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Sovereign Wealth Funds in the European Union

General trust despite concerns

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ABSTRACT

Sovereign wealth funds have become major players in the global finance system and recently have been attracting increasing public attention. The International Monetary Fund (IMF) and some governements are calling for increased controls and regulation. This recent move is aimed to prevent countries like China and Russia using investments in the US or EU to obtain political influence in strategic sectors, such as energy and defence. The rapid growth of sovereign wealth funds risks provoking a protectionist response by industrialised countries, notably within the EU. The European Commission's approach calls for a code of conduct ensuring transparency and that the basic motives for the investment of these sovereign wealth funds become clear and that the funds themselves apply good corporate governance. The proposals discussed by European leaders would feed into international efforts, both at the Organisaton of Economic Co-operation and Development (OECD) and IMF levels.

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Introduction

The European Union (EU) is the world's largest exporter of international investments and at the same time also attracts considerable investment capital in the opposite direction. Those investment flows include sovereign wealth funds (SWFs), which are in fact already present in Europe. According to our survey more than 150 cases of investments[1] done by SWFs can be identified within the EU. The important flows of international investments occurring in Europe reflect the open policy regarding movement of capital.

However this liberal approach towards foreign direct investment (FDI) is called into question when it comes to investment that can be done by SWFS. SWFs have already been dealing in the European and US banking sector and this involvement is seen as just the first step. SWFs are only one particular kind of investor but concerns about them have been expressed in the EU. It is feared that SWFs could be lining up for a massive shopping spree that will end with many companies in Europe coming under their influence: this would validate the saying that "money does buy influence". To their most severe critics, SWFs are a "threat to the sovereignty of the nations in whose corporations they invest".[2] More often, the fear of political influence is mingled with the anxiety that at the very least an attempt might be made to gain access to technologies that would otherwise not be accessible, especially when dealing with partners and market players that have not previously been active on the international stage, namely SWFs from Russia and China. In other words, there is a fear in Western European countries that they will face more directly the political influence of Russia or China because of the leverage gained by their investments in the EU. There is also a risk of losing total control of some technologies.

[1] Our research group is in the process of building an exhaustive database of these investments by SWFs. Please follow our progress at this address: http://www.unifr.ch/pes/fr

[2] Gilson, R. and Milhaupt, C. (2008), Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism, 65 Stanford Law Review, 1345.

Why an EU approach? As usual the European Commission underlines that "a common EU approach would maximise European influence in these wider discussions."[3] But even more important is the fact that if the EU fails to agree a common line, individual EU Member States will probably take measures of their own. The barriers that would result could impede the free movement of capital, both from outside the EU and within. Such an "un-coordinated series of responses would fragment the internal market and damage the European economy as a whole".[4] Indeed the conditions of investment for SWFs would vary in the different EU countries. But such a fragmentation would appear within the common market itself since a SWF having taken control over a European companies could then decide to proceed to new investment in EU countries. Here again it would face obstacles that would represent a danger for one of the most important economic freedoms in the EU.

The objective of this paper is to analyse the existing legal regime applicable to SWFs and to assess its capacity to answer the need for control while ensuring the attractiveness of the EU market as an investment location. First we define SWFs and present the main trends of SWFs in Europe as well as the main concerns and thoughts regarding their effects. Secondly, we analyse the current regulatory framework within the EU. Thirdly, we analyse the main tendencies promoting a multilateral framework for SWFs.

1. THE SWF PHENOMENON IN THE EUROPEAN UNION

We will look first at the difficult definition of SWF (1.1). It will be then necessary to depict the main trends (1.2.) in their investment activities both worldwide and within the common market. Finally, we will summarise the main concerns relating to the SWFs, which shape the approach taken by countries (1.3.).

[3] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A common European approach to Sovereign Wealth Funds, COM/2008/0115 final, 27 February 2008, p. 6.

[4] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A common European approach to Sovereign Wealth Funds, COM/2008/0115 final, 27 February 2008, p. 7.

1.1. Definition of SWFs: the politicisation of capital flows

We should first define what SWFs are and why they have become an important phenomenon in the global economy. Sovereign wealth funds are created when countries have surplus revenues and reserves and their governments feel it would be advantageous to manage these assets with a view to future liquidity requirements and as a way of stabilising irregular revenue streams.[5]

The legal form SWFs take may vary. SWFs can be pools of assets owned and more or less directly managed through the central bank or the finance ministry. These include, *inter alia*, Norway, Singapore's GIC (Government of Singapore Investment Corp), Alaska, Russia, and Qatar. Others are incorporated as private companies with at least some degree of independence, such as the Korea Investment Corporation and Dubai International Capital. The EU itself could create a kind of European sovereign fund in the near future.[6]

However, just like private venture capital, SWFs can cover up exactly who the entrepreneur is. These funds are sometimes channelled through screen companies (e.g. China's Chinalco). Russia uses many shell companies, operating in Cyprus for example. This raises the question of the role of state-owned enterprises (SOEs) and their links with SWFs. It is an important issue since in the case of China, for instance, "most of the large-scale investment projects that weigh heavy in Chinese FDI statistics have so far been executed by Chinese SOEs".[7] The

[5] Blundell-Wignall, A., Hu, Y. and Yermo, J. (2008), Sovereign Wealth and Pension Fund Issues, OECD Working Papers on Insurance and Private Pensions, No. 14, OECD Publishing, pp. 4–5.

[6] The European Investment Bank (EIB) is the investment arm of the European institutions and its aim is to support the development of infrastructure projects within the EU. The Council asked the EIB to establish a working group to explore ways to better coordinate European investment in infrastructure, mainly in the energy sector. The working group was to involve investors from national institutions such as the French Caisse des Depots, the Italian Cassa Depositi e Prestiti and the Hungarian Development Bank. The participation of these institutions sparked suggestions that the aim was to create a kind of European sovereign fund similar to those in Russia or China. But EIB President Philippe Maystadt ruled out this option. "Our current statute prevents us from acquiring participations in companies". It is also a question of money: "Sovereign funds use enormous own resources which the EIB does not have". Indeed, the Lisbon Treaty, if it enters into force, would allow the EIB to invest in companies in order to cover its lending exposures but further changes would be needed to turn the bank into a real sovereign fund. The working group was nevertheless presented as a step in this direction and attracted the unanimous support of Member States, [http://www.euractiv.com/en/euro/europe-turns-eib-fend-recession-threat/article-175341].

[7] Gugler, P. and Boie, B. (2009), The Rise of Chinese Multinational Enterprises, in: Chaisse, J. and Gugler, P., Expansion of Trade and FDI in Asia: Strategic and Policy challenges, London: Routledge, Contemporary Asia Series (forthcoming).

recent actions of Russia's state-owned gas company, Gazprom, exemplify how SOEs can be used to achieve political objectives. Gazprom, which owns about 25% of world gas reserves, supplies 20% of global demand and 25% of the EU's gas. The Russian state has reportedly used Gazprom's economic clout as an instrument to achieve its own political ends. In January 2006, Gazprom cut off gas supplies to the Ukraine, apparently because of a price dispute, but some regarded it as Russia's punishment of the Ukrainians for voting in a government that was not friendly towards Russia. The head of Gazprom has also threatened the EU that it would divert supplies from Europe if the EU thwarted Gazprom's plans for entering the EU. In November 2007, German Chancellor Angela Merkel stopped Russia's Mischkonzerns Sistema from investing in Deutsche Telekom, the largest communications company in Europe. More successfully, Vneshtorgbank, a Russian state-owned bank, has built up a 5 per cent stake in the European Aeronautic Defence and Space Company (EADS), the European aerospace consortium. In addition to the Vneshtorgbank, other Russian investors are interested in taking a massive share in EADS that would exceed the share already acquired by Vneshtorgbank. Some European countries do not want Gazprom, the Russian gas monopoly, to buy their pipelines and gas storage facilities. Even the United Kingdom, which is more open to foreign takeovers, might baulk at China acquiring a media group like Pearson.

On the most superficial level, the difference between SWFs and SOEs is obvious: It is the same as that between any type of investment fund and any type of company. But in reality the difference is not that obvious, and is to some extent misleading, since there are SOEs that are used as a conduit for their respective state's sovereign wealth, as part either of a longer channel involving an SWF or of a shorter channel between the foreign reserve manager and the target company.

As shown by the results of an IMF survey, half of the SWFs are established as legal entities separate from the state or central bank, whereas the other half are established as a pool of

assets not legally separate from the state.[8] SWFs are however a very diverse group of entities. They represent emerging countries and developed countries as well as developing ones. Their histories range in length between decades and one year. They vary in size, structure and purpose. They also have different agreements with host countries.

As a result, SWFs can be defined as pools of investment capital (whatever may be the legal form of the SWF: private or public) controlled by a government or central bank and invested in economic activities in other countries. The source of this capital is foreign exchange reserves, which all governments keep (typically in widely traded currencies such as the dollar, euro, or yen). When there is a surplus current account balance those reserves can be put into an investment fund and used to increase national wealth or diversify sources of revenue.

