Public Footprints*, *supra* note \_\_.

<sup>69</sup> Ronald J. Gilson & Curtis J. Milhaupt, 60 *STAN. L. REV.* 1345, 1352 (2008), available at <http://lawreview.stanford.edu/content/vol60/issue5/GilsonMilhaupt.pdf>.

<sup>70</sup> Epstein & Rose, *supra* note \_\_ (arguing against Gilson & Milhaupt).

<sup>71</sup> A description of CFIUS authority and activities is available on the website for the United States Department of the Treasury. Committee on Foreign Investment in the United States (CFIUS), <http://www.ustreas.gov/offices/international-affairs/cfius/> (last visited Sept. 16, 2008).

The leading broker of international investment norms, the Organization for Economic Cooperation and Development (OECD), had not recovered global credibility after the failure of its Multilateral Agreement on Investment (MAI) in the 1990s.<sup>72</sup> Back then, the OECD faced criticism as an exclusive club dominated by wealthy capital exporters in Europe and North America. In an ironic turn, it was asked to formulate best practices for hosting SWFs.<sup>73</sup>

The IMF was both a natural and an unlikely alternative candidate to come up with norms to govern SWFs. Its macroeconomic and financial stability expertise made the IMF uniquely credible in addressing issues of concern to home and host states alike. It knew all the actors involved<sup>74</sup> and had analyzed the advent of SWFs for some time.<sup>75</sup> Unlike the OECD, the Fund's membership is nearly universal, though its internal governance remains controversial even after a round of reforms to give more voice to the erstwhile periphery.<sup>76</sup> The IMF has jurisdiction over its members' exchange rate policies, current account convertibility, and broad macroeconomic and financial policy responsibility. However, its authority over capital flows, including investment, is partial, ambiguous, and worse for wear since the capital account crises of the 1990s and early 2000s.<sup>77</sup> The Fund's recent track record with policy surveillance has been mixed at best.<sup>78</sup> It did little

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<sup>72</sup> Attempts to revive multilateral investment negotiations at the World Trade Organization after MAI's collapse also failed.

<sup>73</sup> Press Release, Organisation for Economic Co-Operation and Development, OECD Countries Stay Open to Commercial Investments by Sovereign Wealth Funds (Sept. 4, 2008), available at [http://www.oecd.org/document/9/0,3343,en\\_2649\\_201185\\_40409737\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/9/0,3343,en_2649_201185_40409737_1_1_1_1,00.html).

<sup>74</sup> NGAIRE WOODS, THE GLOBALIZERS: THE IMF, THE WORLD BANK AND THEIR BORROWERS 4 (2006) (linking the IMF's policy influence and its long-standing relationships with world governments).

<sup>75</sup> See, e.g., generally, INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT (Apr. 2007).

<sup>76</sup> Press Release, International Monetary Fund, Directors Back Reforms to Overhaul IMF Quotas and Voice (Mar. 28, 2008), available at <http://www.imf.org/external/pubs/ft/survey/so/2008/NEW032808A.htm>.

<sup>77</sup> See e.g., INTERNATIONAL MONETARY FUND INDEPENDENT EVALUATION OFFICE, THE IMF'S APPROACH TO CAPITAL ACCOUNT LIBERALIZATION 3 (2005) available at <http://www.ieo-imf.org/eval/complete/pdf/04202005/report.pdf>.

<sup>78</sup> BUREAU OF INT'L AFFAIRS, U.S. DEPT. OF THE TREASURY, REPORT TO CONGRESS ON IMPLEMENTATION OF THE INTERNATIONAL MONETARY FUND'S 2007 DECISION OF SURVEILLANCE OVER MEMBERS' POLICIES 2 (2008), available at <http://www.ustreas.gov/press/releases/reports/82808report.pdf>. (stating that the IMF's "implementation of the new decision can be viewed as mixed.").

to reduce the imbalances that spawned the new wave of SWFs: it could no more influence U.S. tax policy than China's exchange rate management.