1.2. Trends

Sovereign wealth funds have come into the spotlight (Table 1), especially since 2007 when China declared its intention to invest USD 3 billion of its fund reserves in private holding companies. The SWFs have raised concerns about: financial stability, corporate governance, and political interference and protectionism.

[8] International Monetary Fund (2008), Sovereign Wealth Funds: Current Institutional and Operational Practices, Survey of the International Working Group of Sovereign Wealth Funds, 15 September 2008. [http://www.iwg-swf.org/pr/swfpr0805.htm].

Table 1: Top Sovereign wealth fund M&A transactions 2007–2008

Target	Target nation	Sovereign wealth fund	Value (US$m)
Citigroup	United States	Kuwait Investment Authority (KIA), GIC (Singapore)	12,500.0
UBS	Switzerland	GIC (Singapore)	11,535.0
Citigroup	United States	Abu Dhabi Investment Authority (UAE)	7,500.0
Merrill Lynch	United States	KIA (Kuwait), Korea Investment Corp	6,600.0
Merrill Lynch	United States	Temasek Holdings (Singapore)	5,600.0
Morgan Stanley	United States	China Investment Corp (China)	5,000.0
Laureate Education	United States	Caisse de Depot et Placement (Canada)	3,677.5
OMX	Sweden	DIFC (UAE)	3,551.4
Barclays	United Kingdom	China Development Bank (China)	2,980.1
Budapest Airport	Hungary	Caisse de Depot et Placement (Canada)	2,610.4
London Stock Exchange	United Kingdom	DIFC (UAE)	1,648.0
Related Cos	United States	Mubadala Development Co (UAE)	1,400.0
Carlyle Group	United States	Mubadala Development Co (UAE)	1,350.0
Och-Ziff Cap Mgmt Group	United States	Dubai International Capital (UAE)	1,258.6
Alliance Medical	United Kingdom	Dubai International Capital (UAE)	1,248.7
Mauser	Germany	Dubai International Capital (UAE)	1,159.8
OMX	Sweden	DIFC (UAE)	1,100.6
Bharti Infratel	India	Temasek Holdings (Singapore)	1,000.0
Chapterhouse Holdings Ltd	United Kingdom	GIC Real Estate (Singapore)	954.2
Barneys New York	United States	Istithmar PJSC (UAE)	942.3
Pearl Energy	Singapore	Mubadala Development Co (UAE)	877.5

Source: Thomson Financial 2008

These funds originate from potential geopolitical rivals. As already mentioned, SWFs are not however a new phenomenon (see Table 2). Currently, SWFs and central banks with a large SWF function manage an estimated USD3.2 trillion of assets.

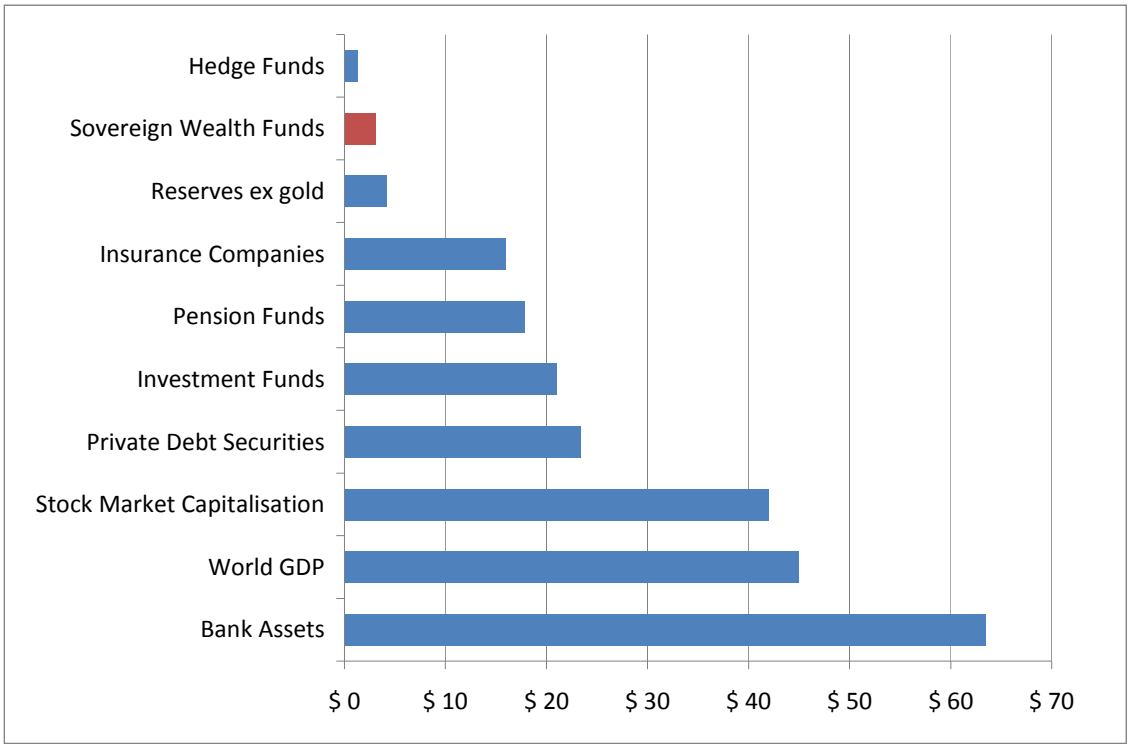
Table 2: Largest sovereign wealth funds (assets under management)

Country	Inception year	Fund name	Source of funds	Assets (US$ bn)
United Arab Emirates	1976	Abu Dhabi Investment Authority	Oil	250 to 875
Norway	1996	Government Pension Fund	Oil	300
Saudi Arabia	n/a	Saudi Arabian funds (various)	Oil	250+
Kuwait	1953	Kuwait Investment Authority	Oil	160 to 250
China	2007	China Investment Corp.	Non-commodity	200
Russia	2004	Stabilisation Fund of Russ Fed.	Oil	120
Singapore	1981	Government Investment Corp.	Non-commodity	100+
Singapore	1974	Temasek Holdings	Non-commodity	100+
Australia	2006	Australian Future Fund	Non-commodity	54
Qatar	2005	Qatar Investment Authority	Oil	50
Algeria	2000	Revenue Regulation Fund	Oil	40
US (Alaska)	1976	Permanent Fund Corporation	Oil	35
Brunei	1983	Brunei General Reserve Fund	Oil	30
South Korea	2005	Korean Investment Corporation	Non-commodity	20
Malaysia	1993	Khazanah Nasional	Non-commodity	18
Kazakhstan	2000	Kazakhstan National Fund	Oil	18
Canada	1976	Alberta Heritage Fund	Oil	15
Venezuela	2005	National Development Fund	Oil	15
Iran	1999	Oil Stabilisation Fund	Oil	13
New Zealand	2001	Superannuation Fund	Non-commodity	11

Source: Jen (2007) and IMF Global Financial Stability Report (2007).

It is however important to put SWFs into perspective with other existing investors. In 2006, by comparison, global stock market capitalisation was USD42 trillion, while the market value of private debt securities was USD23 billion. The importance of SWFs in global capital markets is expected to grow, mainly because of high oil prices, the relative weakness of the US dollar and persistent current account surpluses in China and certain other Asian countries.[9] Morgan Stanley[10] predicts that SWFs may manage USD12 trillion by 2015.

Figure 1. Global Asset Volume Comparison 2005, US$ Trillion



Source: Deutsche Bank 2008

Global Insight announced earlier in 2008 that SWFs have been growing by 24 per cent annually for the past three years.[11] Projecting from this annual growth rate, Global Insight

[9] Blundell-Wignall, A., Hu, Y. and Yermo, J. (2008), Sovereign Wealth and Pension Fund Issues, OECD Working Papers on Insurance and Private Pensions, No. 14, OECD Publishing, pp. 6-7.
[10] Jen, S. (2007), How big could Sovereign Wealth Funds be by 2015?, Morgan Stanley, 4 May.
[11] http://www.globalinsight.com/

forecasts that SWFs will surpass the entire current economic output of the United States by 2015, and that of the European Union by 2016.

1.3. Key concerns expressed in Europe

Investments by SWFs can be politically risky. In 2006, Temasek Holdings, an investment arm of the Singapore government, bought Shin Corp., Thailand's major telecommunications company, for USD3.8 billion from the family of Thaksin Shinawatra, who at the time was Thailand's Prime Minister. Public outrage[12] in Thailand over the sale of what was considered an important national asset to a Southeast Asian rival contributed to Thaksin's being ousted as Prime Minister in a military coup in September 2006 and to some extent to the political chaos in Thailand since then.

In the US, a specific mechanism ensures the control of SWF investments in the national economy. The Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee chaired by the Secretary of the US Treasury, takes part in the US investment policy analysis through reviews that protect national security while maintaining the credibility of open investment policy. In Congress, the CFIUS takes responsibility for monitoring overseas acquisitions of 10% or more of a domestic company's total ownership. Critics argue that the 10% ownership threshold for reviewing these investments is inadequate, pointing out that investors who acquire smaller ownership shares can have a dramatic impact on a company, and on an economy at large. And no definition of national security exists in CFIUS. Since 1988, foreign companies have sent CFIUS several thousand notifications of intent to purchase US companies, but CFIUS has only investigated a few, and of these, it has blocked only one.[13] CFIUS's impact may be greater, however, since many firms withdraw their offers if it looks like CFIUS may investigate them.