The Bretton Woods compromise that rejected Keynes' view of institutionally robust, symmetrical discipline on surplus and deficit countries alike was coming back to haunt its leading proponent in an unexpected, ironic way. The United States, now the top deficit country, avoided public international discipline imposed on the likes of South Korea ten years earlier, because the private market continued to fund the United States ... except that surplus country governments, which now included South Korea, held their reserves in U.S. dollars, and thus became an indispensable part of the "private" market for U.S. government assets. The same U.S. official who had, in a prior life, argued for robust IMF programs in crisis-stricken countries in Asia,<sup>79</sup> would soon return to Asia on a reassurance tour of America's creditors.<sup>80</sup> On the other hand, having deliberately deprived the IMF of meaningful leverage over surplus countries, the United States had to face the downside of the feckless reprimand and the frustration of being the largest shareholder in what increasingly looked like an irrelevant institution.<sup>81</sup>

In a paradox that would repeat itself over the next two years, the Fund's lack of legal and economic power over SWF states might have helped make its involvement more palatable to them. At the 2007 Annual Meetings of the Bretton Woods institutions, the IMF got tagged by way of compromise to help leading SWFs distil "best practices" for going about their business.<sup>82</sup> Prodded by the G-7, the IMF envisaged something along the lines of its prior forays into best practices for fiscal transparency and reserve

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<sup>79</sup> See PAUL BLUSTEIN, *THE CHASTENING: INSIDE THE CRISIS THAT ROCKED THE GLOBAL FINANCIAL SYSTEM AND HUMBLING THE IMF* (2001).

<sup>80</sup> *Preview: Geithner to Reassure Gulf Allies on Dlr Assets*, Reuters (Jul. 13, 2009) at <http://www.reuters.com/article/asianCurrencyNews/idUSLC35935520090713>; *China Skeptical about Geithner Message*, Marketplace, American Public Media (Jun. 1, 2009) at [http://marketplace.publicradio.org/display/web/2009/06/01/pm\\_geithner\\_in\\_china/](http://marketplace.publicradio.org/display/web/2009/06/01/pm_geithner_in_china/)

<sup>81</sup> BUREAU OF INT'L AFFAIRS, U.S. DEPT. OF THE TREASURY, REPORT TO CONGRESS ON IMPLEMENTATION OF THE INTERNATIONAL MONETARY FUND'S 2007 DECISION OF SURVEILLANCE OVER MEMBERS' POLICIES 2 (2008), available at <http://www.ustreas.gov/press/releases/reports/82808report.pdf>.

<sup>82</sup> Press Release No. 08/78, International Monetary Fund, Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund (Apr. 12, 2008), available at <http://www.imf.org/external/np/sec/pr/2008/pr0878.htm>.

management.<sup>83</sup> Yet the new project was quite different. In contrast to its prior code-making experiences, the IMF did not come to the table with authority to determine the standards, assess compliance, or sanction noncompliance, with the result. It dealt with states that by definition did not need its money and were unlikely to need it in the foreseeable future. The IMF's functions were expert, convening, and secretarial. The output was emphatically voluntary;<sup>84</sup> barely soft law.<sup>85</sup> Meanwhile, reports on SWFs' enthusiasm for the exercise were not encouraging. Soon after receiving the assignment, one IMF official observed that the "best" in "best practices" was too controversial. He was right – to a point.

Nevertheless, an International Working Group (IWG) made up of two dozen or so states with SWFs<sup>86</sup> negotiated the Santiago Principles between May and September 2008. They met three times, in Washington, Singapore and Chile, with another drafting session in Norway. The group was chaired by two senior officials, one from the world's largest SWF, the Abu Dhabi Investment Authority, and another from the IMF. Several home and host countries, along with representatives of the OECD, the World Bank, and the European Union, attended IWG meetings as observers. The agreement was announced at the meeting in Santiago on September 2, 2008. IWG member governments quickly signed off on the Santiago Principles text, whereupon it was presented to the IMF's policy-setting International Monetary and Financial Committee (IMFC) and the general IMF membership.<sup>87</sup> A ritual welcome followed.

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<sup>83</sup> INTERNATIONAL MONETARY FUND, SOVEREIGN WEALTH FUNDS—A WORK AGENDA 22 (Feb. 29, 2008) available at <http://www.imf.org/external/np/pp/eng/2008/022908.pdf>.

<sup>84</sup> See Press Conference Call Transcript, *supra* note 29.

<sup>85</sup> For a description of soft law, see Dinah Shelton, Normative Hierarchy in International Law, 100 AM. J. INT'L L 291, 319-22 (2006).

<sup>86</sup> According to the IWG website,

The IWG member countries are: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, and the United States. Oman, Saudi Arabia, Vietnam, the OECD, and the World Bank, participate as permanent observers.

Press Release No. 08/04, *supra* note 1.

<sup>87</sup> Press Conference Call Transcript, *supra* note \_\_\_\_.

It is tempting to see the Santiago Principles as an exercise in technocratic legitimation – a set of anodyne rules to help Chinese, Russian and Arab money look friendlier to their U.S. and European hosts, while maintaining the mandate to invest from the masses at home.<sup>88</sup> This undersells the achievement even without much of an implementation track record to date.

The principles do not claim to be the “best,” but they do aspire to be “generally accepted”, where “general” meant “potentially achievable by countries at all levels of economic development.”<sup>89</sup> This gesture of solidarity across the income spectrum suggests a governance grouping distinct from the “Gs” that came before. Unlike the old G-7 and the G-77, which reflected national income and reinforced something like class stratification among states, and even unlike the G-20, which was deliberately designed to mimic diverse representation of wealthy and middle income countries, the Santiago Principles seem to address a more organically diverse constituency, united by the functional needs of surplus states operating in integrated financial markets.

In substance, the Principles project concern with SWFs’ status at home and abroad, and their competitiveness in the private financial markets. They suggest that SWFs still occupy a contested place in home country politics and policy mix, and continued sense that SWFs’ decision-making is poorly understood and worrisome to hosts – but also a suspicion on the part of many funds that they operate on hostile, unfamiliar turf that may tilt in favor of private and public competitors. The IWG product wants to reassure, but not at the expense of losing autonomy or competitive edge.

The two dozen GAPP line items address the structure and objectives of SWFs (“legal, institutional and macroeconomic” factors), their governance and accountability arrangements (especially decision autonomy from the home government) and their investment and risk management policies, focusing on financial stability.<sup>90</sup> The

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<sup>88</sup> Monk, *supra* note \_\_ at 4-6.

<sup>89</sup> GAPP at 5.

<sup>90</sup> GAPP, *supra* note \_\_. This framing is broadly in line with earlier pronouncements by the G-7, and consistent with the comprehensive “Blueprint for SWF Best Practices” proposed by Truman earlier in

document is suffused with accountability rhetoric, which is cited in support of all but a few of the two dozen principles. At the same time, the Santiago Principles take a particular view of accountability. Viewed through the framework outlined in Part IV of this Article, the IWG goes the farthest in private accountability—internally, answering to their owners under the terms of their constitutive arrangements (e.g., GAPP 6-10), and externally, abiding by the laws their hosts made applicable to similarly situated (mostly private) investors (e.g., GAPP 15), and participating in the global financial markets in the manner of profit-driven private investors (e.g., GAPP 2, 17, 19). GAPP Principle 21 takes a forceful stand on SWFs’ shareholder rights. In this view, SWFs capacity to exercise shareholder rights—as passive or active managers of their investments—is an essential attribute of accountability to their own shareholders. The way in which IWG approached this principle illustrates the tension between internal and external private accountability. On balance, GAPP 21 was a clear victory for internal accountability; however, in a nod to the private external audience, the SWFs would disclose their voting policies and intentions *ex ante* and their voting record *ex post*.