[12] Fotak, V., Bortolotti, B. and Megginson, W. (2008), The Financial Impact of Sovereign Wealth Fund Investments in Listed Companies, Mimeo, p. 7.

[13] That case involved the purchase by the China Aviation Technology Import-Export Corporation—the import-export arm of Beijing's Ministry of Aerospace—of MAMCO, a privately-owned, Seattle-based manufacturer of civilian aircraft parts.

The concerns expressed in the US are known and shared by the EU. Owing to the geography, however, Europeans are perhaps more concerned about Russia. At the same time, because of the financial crisis, the US market remains the more attractive for SWFs. These two variables explain to some extent the different perceptions on the two sides of the Atlantic and the differences in terms of regulatory approach.

If we look at the particular case of Europe, it seems that four issues are raised by SWFs. The role of governments is called into question while the lack of transparency of SWFs is also a cause for concern. The alleged political objectives of SWFs are feared as well. Finally there is certainly a difficulty in accepting a shift in the balance of power in the world economy from Western industrialised countries to new emerging market giants.[14] These four issues are considered below.

First, liberalism advocates market forces and commercial activity as the most efficient methods for producing and supplying goods and services. At the same time liberal policies shun the role of the state and discourage government intervention in economic and financial affairs as was the case in the European Common Market. The 25 years following deregulation, privatisation and the removal of border restrictions provided fertile ground for corporate activity, and corporations grew rapidly in size and influence. Corporations are now the most productive economic units in the world, more so than most countries. The activity of SWFs gives cause for concern first for this reason: it raises questions on the role of market forces and contradicts the trend of reducing the role of governments in the European and global economy.

Secondly, if the role of governments is more important than classical economic theory requires, it suggests that investment decisions are not only made in search of investment opportunities that yield optimal risk-adjusted rates of return. If SWFs make substantial foreign investments in privately owned companies, concerns are raised about the validity of this hypothesis. The management of SWFs may be motivated by "nationalistic

[14] Lyons, G. (2008), State Capitalism: The rise of sovereign wealth funds, 14 Law and Business Review of the Americas, 5.

considerations",[15] deviating from conventional wealth maximisation. Specifically, could a government use its SWF as a financial instrument to achieve a political objective? Russia and China are regularly singled out as countries with major strategic and political interests. Such a desire to obtain control over critical infrastructure within an investee country raises issues of market integrity and national security.[16]

Thirdly, the operations of SWFs are often obscure. It is true that when even the most secretive SWF makes an investment, it must comply with the disclosure obligations of the countries in which it is investing. So, when the newly formed China Investment Corporation bought into Blackstone in summer 2007, it was compelled to disclose the terms of the deal and other material information as part of Blackstone's regulatory filings in the US. All the question is to know what are the disclosure requirements on case by case basis? Repeated reference is made to the transparent Norwegian system (The Government Pension Fund – Global) that operates good governance.[17] However SWFs usually lack structures that are transparent and management processes that are domestically and internationally accountable. They work in an opaque way. SWFs do not publish statistics on their composition and size or their investments and strategies. For this reason, the IMF itself has relied on a collection of estimates of the size of the funds made by private financial institutions. We ourselves have to rely on very fragmented information to analyse the situation in the EU. There is no data in the hands of the European Commission. The scope and scale of SWFs also increase the potential for deliberate or accidental financial disruption. In a period of global financial turmoil such as now, whether or not the managers of these funds can be counted upon to act in a stabilising manner will be a key concern.

[15] Aizenman, J. and Glick, R. (2008), Sovereign Wealth Funds: Stylized Facts about their Determinants and Governance, NBER Working Paper No. 14562, December 2008, p. 23.

[16] Greene, E. and Yeager, B. (2008), Sovereign wealth funds – A measured assessment, 3 (3) Capital Markets Law Journal 2008, 247.

[17] Norway, one of the world's largest petroleum exporters, has invested its oil wealth in a fund with a current market value of more than USD350 billion. This makes it Europe's largest SWF, lagging behind only that of the United Arab Emirates. See, Chesterman, S. (2008), The Turn to Ethics: Disinvestment From Multinational Corporations for Human Rights Violations — The Case of Norway's Sovereign Wealth Fund, American University International Law Review (forthcoming).

Finally, the rise of SWFs is one sign of the shift in the balance of power in the world economy from Western industrialised countries to new emerging market giants like China and the oil-rich Middle East and perhaps India soon.[18] Capital has "historically tended to flow from the core of an economic system to its periphery [...] sovereign wealth funds play a potentially important role in this apparent reversal. The sense that capital is increasingly flowing from the periphery to the core is raising a variety of political sensitivities in the core countries".[19] Sovereign wealth funds are more than just another asset class: the lightning growth of SWFs and their assets is in fact a reflection of a shift in emphasis in the global economy. Just as the norm in recent decades was for western companies and portfolio investors to invest in emerging and developing countries, meaning that capital flowed from 'North' to 'South',[20] it is now logical from an economic point of view that the present capital surpluses in the 'South' will seek out investment opportunities in the 'North'. In some cases this is through private sector investment, but since many emerging and developing countries do not (for various reasons) have privately owned companies of a sufficient size to invest significantly in industrialised countries, this role is increasingly being performed by SWFs.

2. THE EU REGULATORY FRAMEWORK

Because of the concerns existing in Europe, the European institutions decided in 2008 to agree on the basic principles that should shape the EU approach towards SWFs. A consensus emerged towards a common approach (2.1). It has been decided not to create *ex nihilo* a new mechanism of control but to rely on the existing rules of the common market (2.2) that enable Member States to derogate to the principle of freedom of movement of capital (2.3).

[18] Recent media reports suggest that India is planning to set up a sovereign wealth fund (or a fund that invests the country's national savings in international assets). For example, on 19 February 2008, *The Economic Times*, wrote that "the government is planning to create a multi-billion-dollar sovereign wealth fund, [the] first of its kind in India, which aims to invest in energy assets such as oil, gas and coal across the world."

[19] Hildebrand, P. M. (2008), The challenge of sovereign wealth funds, VoxEU online, 21 January 2008 [http://www.voxeu.com/index.php?q=node/881].

[20] Ruet, J. (2009), The reshaping of global capitalism by MNEs from emerging countries, in: Chaisse, J. and Gugler, P., Expansion of Trade and FDI in Emerging Asia: Strategic and Policy challenges, London: Routledge, Contemporary Asia Series (forthcoming).

2.1. Consensus of EU institutions towards a common approach

SWFs raise concerns because they show the importance States can have in the global economy and this may be considered as detrimental to the role of market forces. These State SWFs may not decide for economic reasons to invest but rather for political purposes, and could have political project. On top of this, the only State-SWFs targeted in this situation are in the developing world. Politicisation of capital flows through SWFs and European concerns about this raise the question of how the EU and its Member States should react. In their specific case, is there a need to regulate at the international, European or the domestic level? How should they regulate: through hard law or soft law?

There are certain fundamental aspects of SWFs that need to be addressed. Legitimate questions include: Who controls them and what is their investment strategy? Proposals and actual policy initiatives have varied widely, from calls for increased transparency of funds' investment positions to calls for reciprocity in market access. All these options have diversified risks, but above all have the drawback that they send "a misleading signal – that the EU is stepping back from its commitment to an open investment regime. They would also be difficult to reconcile with EU law and international obligations."[21] Host states articulate a range of reasons for scrutinising SWFs and SOEs more than private investors as indicated in box 1.

[21] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A common European approach to Sovereign Wealth Funds, COM/2008/0115 final, 27 February 2008, p. 7.

Box 1: Main reasons to scrutinize SWFs more than private investors

- ✓ Fears that countries, as owners of SWFs, invest in companies with a view to acquiring 'know how' (intellectual property, patents, etc.)
- ✓ Danger of foreign investment in companies that are directly or indirectly involved with issues of national security
- ✓ 'Political' investments that create dependencies (in the energy sector, for example)
- ✓ Lack of transparency in the investment policy of SWFs
- ✓ Reciprocity: how can countries that invest in foreign companies via SWFs be prompted to adopt a less restrictive policy with regard to foreign investment in their own country (e.g. China)?

Some have called for an EU committee on foreign investments to mirror arrangements in the US, an EU-wide screening mechanism or some "golden shares"[22] mechanism for non-EU foreign investment. Such a mechanism is not anticipated at the European level.

The debate took place within the EU on another basis and with different aims from those of the US. There is a clear consensus of EU institutions towards a common approach. The European Commission took the initiative in a communication released in February 2008, which was supported by the European Council and the European Parliament later in the year.

[22] These are non-standard shares, the ownership of which confers special rights on the holder. Recent landmark decisions of the ECJ regarding compatibility of "golden shares" with EC law are a clear indication that the concept of "golden shares" violates one of the four fundamental freedoms conferred on individuals by the EU Treaty, namely the free movement of capital. According to case law of the ECJ rules governing "golden shares", an actual exercise of any rights attached to a "golden share" by any public body must be based on criteria of non-discrimination and an effective legal remedy has to be guaranteed. The judgments do not present a straightforward prohibition of "golden shares", however, they set out strong limits on their application..

2.1.1. European Commission initiative

The question of SWFs was first discussed by the US and EU at the meeting of the Transatlantic Economic Council held in Washington on 9 November 2007. It was agreed at this meeting to formally launch an Investment Dialogue to promote open investment regimes globally in a fully safe environment.[23]

In February 2008, the Commission presented a communication entitled 'A common European approach to Sovereign Wealth Funds'[24]. In common with all the Commission Communications documents, this text is one with no legal significance sent by the Commission to the other European institutions. The aim of the Commission is to set out new programmes and policies. According to this 2008 communication, new legislative measures at Community level are unnecessary.

The common approach recommended by the Commission was based on five principles:

- commitment to an open investment environment,
- support of multilateral work,
- use of existing instruments,
- respect of EC Treaty obligations and international commitments,
- and finally, proportionality and transparency.

The communication from the Commission set out some of the options that are available.

In the context of the financial crisis, there is now a need to attract liquidity in Europe as well as in the US. In this regard, regulation is scarcely the best response, because few requirements could be usefully imposed on SWFs. The EU has a tradition as an open investment environment, which cannot be denied. The principle of free movement of capital was laid down in law in 1993. In order to inspire confidence among citizens and companies and to ensure protection for funds invested, as well as to provide equal competitive conditions, the EU has adopted common minimum requirements for banks, insurance companies, fund management companies and others. The basic idea is that companies that

[23] "We note the growth of investments by government-controlled investors such as sovereign wealth funds. We welcome commercially-driven investment from these investors and note the importance of transparent investment policies". Transatlantic Economic Council Report to the EU-U.S. Summit 2008, U.S. – EU Open Investment Statement, Annex, Office of the Press Secretary, June 10, 2008.

[24] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A common European approach to Sovereign Wealth Funds, COM/2008/0115 final, 27 February 2008.

are authorised to conduct activities in one of the Member countries ("country of origin") must be able to sell their services or establish branches throughout the EU.

The scope and the quality of the information that the funds are making available to the market tend to differ enormously from fund to fund. This raises the fear that the investment of these monies could give the foreign governments concerned excessive political influence. If the funds are transparent and comply with clear rules of accountability, then the fact that they are state-owned investment vehicles should not give cause for concern. The communication advocates a common European approach based on cooperation between the countries receiving the SWFs, the funds themselves and those responsible for them, with a view to establishing, 'a set of principles ensuring the transparency, predictability and accountability of SWFs' investments'.

Further, all investors in the single market should have to observe the same regulations as they apply to competition, the internal market and employment law. The various instruments to control foreign investments that Member States adopt in order to protect public security, law and order must abide by Community guidelines.

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

2.1.2. Council approval

On 4 March 2008, the Council held an exchange of views on issues relating to SWFs,[25] with a view to further discussion by the European Council at its spring meeting (13 and 14 March

[25] Council of the European Union, Economic and Financial Affairs, 2857th Council meeting, 7192/08, 4 March 2008.

2008). Delegations agreed on the need for the EU to forge a common position, so as to help ensure that their shared objectives are met through the work of international fora. Commitments, in particular with regard to the separation of the management of SWFs from political authorities, should be central to any agreement at the global level. And if international negotiations were not to develop satisfactorily, further action should be considered at EU level.

The Council took over the ideas set out by the Commission, clarifying, in particular, two principles out of the initial five.

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

At the meeting at the Spring Summit on 13–14 March 2008,[26] the European Council welcomed the Commission Communication on SWFs. The European Council agreed on the need for a common European approach taking into account national prerogatives, in line with the five principles proposed by the Commission, namely:

- commitment to an open investment environment;
- support for ongoing work in the IMF and the OECD;
- use of national and EU instruments if necessary;
- respect for EC Treaty obligations and international commitments;
- proportionality and transparency.

The European Council supported the objective of agreeing at the international level on a voluntary Code of Conduct for SWFs and defining principles for recipient countries at the

[26] Council of the European Union, revised version of the Presidency Conclusions of the Brussels European Council (13/14 March 2008), 7652/1/08 REV 1, Brussels, 20 May 2008.

international level. In this respect, they reiterated the EU's "support for the ongoing work in the International Monetary Fund (IMF) and the OECD".
In any event, this is a clear rejection of a European-wide screening mechanism that would echo the system in the United States.

With the aim of giving coordinated input to this ongoing debate, the European Council invited the Commission and the Council to continue their work along these lines stressing the importance of a common European approach on sovereign funds during this debate at the international level. However, the European Council also strongly insisted that governments should be allowed to "make use of national and EU instruments if necessary" to counter foreign investments not justified for commercial reasons.

2.1.3. Parliamentary Approval

The European Parliament (EP) welcomed the Commission Communication on SWFs, which reasserted the importance of open markets and the Commission's commitment to a global solution. The EP expressed its concern "that the lack of transparency of certain SWFs may not allow a proper understanding of their structure and motivation; requests the Commission to acknowledge the fact that transparency and disclosure are the key principle for the establishment of a truly level playing field and the smooth running of markets in general".[27]

The European Economic and Social Committee (EESC) went in the same direction adding its support for the European Commission proposal. The EESC underlined that "the Commission should work together with the Member States and the supervisory authorities to improve the transparency of these funds, understand their motives and make sure they

[27] Resolution of European Parliament on sovereign wealth funds, P6_TA-PROV(2008)0355, Strasbourg, 9 July 2008, point 2.

are not pursuing political objectives".[28] Generally, "the EESC would urge the Commission to present, as soon as possible, its draft legislative provisions aimed at stepping up the information provided by institutional investors with regard to their policies in respect of investment and voting".[29]

2.2. Application of Existing EU law

The present debate around SWFs may suggest that no rules exist to regulate them. This is not the case. As underlined by the EC Comission in its 2008 communication, EC law provides a comprehensive regime to regulate the establishment and the actions of foreign investors, which "covers SWFs in exactly the same way as any other foreign investor".[30]

2.2.1. Free movement of capital as a principle

The free movement of capital is not absolute. As a fundamental principle of the Treaty, it may be regulated in two respects at the European level under Article 57 (2) EC:

- First, the Community may adopt, by qualified majority, measures on the movement of capital from third countries involving direct investment.
- Second, it is not excluded that the Community can introduce (by a unanimous decision) measures that restrict direct investments.

Art. 57 gives EU the competence to adopt measures with regard to the establishment of foreign investors in the Union. This includes adoption of internal EU legislation and conclusions of international investment agreements (IIAs) like EU FTAs.

[28] Opinion of the European Economic and Social Committee, Section for Economic and Monetary Union and Economic and Social Cohesion (ECO/204), Opinion on Financial integration: the case of European stock markets (own-initiative opinion), CESE 283/2008, 13 February 2008, para. 1.5.

[29] Opinion of the European Economic and Social Committee, Section for Single Market, Production and Consumption (INT/332), Opinion on Review of the Single Market (exploratory opinion), CESE 89/2007, 17 January 2007, para. 1.1.15.

[30] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A common European approach to Sovereign Wealth Funds, COM/2008/0115 final, 27 February 2008, p. 5.

Free movement of capital, unlike the other freedoms of movement established by the EC Treaty, does not apply solely between Member States. It also prohibits restrictions on the movement of capital between Member States and third countries. Foreign investors thus benefit from important rights to invest within the EU. Since the SWFs' investments have to be treated the same way as any other FDI, SWFs must benefit from the free movement of capital.

There are however some limits to the principle. The limitations on the principle of free movement of capital include two sets of provisions, consisting, first, of safeguard clauses and, second, of derogations. The scope of these limits will determine the room for manoeuvre for national governments to restrict FDI in their territories. The broader these exceptions, the easier it will be to limit the access of SWFs to EU common market. The more narrowly these limits are conceived, the easier it will be for SWFs to come into the EU market.

The safeguard clauses are contained in Articles 59 EC and 60 EC. They relate only to third countries. They are of a temporary nature and are intended to be applied in exceptional circumstances. The derogations are laid down in Articles 57 EC and 58 EC. Article 57 EC also concerns only relations with third countries and covers movements of capital regarded as being particularly sensitive. These are movements of capital involving direct investment (including investment in real estate), establishment, the provision of financial services or the admission of securities to capital markets.

2.2.2. Restriction to the movement of capital on the gound of Article 58 ECT

The most important when it comes to potential obstacles to SWFs' investment in the EU is Article 58 EC. It describes the powers retained by the Member States which enable them to restrict the movement of capital to or from other Member States or third countries. In the light of the precise and unconditional nature of that provision, the Court held in *Sanz de Lera*

and Others[31] that the principle of free movement of capital has direct effect in that it prohibits restrictions both between Member States and between Member States and third countries. Article 58 EC provides:

> 1. The provisions of Article 56 shall be without prejudice to the right of Member States:
> (a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested;
> (b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.
> 2. The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.
> 3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56.'