The Principles address public internal accountability through a combination of structure—for example, organizational separateness from the government, professionalization of management, arm’s length dealings with third parties (e.g., GAPP 6, 9, 14)—and disclosure. Some of the most significant disclosure is made to the owner, not the domestic public, effectively relying on the broader government accountability channels to inform the populace, along with the world at large (e.g., GAPP 5). To the consternation of many long-time observers, IWG deemed total fund size too sensitive to require disclosure at all.<sup>91</sup> Yet some of the most forceful language in the Principles is used to disclaim “any intention or obligation to fulfill, directly or indirectly, any geopolitical agenda of the government.”<sup>92</sup> It is almost as if the SWFs sought to use the

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2008. Truman, *supra* note \_\_. As noted earlier, *supra* note \_\_, the Blueprint includes public pension funds in the definition of SWFs. These generally score better than non-pension SWFs (although some non-pension SWFs score equally well). It is possible that pension funds enjoy a greater public perception as “other people’s money” – funds belonging to a defined constituency, rather than taxpayers at large – that entails a higher burden of accountability to the owners.

<sup>91</sup> See e.g., Truman at \_\_.

<sup>92</sup> GAPP 2 Explanation and Commentary, *supra* note \_\_ at 12.

Santiago Principles as a commitment device for their own governments, an internal non-interference pact of sorts.

The treatment of public external accountability is similarly strained. Over half of all the Principles refer to the sentiment most clearly expressed in GAPP 19: SWFs are in the business of maximizing “risk-adjusted returns” and operate solely “based on economic and financial grounds”. Any social, ethical or religious motive is a deviation from the group norm (albeit one in which some important members like Kuwait and Norway engage), which must be specifically disclosed. Moreover, many of the disclosure obligations elsewhere in the document are justified in terms of dispelling “concern about potential noneconomic or nonfinancial objectives.”<sup>93</sup> The funds’ contribution to global financial stability comes not of a sense of public duty, but rather of their capacity—by virtue of their economic objective and structure—“to take a long-term view in their investments and ride out business cycles.”<sup>94</sup>

When IWG announced agreement on the Santiago Principles, its members were at pains to disassociate them from the IMF surveillance process: they insisted that everything about the principles was voluntary. Perhaps as a matter of preemption, the Santiago Principles incorporate a periodic internal review mechanism.<sup>95</sup> In theory, nothing prevents the IMF from considering GAPP criteria in its assessment of home and host policies implicating SWFs, just as nothing prevents a host government from using GAPP as part of its investment screen. But doing so may undermine the Principles’ legitimacy in the home countries, and scuttle cooperation between new and old powers and institutions.

IWG work since the launch in Santiago confirms the view of the forum as, at least in part, an exercise in governance preemption. In the fall of 2008, the IWG secretariat released a SWF survey, answering calls for transparency while seizing initiative and asserting control in a field where authoritative information was scarce and analysis was dominated

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<sup>93</sup> GAPP 21, *supra* note \_\_ at 23; *see also, e.g.*, GAPP 6, GAPP 16 Explanations and Commentary.

<sup>94</sup> Santiago Principles: Objective and Purpose, GAPP, *supra* note \_\_ at 3.

<sup>95</sup> Press Conference Call Transcript, *supra* note 29.

by private investment banks and consultancies.<sup>96</sup> Six months after presenting the Principles to the IMFC, the group released the Kuwait Declaration establishing a standing forum of SWFs. The Forum is “a voluntary group of SWFs” whose membership is open to funds that meet the GAPP definition of SWF and, significantly, “endorse” the Principles. It is a soft institutional counterpart to the emphatically soft law of the Santiago Principles. The IMF will serve as the Forum’s interim secretariat.<sup>97</sup>

The IWG effort so far builds on and borrows elements of several established species: best practices produced by and for the public sector (for example, IMF on fiscal transparency), corporate codes of conduct produced by the private sector to regulate itself, and principles jointly produced by public and private actors to regulate private conduct (for example, the Equator Principles, a collaboration between private banks and the International Finance Corporation). GAPP would be unusual because the principles are produced by and for public entities, yet they purport to regulate market activity.<sup>98</sup> Governments as market actors<sup>99</sup> seem to favor self-regulation.