Article 58 stipulates that the Member States have the right to put in place restrictions on grounds of public order or public security. A Member State is entitled to restrict Treaty freedoms on the basis of legitimate national security concerns. Article 58 stipulates that the Member States have the right to put in place restrictions on grounds of public order or public security. Free movement of capital, unlike the other freedoms of movement established by the EC Treaty, does not apply solely between Member States. It also prohibits restrictions on the movement of capital between Member States and third countries. This is true in respect of all investments, be they from SWFs, state-controlled companies, private companies or others. Furthermore a number of Member States have measures in place that, for example, restrict investments in the defence sector.

We must emphasise that the list of justification measures in Article 58(1)(b) EC is not exhaustive. However, whatever the ground relied on, the measure in question must be suitable for the purposes of attaining the objective which it pursues and not go beyond what

[31] Joined Cases C-163/94, C-165/94 and C-250/94 [1995] ECR I-4821.

is necessary in order to attain it: proportionality test. The Court has also provided criteria to assess the proportionality: national measures must aim at the protection of a legitimate general interest and foresee strict time limits for the exercise of opposition powers; assets or management decisions targeted must be specifically listed.

Lastly, in *Test Claimants in the FII Group Litigation* (2006), the Court stated that it may be that a Member State will be able to demonstrate that a restriction on capital movements to or from third countries is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on capital movements between Member States (Case C-446/04 [2006] ECR I-11753, paragraph 171). In analysing whether such restrictions are justified, different considerations may apply than is the case with purely intra-Community restrictions.

Article 58 has never been invoked in the context of SWFs. In other words, no Member state has ever adopted a law restricting FDI from SWFs nor has a Member State ever enforced a decision rejecting a SWF investment arguing as to the validity of the decision as an exception (art. 58) to the principal of freedom of capital movement (art. 57).

This does not however remove the need to clarify the interpretation of Article 58, which provides for restrictions on the free movement of capital on grounds of public order. Because it has not been applied until now in the context of SWFs, it is worthwhile ensuring that Member States will not be tempted to make extensive use of it. To this end, an option could be to develop, as the French government did (see below), a short-list of sensitive sectors where "enhanced scrutiny" is exercised over inflows of funds, whether private or SWF, leaving all other sectors with free entry. It could take the form of a paragraph added to article 58.

2.3. Monitoring and coordination of national regulations

Most countries do have laws and regulations that restrict foreign investments in industries considered senstivive to national security or sovereignity. Some regulations provide the right to review proposed foreign investment. Any national legislations that establish mechanisms to control SWFs are by nature exceptions to the application of the principles of free movement of capital and establishment.

Recent experience shows that the opacity of some SWFs risks prompting defensive reactions. In October 2008, the Italian government announced first that SWFs wanting to buy shares in Italian companies should 'generally' stay below 5 per cent, suggesting that a new law should be passed. This was a reaction to the purchase by Italy's former colony, Libya, of a 4.23 per cent stake in the number two Italian bank UniCredit SpA.[32] However, shortly after this, Foreign Minister Franco Frattini said that there is no need for a threshold but there is a need for transparency.[33] Such a u-turn should be interpreted as abandoning any plan to pass a new law and refer to the multilateral approach supported by the EU.

However the UK and France have already introduced legislation allowing them to fend off investments from SWFs. Germany has initiated a legislative process and the German Parliament should pass the new law soon.

We think that any discussion of foreign investment by SWFs must recognise the differences in investment objectives among different types of state-controlled investing entities;[34] this justifies, at the European level, the fact that countries should be able to adopt minimal provisions so as to have the means of oversight for the few exceptions, to rule out a possible threat to national security interests. In other words, the 27 Member States of the European Union should have the power to block investments only in sensitive, security-related sectors. Restricting the flow of capital for other reasons will lead to legal action by the European Commission, the Union's executive arm.

[32] Dinmore, G. (2008), Italy set to curb sovereign wealth funds, *Financial Times* 21 October.
[33] Reuters Agency (2008), No need to cap sovereign fund holdings, 23 October.
[34] Greene, E. and Yeager, B. (2008), Sovereign wealth funds – A measured assessment, 3 (3) Capital Markets Law Journal 2008, 247.

Such national measures should not contradict the common European approach advocated by the Commission on the basis of the principles supported by the European Council. The national measures must be envisaged in the context of a common European approach, which they should complement. Europe must avoid any uncoordinated responses that give the wrong message about the EU stepping back from its commitment to being a welcoming environment for investment.

For these reasons there is a need for the Commission to analyse the existing initiatives, establish effective coordination and ensure that coordination does not encroach upon national prerogatives and competences in terms of protection. This analysis of European practices is done by the European Commission Directorate General for Economic and Financial affairs. We will detail existing laws in three countries of the EU: the UK, France and Germany. These three countries seem to be the most relevant examples since they are the main destinations for investment within the EU while they are simultaneously three important actors in the decision-making procedure in the EU. Whether or not a CFIUS like mechanism should be introduced in the EU, the decision would require the support of these three countries.

2.3.1. Control of foreign takeovers in the UK

In Britain, corporate mergers and acquisitions can, in principle, be reviewed for the purpose of protecting investors and ensuring fair competition through the Enterprise Act of 2002.[35]
A merger situation can be considered under the competition legislation if either or both of the following test are satisfied, namely a UK turnover of the enterprise being acquired in excess of £70m. or that the combined business will account for more than 25% of a supply market within the United Kingdom or a substantial part of it. The substantive test applied to the merger is whether it may be expected to result in a substantial lessening of competition as a result of the transaction.

[35] http://www.opsi.gov.uk/acts/acts2002/pdf/ukpga_20020040_en.pdf . See, Cosmo, G. (2004), The Enterprise Act 2002 and Competition Law, Modern Law Review, Vol. 67, pp. 273-288.

Furthermore, the government can intervene in mergers and acquisitions in areas of national security and the media if their acquisition is against the public interest. Amongst many other things[36], the Enterprise Act 2002 makes the Competition Commission determinative in merger cases and in market investigations (which replace complex monopoly investigations), and changes the substantive question for these investigations away from whether the specified matters operate, or might operate, against the public interest, to one of the following tests:

- a qualified public interest test, in cases raising specific public interest issues (e.g. national security or media public interest);
- a test of the prejudice to Office of Water Supply's ability to make comparisons between water enterprises, in certain mergers between water companies;
- a substantial lessening of competition test, for all other mergers; and
- whether "market features" have an "adverse effect on competition", for market investigations.

Even if traditionally more liberal than continental Europe, Great Britain through its Chancellor, Alistair Darling, backed the move by the G7 to toughen its approach to SWFs. He warned foreign governments that Britain would not tolerate politically motivated investments in key UK companies. These comments were intended as a warning to Russia that Britain would not tolerate Russia's state-owned energy company taking a stake in Centrica, the owner of British Gas. The Russian state-owned gas and oil conglomerate that already supplies around a quarter of EU gas and has re-acquired most of the pipelines running from Central Asia, would not be a welcome bidder for UK gas grid operator Centrica.

2.3.2. Control of foreign takeovers in France

[36] Prentice, D. (2004), Bargaining in the Shadow of the Enterprise Act 2002, European Business Organization Law Review, 5 , pp 153-158.

In France, a law dated 9 December 2004 modified the legislative part of the Monetary and Financial Code. The new article L 151-3 strictly limits the field of control to the reasons expressly indicated in the treaty for a possible exception to the free circulation of capital: national defence (art. 296 TEC), public order and public security (art. 58-1 TEC).

Following the rumour of a takeover of Danone by an American company, the French Economy Minister announced the publication of a Decree allowing French authorities to control foreign investments that are carried out in France. This Decree No. 2005-1739 of 31 December 2005[37] defined the sectors concerned and ensured the respect of the EU principle of proportionality.

The following will be considered as an "investment":

- any takeover of a company headquartered in France;
- the direct or indirect acquisition of all or part of a branch of a company headquartered in France; and
- crossing a 33.33% threshold of direct or indirect stock holdings or voting rights of a company headquartered in France.

The Decree introduced differentiation according to the origin of the investment (EU Member Country or third country). This difference in treatment, which is permitted by the rules of the WTO and the EC treaty (article 57), leads to continuation of the previously applicable regime for operations originating in third countries, but with greater precision in the field of application. For EU investors, on the other hand, only those operations leading to the effective transfer of a sensitive activity will be concerned. The objective sought is clear: France can oppose the relocation of activities or product stocks (vaccines needed in case of a bioterrorist attack, for example) essential to its security or defence.

Moreover, this Decree set out a clear list of sectors which are considered strategic, and in which investment can be subject to authorisation. The national security rationale for this list is quite clear. The Decree has not been applied so far.

However, and importantly, the European Commission has decided to ask France formally to modify Decree 2005-1739 of 30 December 2005, which creates an authorisation procedure for

[37] Décret n°2005-1739 du 30 décembre 2005 réglementant les relations financières avec l'étranger et portant application de l'article L. 151-3 du code monétaire et financier, JORF n°304 du 31 décembre 2005 page 20779.

foreign investments in certain sectors or activities that could affect public policy, public security or national defence. The scope of the authorisation procedure is more extensive for investments originating from third countries, but this is authorised by Article 57 of the Treaty, as this measure already existed prior to 31 December 1993. However, because indirect investments are also subject to authorisation, the procedure foreseen for third-country investments could create a restriction on investments by companies that are legally established in the EU, but that have shareholders established in third countries. Such a restriction on investment is considered incompatible with the free movement of capital and the freedom of establishment. The Commission is concerned that some of the provisions of this Decree could discourage investment from other Member States, in contravention of EU Treaty rules on the free movement of capital (Article 56) and the right of establishment (Article 43). This requirement imposed on European companies owned by third country investors also contravenes the principle of Art 48, which establishes that companies established in Member States should be treated like nationals of Member States.

The European Commission decided in October 2006 to send a formal request to France. This request takes the form of a letter of formal notice, the first stage of infringement procedures under Article 226 of the EC Treaty. France was asked to send its reply within two months. However until now, the Commission has not issued a formal request to the French Government to amend the legislation.

2.3.3. Control of foreign takeovers in Germany

A look at the ownership structure of the DAX corporations makes Germany's openness to foreign investments, including those by sovereign funds, clear. Foreign investors are involved in many German DAX companies, and sovereign funds from Kuwait and Dubai are shareholders in leading DAX companies like Daimler and Deutsche Bank. In Germany, there is a concern that a SWF could buy some large German companies including Deutsche Telecom, Deutsche Bank or recently Deutsche Bahn.[38] There seems to be recognition of the importance of national security in the economic realm, but more protectionism tools have not been introduced until recently.

However German government officials appear troubled about a number of diverse issues and recent developments, including:

- the ability of SWFs to leverage cash to make large acquisitions;
- a potential indirect takeover of one of Germany's largest banks by a foreign government;
- state-controlled investors buying small engineering companies to siphon off patents and intellectual property; and
- national security concerns if parts of the German energy infrastructure were to be acquired by political investors rather than investors driven by commercial imperatives.

The Cabinet of the German Ministry for the Economy took a decision on Foreign Trade and Investment Law on 20 August 2008.[39] This decision is aimed at protecting strategic German industries from unwanted foreign takeovers. The law, which has yet to receive parliamentary backing, would give the German federal government the right to veto any

[38] NN, Chinesen wollen die Deutsche Bahn, *Die Zeit*, 4 September 2008.

[39] Benoit, B. (2008), Berlin foreign investors' bill clears hurdle, *Financial Times*, 20 August 2008 [http://www.ft.com/cms/s/0/ac2762d6-6eff-11dd-a80a-0000779fd18c.html?nclick_check=1].

investment from non-EU or European Free Trade Association countries (i.e. Switzerland, Norway, Liechtenstein and Iceland) amounting to 25% or more of a company's stakes, if it deems that national security is at risk.

Based on the US model, Germany's plans could lead to further attempts across the 27-Member EU aimed at blocking foreign investment incursions into sensitive industries. Under Germany's proposals, "public order and security" are the principal criteria for triggering a review of foreign groups' investment plans.

There is a kind of contradiction between private and public interests as the German case reveals. German business associations (e.g. Germany's International Chamber of Commerce and the Federation of German Industry) did not support the government decision and expressed doubts because the decision is alleged to go against EU rules on the free movement of capital. The *Bundesverband der Deutschen Industrie* (BDI) insists that the law would be in breach of EU legislation on the free movement of capital – which is meant to apply equally to EU and non-European investors. It further argues that its definition of national security is too broad.

Economy Minister Michael Glos insisted that the mechanism would be used only in "extremely rare" cases and that "the majority of foreign investments won't be affected". "Germany is and remains open to foreign investment".

But the government says the law merely brings German law into line with existing legislation in France, the UK and the US.

In other words, just as other countries have already done, Germany is creating governmental means of oversight for the few exceptions, to rule out a possible threat to national security interests. Investment protectionism or an overall rejection of investments by sovereign funds, now and in the future, will not and cannot happen in Germany.

3. The EU support for a multilateral solution

From the European perspective, the EC is not the level at which a decision on a binding regulation could be taken because SWFs are conceived as a global issue. As SWFs have an international scope, the EU decided to cooperate with the other recipient countries, on the one hand, and with the SWFs and those responsible for them, on the other. The European approach (i.e. the proposal of the Commission supported by all the other European institutions) acknowledges this analysis and is well in line with the EU tradition of preferring multilateral bodies rather than a unilateral approach. The option taken by the EU is important because it gives support to the work done by the IMF and OECD.

3.1. Options for a multilateral solution

Unilateral action could be disastrous for diverse reasons. Obviously it can be seen or strategically said to be protectionism. But unilateral actions could also proliferate, contributing to the creation of multiple and very diverse standards. This could impose undue costs of compliance on SWFs and hence affect the efficient flow of capital.

For all these reasons, it was not deemed appropriate to adopt a narrow European approach. Rather, it is necessary to seek an international and global solution as justified in the 2008 Communication. The Union is thus playing an active role in ensuring that the work of the multilateral bodies moves forward. The Commission seeks a code of conduct that would be developed jointly at the global level by the recipient countries and by the funds themselves. A voluntary code of conduct that lays down basic standards for governance and transparency would ensure greater clarity in the functioning of the funds. The objectives expressed in the Commission communication are to "obtain greater clarity and insight into the governance of SWFs […] and to deliver greater transparency on their activities and investments".[40]

[40] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A common European approach to Sovereign Wealth Funds, COM/2008/0115 final, 27 February 2008, p. 8.

In October 2007, the G7 Finance Ministers invited major multilateral organisations, such as the IMF and the OECD, to launch a reflection on the role of SWFs and on the mechanisms to address the challenges they pose. Since the European Council meeting in March 2008 signalled its support for this approach, the European Commission has been actively involved in the work of the IMF and OECD on the definition of best practices. Since the G7 summit, the activities in the IMF and OECD have been running in parallel but they are not dealing with exactly the same themes. They are however generally described as complementary.

3.2. OECD: Best practices for recipient countries

The OECD Working Group is doing complementary work. It is seeking to determine how recipient countries should behave in response to the influence exerted by SWFs. In the OECD forum, work is under way among recipient countries to identify best practices with respect to SWF investment frameworks, building on principles of non-discrimination, transparency, predictability and accountability.

3.2.1. Towards OECD Guidelines mid-2009

Since 1960, the Commission of the European Community has had the status within the OECD of a quasi-Member.[41] The members of the EC delegation thus sit in on the OECD's various specialised committees which monitor the work of the Secretariat.

On the occasion of the OECD Ministerial Council Meeting in Paris on 4–5 June 2008, Ministers adopted the OECD Declaration on SWFs and Recipient Country Policies.[42] It

[41] The signatory states decided that the Commission of the European Community "shall participate in the work" of the OECD. See: Supplementary Protocol No. 1 to the Convention on the OECD, 14 December 1960.

[42] OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies (Meeting of the Council at Ministerial Level, 4–5 June 2008), C/MIN(2008)8/FINAL, adopted by Ministers of OECD countries at the Council at Ministerial level, 5 June 2008 [http://www.olis.oecd.org/olis/2008doc.nsf/linkto/C-MIN(2008)8-FINAL].

admits that "SWFs have become a key player in the new financial landscape. Ministers welcomed the benefits that SWFs bring to home and host countries and agreed that protectionist barriers to foreign investment would hamper growth. They recognized the rapidity with which the OECD has responded to the mandate given by the G7 Finance Ministers and other OECD Members. Ministers praised the Report by the Investment Committee on SWFs and the guidance they give to recipient countries on preserving and expanding an open environment for investments by SWFs while protecting legitimate national security interests. They expressed their support for the work at the IMF on voluntary best practices for SWFs as an essential contribution and welcomed the continuing co-ordination between the OECD and the IMF. Ministers looked forward to future work on freedom of investment by the OECD, including surveillance of national policy developments".

OECD is expected to release the guidelines in mid-2009. These guidelines would draw on the OECD's extensive work on the treatment of foreign investment in OECD economies. OECD work will also draw on the OECD Guidelines for Corporate Governance of State Owned Enterprises (the SOE Guidelines).

3.2.2. A requirement of reciprocity?

There are also concerns about restrictions on investments that EU firms may face when they want to make investment in the countries concerned. Another issue to consider is investment reciprocity. This is a point on which the European Commission has not yet made any proposal and on which OECD guidelines may take a position to either tolerate or to exclude SWFs investment.

How can countries that invest in foreign companies via SWFs be prompted to adopt a less restrictive policy with regard to foreign investment in their own country (e.g. Russia or China)?

Luxembourg's Finance Minister Jean-Claude Juncker has led the charge in the EU, clearly sourcing his resistance to SWFs from Russia over the reciprocity issue. He said that it is unacceptable that while Russia's government-affiliated fund is sweeping into Europe, European companies are in a situation where they are unable to undertake similar activities in Russia. He said that EU should respect the principle of reciprocity. It would be dangerous to leave everything up to the market. Minister Jean-Claude Juncker added that it is necessary to take strong political action to strengthen surveillance and ensure transparency in financial markets.