The new SWF forum combines features of a macroeconomic policy coordination body (the G-7) and a producer’s cartel (OPEC). Yet it also evokes the ascendance of the Financial Stability Board (FSB, *nee* Financial Stability Forum), a group of public and private regulators and standard setters formed in the wake of the Asian Financial Crisis of the late 1990s, which has assumed an outsize role in the regulatory reform proposals coming out of the current crisis.<sup>100</sup> Neither has legal personality or much of an infrastructure; yet both have charter-like mandates, norm-generating authority, and

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<sup>96</sup> Sovereign Wealth Funds: Current Institutional and Operational Practices (Sep. 15, 2008), available at <http://iwg-swf.org/pubs/swfsurvey.pdf>. SETSER REPORT, *supra* note 4, at 40 (noting a decline in transparency).

<sup>97</sup> International Working Group of Sovereign Wealth Funds, “Kuwait Declaration”: *Establishment of the International Forum of Sovereign Wealth Funds*, Apr. 6, 2009, at [www.iwg-wf.org/mis/kuwaitdec.htm](http://www.iwg-wf.org/mis/kuwaitdec.htm)

<sup>98</sup> Compare INSTITUTE OF INT’L FINANCE, INC., PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING IN EMERGING MARKETS (2005), available at <http://www.iif.com/download.php?id=4fyB5BGiKzU>.

<sup>99</sup> See, generally, Giselle Datz, *Governments as Market Players: New Forms of State Competition, Adaptation and Innovation in the Global Economy* (Oct. 2007) (unpublished manuscript, on file with author); Eric Helleiner & Troy Lundblad, *States Markets and Sovereign Wealth Funds*, GERMAN POLICY STUDIES (forthcoming Fall 2008).

<sup>100</sup> Financial Stability Board, at [www.financialstabilityboard.org](http://www.financialstabilityboard.org); see also [G-20 Communiqués Nov. 15, 2008 and Apr. 4, 2009].

enough of an organizational chart to fit somewhere in between bureaucratic networks<sup>101</sup> and full-fledged international institutions on the Bretton Woods model. The IWG's decision to stick around and morph into the Forum is further evidence of the surplus countries' taking ownership of the SWF form, and using it as a vehicle not just to allay deficit country fears, but more importantly, to participate in the governance of international finance.

## **VI. Conclusion: Old Problems and Soft Models**

In 1952, the top lawyer at the U.S. State Department informed his counterpart at the Justice Department that the United States would no longer support sovereign claims of absolute immunity in U.S. court cases involving commercial activity by another state. The law was keeping pace with the international economy:

[L]ittle support has been found except on the part of the Soviet Union and its satellites for continued full acceptance of the absolute theory of sovereign immunity. ... The reasons which obviously motivate state trading countries in adhering to the theory with perhaps increasing rigidity are most persuasive that the United States should change its policy. ... [T]he department feels that the widespread and increasing practice on the part of governments engaging in commercial activities makes necessary a practice which will enable persons doing business with them to have their rights determined in the courts.<sup>102</sup>

The United States was responding to state-owned commerce from the Soviet bloc. Operating "not as a regulator of a market, but in the manner of a private player within it"<sup>103</sup> exposed states to lawsuits in U.S. federal courts.

The commercial activity exception to sovereign immunity was from the start a way of mediating U.S. interaction with countries that held different views of the state's role in

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<sup>101</sup> See ANNE-MARIE SLAUGHTER, *A NEW WORLD ORDER* (2004) for a description of the network model.

<sup>102</sup> Letter from Jack B. Tate, Acting Legal Adviser, Department of State, to Acting Attorney General Philip B. Perlman (May 19, 1952), reprinted in 26 DEP'T STATE BULL 984, 984-85 (1952).

<sup>103</sup> *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 614 (1992). However, an activity that may be private for foreign sovereign immunity purposes may be public in other areas of the law: Argentina's market borrowing is patently commercial; Kentucky's is "quintessentially public". *Dept. of Revenue of Ky. v. Davis*, 128 S. Ct. 1801, 1810 (2008). Identity matters.

the economy. But because the dominant mode of interaction between the United States and the Soviet Union in 1952 was trade, the way the Soviets organized their internal affairs was unimportant – the new exception to sovereign immunity would help level the playing field for U.S. firms, not manage their acquisition by the Soviet state.

Fifty years later, with a new wave of large-scale sovereign investment, hereto irrelevant details of how other states run their economies have become critical. Conflicting accountability demands arise more often and in more legal fields, including corporate, banking, tax and securities. To rephrase Justice Scalia, SWFs operate *both* as regulators of the market and as private players within it.<sup>104</sup> The concern goes far beyond SWFs, whose investment strategies have been largely passive to date.<sup>105</sup> Outsize debt holdings by foreign central banks, notably China's,<sup>106</sup> and infrastructure acquisitions by state-owned enterprises, notably Russia's,<sup>107</sup> reveal a new level of interdependence among systems that have little in common otherwise. Brazil, China, Norway, Qatar and the United States mix public and private in different ways. When their hybrids go global, they reshape the law and structure of global finance.<sup>108</sup>

The project launched in Santiago may be a preview of this structure. Even if it fails to generate durable norms or enforce compliance, the effort will have been significant for three reasons. First, it goes to the old problem of securing the cooperation of surplus countries in global economic governance. Perversely, the involvement of SWF states, such as it might turn out to be, may be due to the fact that their biggest debtor still issues the predominant reserve currency. With limited diversification options (selling dollar assets would bring down the value of their reserves), surplus countries are vested in securing maximum investment opportunities. Thus they have come to preach the virtues of open capital flows, despite their own record of profound ambivalence about them, to a newly skeptical audience in the financial center. China's recent advocacy of a new

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<sup>104</sup> *Weltover*, 504 U.S. at 614; see Datz *supra* note \_\_\_ for examples.

<sup>105</sup> Setser argues SWFs are a distraction. SETSER REPORT, *supra* note \_\_\_, at 10.

<sup>106</sup> Cf. Jamil Anderlini, *Beijing Uses Forex Reserves to Target Taiwan*, FT.com, Sept. 11, 2008, available at <http://www.ft.com/cms/s/0/22fe798e-802c-11dd-99a9-000077b07658.html>, (last visited Sept. 21, 2008).

<sup>107</sup> Richard Wachman, *Gazprom Seeks to Build Empire Via European Utilities Stakes*, THE OBSERVER, Jan. 28, 2007, at 2, available at <http://www.guardian.co.uk/business/2007/jan/28/russia>.

<sup>108</sup> Helleiner & Lundblad, *supra* note \_\_\_.

global reserve currency, specifically grounded in Keynes' proposal, may change the dynamics of cooperation.<sup>109</sup> In the unlikely case that a viable new currency springs up soon, the incentives and structures for cooperation among surplus and deficit countries may shift yet again.

Second, the Santiago Principles and the Kuwait Declaration appear to reinforce the soft law trend in global finance, which has been gaining with the crisis and the inclusion of more diverse actors in the governance regime. This trend seems especially ironic compared to the formal and binding institutional structure that Keynes had in mind. If such soft self-regulation succeeds where formal institutions have failed so miserably, it will call for a reassessment of what might look like the "new soft law," and especially the soft institutions, which lack only binding legal force.