Some of the countries that sponsor SWFs impose severe restrictions on inward foreign investment by individuals and firms in the EU and other OECD countries (e.g., the People's Republic of China and Russia). The will of SWFs to invest a large portion of their assets in the EU creates an opportunity to press restrictive home countries to open their economies to inward foreign investment.
EU wishes to ensure that there is a level playing field for every aspect of economic cooperation (with particular attention to energy as a prime area of cooperation between the EU and Russia), whereas Russia wants each sphere to be treated separately (in terms of volumes of investments).

Furthermore, the EU initiated the discussion about sovereign funds and their investments in the EU. Both the European Commission and the European Council stressed the necessity to guarantee transparency of ownership structure and interests of these funds as well as independence of their management. These discussions can potentially create a leverage to limit Russian investments in the EU if the EU's views on reciprocity are not taken into account. Since many SWFs are located in countries which are financially less open than a typical OECD country, the immediate effect of a strict application of the reciprocity principle would be to place strong limitations on SWF investments.

The reason why such reciprocity was not included in the Commisson proposal is certainly because the EU is the biggest investor internationally. For this reason it could be perceived as an excuse for protectionism to keep out other investors. But restricting investment risks

retribution in countries with sovereign funds, including Russia and China, where European companies are active.

3.3. IMF: Influencing the conduct of the SWFs

The International Working Group (IWG) of Sovereign Wealth Funds[43] in the IMF, which meets monthly, tried to see how the conduct of the SWFs themselves can be influenced. The European Community is not a member of the IMF. However the creation of the euro gave a strong impetus to the coordination at IMF. EU Member States have set up a multilayered structure of coordination, composed of a Brussels-based committee and an informal group of Member States' officials who gather in Washington.[44] Its position during IMF negotiations mainly cover issues of transparency (3.1.1) and governance (3.1.2). The IMF has been developing a set of Generally Accepted Practices and Principles (GAPP) for SWFs directly in cooperation with the owners of the SWFs. The representatives of 26 SWFs met in Santiago at the beginning of September 2008 and agreed on a set of 24 voluntary principles for the funds to follow and to ensure their competitiveness in global financial markets. These GAPP or "Santiago Principles" were released on 11 October 2008 and are analysed below (3.1.3).

3.3.1. Transparency

As reported by the European Commission, it is true that since SWFs "are managed independently from a country's foreign exchange reserves, they are excluded from transparency mechanisms such as the IMF maintains for foreign exchange reserves (IMF Special Data Dissemination Standard, SDDS)."[45] But when we look at the facts, the SWFs lack of transparency has some correlation with whether the government controlling these funds

[43] International Working Group of Sovereign Wealth Funds website: http://www.iwg-swf.org/index.htm

[44] Nicolas, C. (2006), European Coordination at the World Bank and International Monetary Fund: A Question of Harmony?, ADS Consultants report, Brussels, 8–10.

[45] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A common European approach to Sovereign Wealth Funds, COM/2008/0115 final, 27 February 2008, p. 9.

is democratic or autocratic (i.e. "non-democratic" in one way or another). Democratic governments typically have to meet, in their governance and in their institutions, transparency standards that dictatorships and sheikhdoms do not have to. But because a fair number of countries with SWFs are non-democratic, the non-transparency makes recipients of these funds afraid that non-commercial "strategic", political and social factors would prevail in the making of their investments.

Tranparency, as stipulated by the Commission (Box 2), can be understood as a requirement for the publication of statistics and data.

Box 2: Transparency as suggested by the EU approach

Transparency practices that could be considered would include:

- Annual disclosure of investment positions and asset allocation, in particular for investments for which there is majority ownership;
- Exercise of ownership rights;
- Disclosure of the use of leverage and of the currency composition;
- Size and source of an entity's resources;
- Disclosure of the home country regulation and oversight governing the SWF.

The criteria mentioned in the EU approach are very classical. But this transparency requirement should be reinforced.

In an East Asian context, the Government of Singapore Investment Corporation (GIC) and Temasek, another Singaporean government-controlled investment vehicle, have pioneered the use of SWFs. Both funds are notorious for their lack of transparency and closeness to the Lee dynasty that has dominated Singapore's authoritarian political system for decades. The key point to emphasise about the Singaporean experience is that foreign reserves have been recycled through state investment vehicles to underpin an overall vision of economic

development and strategic investment.[46] Tamasek in particular has been responsible for exporting this strategic investment approach overseas. Significantly, the Singaporean approach has been a major influence on China's emerging overseas investment strategy.[47]

It is then tempting to refer to good models. The Norwegian Pension Fund is often held up as a good benchmark with regard to transparency and governance. Information on its global performance and risk exposure is reported quarterly and its holdings in about 3,500 companies are detailed annually – in most cases, its investment in any one company amounts to less than one per cent of available shares. The fund does not seek to control companies through buy-outs. By its own rules the fund restricts its ownership in any company it invests in to five per cent of shares. The investment objectives are purely financial in nature, safeguarding assets for the long term.

Another example, the Irish National Pension Reserve fund, which publishes its investment strategy in an annual report, is often mentioned as a good model. Although relatively modest, with current assets of approximately USD30bn, the Irish National Pension Reserve Fund publishes its investment strategy, details of its investment conduits and agents and an audited yearly report of its holdings in every company. This is what transparency is about. Anybody can find out which shares it holds and what its strategy is.

However, beyond any requirement for transparency, issues concerning the nature of the state in SWF countries will surface. A powerful state may establish a degree of order in business and state affairs. But in the countries of the middle east and in Russia the very nature of the "originating" state guarantees that there will be problems, notably because of the absence of freedoms and rule of law. Many western accounting practices are far from perfect in this respect, but in the middle east the situation is on another level of unreliability: it is no exaggeration to say that no official and business statistics (on oil output or revenue, or on state income or expenditure) are reliable.

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[46] Rodan, G. (2006) 'Singapore: Globalization, the developmental state and politics', in G. Rodan, K. Hewison and R. Robison (eds.) The Political Economy of South-East Asia: An Introduction, 3rd edn. (Melbourne: Oxford University Press):136–167.

[47] Burton, J. (2007) 'Singapore's wealth fund flattered by imitation'. *Financial Times* September 4.

In any case, the transparency requirement cannot be a unilateral one. The ideal equation reveals a bilateral process. For the funds themselves, clarity will mean stability and will reduce the risk of setbacks. For those national economies in which the funds are investing, a stable, predictable and non-discriminatory framework will eliminate the risk of these important investors voting with their feet, in other words leaving Europe and investing elsewhere.

But the EU approach could be more convincing if it could insist on other reasons for transparency.

The citizens of the countries whose funds are being invested would gain a tool to hold their leaders accountable for how these funds are invested. It is a matter of fact that undemocratic regimes may not readily embrace fund disclosure for the sake of the people they rule over. But it can be assumed that Russia launched its National Wealth Fund beginning January 2008 with high levels of transparency and disclosure in part to insulate fund managers from allegations of theft or other improper conduct should an investment go sour in the future. So, when the newly formed China Investment Corporation (CIC) bought into Blackstone inn 2007, it was compelled to disclose the terms of the deal and other material information as part of Blackstone's regulatory filings in the US. This turned out to have some very real consequences back home. Soon after CIC invested in Blackstone, the holding lost nearly US$1 billion in less than a month. Chinese citizens immediately let their political leaders know how they felt about their country's savings being squandered by flooding the Internet and other media outlets with angry criticism. China Investment Corporation bought its original stake in the Blackstone Group just before the company's US$31-a-share initial public offering in June 2007, but has seen the value of its investment sink as a year-long crisis froze credit markets, prompting widespread criticism. Blackstone's shares end October 2007 traded at US$ 7.89.

When it emerged that China Development Bank (CDB), having already lost another billion in its investment in Britain's Barclays Bank, was considering pouring US$ 2 billion into

Citigroup as part of the American lender's January rescue package, Chinese politicians quietly killed the deal. While no official explanation was given, China experts believe that the State Council's[48] rejection of the CDB-Citi investment was driven by fear of experiencing another highly visible loss and the desire to avoid the resulting political backlash at home. It is not just the public grumbling that was noteworthy, but that Chinese political leaders heard it and apparently reacted.

3.3.2. Governance

In terms of governance other standards already exist. The 2001 IMF *Guidelines for Foreign Exchange Reserve Management*[49] lay down important principles which could be extended to SWFs. Equally, the OECD *Guidelines on Corporate Governance of State-Owned Enterprises*[50] put forward principles relevant for SWFs that undertake cross-border investments as underlined by the Commission communication.[51]

It has been observed that "SWFs do not meet the standards set by local financial institutions, which demand rigid governance structures and disclosure. As a result, we can infer that if SWFs align their governance practices with those of the local financial institutions, legitimacy would be granted".[52]

The standards applicable to SWFs should set out clearly the role of the government and the managers of the investment mechanism, what entity sets the policies, how those policies are

[48] Executive power is vested in the State Council, which is the Central Government.