Third, the experience with SWFs may help establish a new role for the IMF in financial diplomacy: a shift from the hard power of conditionality in the 20<sup>th</sup> century to the soft power of persuasion and expertise in the 21<sup>st</sup>. In the world of soft power, brokering compromise on sovereign investment is a big step up from technical assistance. The financial crisis has reinforced the IMF's role as a source of balance-of-payments support, and has more than doubled its resources. On the other hand, the rise of the FSB—a soft institution without the IMF's legitimacy baggage, charter and funding constraints, but with a huge mandate from the G-20—brings real competition to governing finance. The interactions between the IMF and the SWF Forum may reveal new modes of cooperation between formal and informal governance arrangements.

Importantly—perhaps most importantly—the impact of recent developments on the people and governance arrangements in surplus states is uncertain. The Santiago Principles have already helped advance disclosure of how governments manage of the people's money; however, the fact that new transparency came in the middle of the worst financial crisis in recent memory has caused political tensions at home. This is probably to the good on balance, but no more pleasant for it from the politicians' perspective.

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<sup>109</sup> See e.g., *Handle with Care: China Suggests an End to the Dollar Era*, THE ECONOMIST, Mar. 26, 2009.

Retrenchment at home would be a bad outcome, confirming the most cynical prognoses on the effects of people power in finance, and setting back international governance.

In sum, the Santiago experiment may launch a durable policy coordination regime among key actors who had trouble taking center stage in the 20<sup>th</sup> century institutional framework. Ad-hoc, interest-based groupings such as the IWG or its successor SWF Forum, horizontally linked with established institutions such as the IMF, may offer a new model to complement the G-20 and further displace the old G-7 order.

Just as easily, the Santiago Principles could fail. They may turn out to be too vague or too stingy to reassure the hosts, too restrictive to bind a set of very diverse and very rich actors whose interests often conflict, or too radical to coexist with tightly controlled domestic political regimes. More likely, if the principles succeed at fostering model corporate governance and transparency in SWFs, the (still-hypothetical) threats that prompted the creation of the Principles may assume different form – shifting out of SWFs into reserve pools, state-owned enterprises, or new vehicles as yet unknown. The GAPP model would still be out there, but it would apply to an unimportant fringe of sovereign finance.

Whatever the outcome, the Santiago Principles implicate substantive issues that have been at the core of governing global finance for over half a century. SWFs have gone from an incongruous fiction concocted by scared Western politicians to catalysts for negotiating the terms of integration and governance among different political, social and economic systems – Saudi Arabia, Brazil, China and Norway, and their hosts in the United States, Europe and Africa.

As part of its response to the ongoing financial crisis, the United States Government took a 36% ownership stake in Citigroup. Citi also attracted “private” capital from Government of Singapore Investment Corporation (GIC), a sovereign wealth fund.<sup>110</sup>

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<sup>110</sup> [Citigroup S-5] at 70, at <http://www.sec.gov/Archives/edgar/data/831001/000119312509150642/ds4a.htm>.

Citi's newly public ownership ran afoul of the laws in foreign jurisdictions where it had bank subsidiaries. For some time, the markets fretted that Citi would be forced to sell Banamex, a profitable bank and Mexico's second largest. A flurry of diplomatic efforts brought promises of emergency legislation in Mexico and elsewhere.<sup>111</sup> It is tempting to see this incident as a turning of the tables on U.S. protectionists, and there is a sense in which it is. But it may make more sense to see these and other developments since 2005, including the financial crisis, as part of the evolution of a global financial system where pure forms are increasingly scarce, and everyone is a hybrid.

SWFs are neither good nor bad. They may even turn out to be unimportant. But they are a sign of things to come. International legal and financial systems need the capacity to adjust accordingly.

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<sup>111</sup> See Mexico Treasury Seeks Measure Favoring Citigroup, New York Times DealBook Blog, Mar. 20, 2009.