[49] http://www.imf.org/external/np/mae/ferm/eng/index.htm

[50] http://www.oecd.org/dataoecd/46/51/34803211.pdf

[51] Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, A common European approach to Sovereign Wealth Funds, COM/2008/0115 final, 27 February 2008, p. 9.

[52] Monk, A. (2008), Recasting the Sovereign Wealth Fund Debate: Organizational Legitimacy, Institutional Governance and Geopolitics, Oxford University Centre for the Environment, Working Papers in Employment, Work and Finance, No. WPG08-14, p. 13. One case study of the China Investment Corporation (CIC) to crystallize the above conceptualization of how governance interacts with legitimacy. See, Monk, A. (2008), Recasting the Sovereign Wealth Fund Debate: Organizational Legitimacy, Institutional Governance and Geopolitics, Oxford University Centre for the Environment, Working Papers in Employment, Work and Finance, No. WPG08-14, p. 13.

executed, and the accountability arrangements. It its approach, the EU has identified six principles of good governance (Box 2).

Box 2: EU principles of good governance applicable to SWFs

Principles of good governance include:

- The clear allocation and separation of responsibilities in the internal governance structure of a SWF;
- The development and issuance of an investment policy that defines the overall objectives of SWF investment;
- The existence of operational autonomy for the entity to achieve its defined objectives;
- Public disclosure of the general principles governing a SWF's relationship with governmental authority;
- The disclosure of the general principles of internal governance that provide assurances of integrity;
- The development and issuance of risk-management policies.

3.3.3. Santiago Principles

The drive by the US and the EU to draw up the code of best practices, including a renunciation of political motives, has stirred resentment among some of the investors responsible for the funds, particularly in China and some in the Gulf.[53] At the World Economic Forum 2008, representatives of some of the Gulf funds said such a code was unnecessary and intrusive, since the investment funds had never done anything to arouse suspicion. Some Chinese officials have also been quoted as saying that the best practices idea was unnecessary.[54]

[53] The UAE has criticised the IMF for its decision to interfere in the activities of the SWFs, branding it a politically motivated move. Central Bank Governor Sultan bin Nassir Al Suwaidi said the IMF lacks sufficient experience in such issues and its involvement following Western pressure could discourage further SWF investment in the United States. According to an IMF statement, Al Suwaidi's address was on behalf of the United Arab Emirates and other Arab central bank governors representing their countries at the meeting. The states he represented included Bahrain, Egypt, Qatar, Jordan, Kuwait, Iraq, Lebanon, Libya, Oman, Syria, and Yemen. Al Sewerky, H (2008), Suwaidi critical of IMF attempt to monitor SWF investments in West, Emirates Business 24-7.

[54] Weisman, S. (2008), Sovereign wealth funds promise to avoid 'geopolitical goals', *International Herald Tribune*, March 21.

The task of the IMF was difficult. The challenge was known from the beginning but became even more complex in the context of the financial crisis. What would be the best way to advance calls for increased SWF disclosure for instance? The issue cannot be framed as a threat to withdraw the privilege of investing in Western markets. Many countries with large SWFs are tired of being lectured to. Given global imbalances and the funding needs of a capitalist economic system, such threats are unlikely to be effective. In the same vein, the IWG had to overcome objections by some members that adopting principles would somehow validate concerns about the activities of SWFs. Some funds were also loath to adopt any practices that would put them at a disadvantage relative to other investors, particularly as this related to the confidentiality of their investment activities.

The principles encourage the funds to explain their investment criteria, and recommend that they avoid buying stakes in sensitive companies, such as Western defence contractors. They also vote on setting up a standing committee that will update the guidelines and liaise with Western governments and institutions such as the World Bank and IMF on issues of concern. The principles make repeated mention of the need for greater transparency. The full list of principles includes recommendations that sovereign funds coordinate their activities with their respective governments and central banks to avoid interfering with domestic economic policy. Funds should disclose their sources of funding and the conditions under which their owners can withdraw them. Sovereign fund managers should be independent of the fund owners, but fully accountable, publishing annual reports and undergoing annual audits. To address criticism among some economists that the funds' secrecy contributes to volatility in capital markets, the principles call for funds to disclose "relevant financial information" to "contribute to stability in international financial markets and enhance trust in recipient countries." Each funds' investment policies should be made public, including the extent to which they employ outside managers. The principles also address concerns about conflicts of interest arising between the funds and their government owners, calling for funds to avoid taking advantage of privileged information or influence when investing.

But the principles stop short of requiring an explicit pledge not to invest for political ends. The principles include a call for funds to abide by local rules and regulations and base their

investments on financial and economic grounds. They even call on funds to disclose any investment decisions "subject to other than economic and financial considerations." Above all the **IMF guidelines are based on a standard definition of SWFs. They do not cover SOEs as made clear by a footnote**. Consequently they could find themselves in the pointless situation of being rigorously adhered to by e.g. Norway's Government Pension Fund – Global, while Russia's Gazprom felt no need to take any notice of them. If so, the SWF guidelines will serve little more than a public relations purpose if they encourage sovereign investment to flow through other investment vehicles not covered by the guidelines. It might then make sense to go on to redefine SWFs along broader lines. Robert Kimmit, the current Deputy Secretary of the Department of the US Treasury, suggests that SWFs could be conceived as "large pools of capital controlled by a government and invested in private markets abroad",[55] rather than as the funds that serve exclusively as investment vehicles for these pools. With "sovereign wealth fund" defined in this way, a code of conduct for SWFs would cover sovereign wealth at its source, regardless of the route it then took to reach any foreign investment target.

4. Conclusions

The Commission expected Member States to send a strong signal regarding their readiness to take joint action to avoid a repeat of the financial turmoil that has hit the global economy since the US mortgage crisis in summer 2007. As the current financial turmoil demonstrates, financial liquidity is vital for Western economies. We have recently seen firms on both sides of the Atlantic – for example Barclays and Citibank, seek out sovereign funds. Their finance was needed to allow these companies to fulfil their strategic aims. Even Russian sovereign funds have not attempted to buy into any strategic assets; they are taking very limited stakes in some companies and the European Commission and the national governments are watching this activity. But there is no evidence at the moment that these sovereign funds are being used for any nefarious purpose. Let us add that we also expect that national security

[55] Robert M. Kimmitt: Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy, Foreign Affairs, January/February 2008.

would be a concern even where the proposed buyer is a private company (e.g., where the state and the private sector are tightly linked in the buyer's home country).

Sovereign wealth funds did not arrive on the investment scene only yesterday, but have in fact been investing in Europe for about 50 years. These responsible and reliable investors have pursued a long-term, stable policy that, moreover, has certainly stood the test during the recent turmoil in the financial markets. These funds have provided capital just when it was most desperately needed. The purpose of SWFs is to invest surplus state reserves to yield profits. The investing countries may well be entitled to seek the best way to invest their reserves in foreign currency. The funds improve the liquidity of the financial markets and create growth and jobs. They also contribute to investment for the longer term. They create stability for the companies they invest in.

Over the years, the **free movement of capital has contributed to growth in Europe and in the world as a whole**. It should not endanger the future through overregulation and protectionism, but rather should abide by free market principles. Hence **two clear conclusions can be drawn at this stage**:

- It appears that a new wave of protectionism against foreign ownership represents a **reincarnation of protectionism from years past**.[56]
- **Any domestic or European regulation would send the wrong signal** as to the EU (or individual Member countries) being a good place to invest.

Europe must remain an attractive place for investment. Sovereign Wealth Funds are the by-products of increasing globalisation and of the benefits of international trade. The have so far always proved to be good shareholders. They are interested in the long-term, positive development of their business and hence in obtaining a good, long-term rate of return on their investment. The EU should, therefore, continue to allow them the scope to invest. These funds can, however, also pose threats. We will have to look at the type of investments they are making and whether they meet the requirements for transparency. Without continued

[56] See, Gugler, P. and Brunner, S. (2008), Les défis du patriotisme économique en matière d'investissements étrangers en Europe: l'apport possible d'une approche multilatérale, 66 (1) Revue Economique et Sociale (2008), 1–11.

inward investment, the EU economy will stagnate. It has no interest in erecting barriers to investment. The EU looks at sovereign investment as an important engine for worldwide economic growth. If it were to restrict the activities of sovereign funds within European borders, it might find itself at an economic disadvantage, with important investment dollars going to other parts of the world.

There is a risk of seeing a strategy being implemented in each of the Member States that, ultimately, would not help to tackle the reality. **There is a need to make clear at the European level which sectors should be protected from foreign takeovers and to go beyond the vague criteria of public order and public security**. Such a list of EU strategic sectors could be drafted and would isolate energy, technologies and other relevant sectors. from standard competition. In addition, public mistrust of overseas investment and isolationist sentiment could cause an overreaction to the question of regulation. This could have far-reaching consequences not only financially, but in terms of diplomatic and economic relationships with other nations. To that extent, European leaders do not have the same policy towards Russia as they do towards the US. To this extent, **there is a need to clarify the interpretation of Article 58 ECT**, which provides for restrictions on the free movement of capital on grounds of public order. Because it has not been applied until now in the context of SWFs, it is worthwhile ensuring that Member States will not be tempted to make extensive use of it.

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