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DOMESTIC CONSTRAINTS ON SOVEREIGN WEALTH FUND INVESTMENT ACTIVITY

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I. Introduction

Much of the sovereign wealth fund (“SWF”) debate has taken place in the international context and understandably so. That SWF investments take place across national borders continues to raise questions relating to their impact on the stability of the international financial system and whether or not such investments are commercially or strategically motivated.¹

At a time when the world was flush with liquidity, politicians sought to answer these questions through regulation. Concerned that SWFs would be used by their states as tools to allocate vast financial resources to advance political rather than economic ends while “snapping up the crown jewels of Western economies”, politicians busied themselves lobbying for increased host country and international regulation of SWF activity.²

This pre-2008 world was marked with congressional hearings by the Committee on Foreign Investment in the United States and other foreign investment oversight bodies related to acquisitions by and failed transactions of SWFs.³ SWFs passionately defended themselves arguing that their investments were strictly commercial and that they were independent of their home states’ strategic policy objectives.⁴

This paper argues that those pre-2008 concerns are no longer salient. Instead of focusing on the most effective way international and/or foreign regulations can discipline SWF investment activity, we need to take an inward analytical turn in the debate. This inward turn should regard domestic legal and structural factors within states with SWFs (“SWF States”) as the most effective constraints on SWF behavior.

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¹ See generally, Gerard Lyons, “State Capitalism: The Rise of Sovereign Wealth Funds” (2008) 14 *Law and Business Review of the Americas* 179 and “Sovereign Wealth Funds: Background and Policy Issues for Congress” CRS Report for Congress (31 January 2008).

² See Joshua W. Casselman, “China’s latest ‘threat’ to the United States: The Failed CNOOC-UNOCAL Merger” (2007) 17 *Indiana International and Comparative Law Review* 115

³ *Id.*

⁴ China’s CIC Uneasy at Investment being politicized” *Reuters* (13 June 2008). CIC’s President Gao Xiqing declared that CIC was exclusively commercially driven and that it was a passive investor that does not seek representation on the boards of its potential targets.

This paper preliminarily raises three reasons for this. First, the financial crisis lessened the demand for discipline over cross-border investments by SWFs. Host states, once opposed to SWF investment within their borders, are now more keen to attract such investment so as to increase levels of liquidity in their financial systems. Second, there is doubt that the international regulatory framework related to SWFs can be effective in disciplining SWF behavior. Third, anecdotal evidence from SWF behavior in the course of the continuing financial crisis suggests that SWFs, or at least the interest groups who influence SWF activity, may be more sensitive to domestic constraints rather than external pressure. Accordingly, it may be more useful for the debate to take an inward turn and look at the domestic legal and structural constraints on SWFs. As the global financial crisis continues, SWFs will remain under pressure to balance their desire to invest globally with the vigilance to stabilize their home economies.

This paper briefly sketches an analytical framework which may be used to discuss domestic regulatory constraints on SWFs investments. It will then conclude with a brief discussion on the implications of an inward turn on future research into SWF regulatory policy.

II. Why the Need for an Inward Turn in the Debate

Existing international regulatory frameworks relating to SWFs are at best weak and are expected to remain so. Attempts by the International Monetary Fund to formulate international regulations for SWFs have so far met with limited success as the resulting Santiago Principles are only “soft law” and are not binding upon states or SWFs although they may evidence nascent or evolving customary international law.

There are three main reasons why an inward turn in the SWF debate may prove useful. First, the regulatory environment that SWFs have to navigate has changed remarkably since 2008/2009. Post-2008, states that initially championed tighter regulation of SWF investment such as the United States found themselves needing financial support from SWFs. For example, the United States Treasury Department attempted to broker a deal in which either China Investment Corporation (“CIC”) or Korea Investment Corporation would save Lehman Brothers.⁵ At the same time, SWFs faced domestic pressure to turn inward and support domestic financial institutions. As access to credit worldwide dried up, investors fled from emerging markets, increasing pressure on local currencies and consequently the vulnerability of domestic banks with large foreign exchange liabilities.⁶ That has required using foreign exchange reserves to backstop currencies and support local banks and, in many cases, calling on SWFs to invest at home.

Having to decide between cross-border investment opportunities and domestic demands, many SWFs predictably chose the latter.⁷ This shows that while their investment activities are often cross-border, SWFs may be most influenced by domestic constraints.

⁵ See Andrew Ross Sorkin, *Too Big to Fail* at 444.

⁶ Steven C. Johnson, “Crisis pushes sovereign wealth funds to go domestic”, *Reuters*, available at <http://in.reuters.com/article/2008/10/23/idINIndia-36112720081023>.

⁷ *Id.*

Second, states with SWF States tend to be more politically conservative with economies dominated by the state. The recent trend toward more liberal politics in some SWFs states characterized by the Arab Spring may also lead to increased demand for domestic oversight over SWF activity. Hence, a domestic oriented analysis of SWFs would be relevant as the heightened sensitivity for international or cross-border discipline of SWF activity has waned somewhat, and domestic demands for discipline and stronger governance of SWFs increase over time.

Third, as the number of SWFs grows, competition between SWFs may increase. Increased competition between SWFs may lead to increases in levels of domestic governance standards. There are market incentives for SWF states to increase home regulation of their own SWFs.⁸ Increased home regulation may allow SWFs to enjoy better access to host states. Similarly, acquisition/investment targets may be less hostile to SWFs that are perceived to be well regulated. However, increase regulation comes at a cost and a review of literature in relation to comparative corporate governance standards suggests that states will only increase regulation to a point where domestic enterprises remain competitive against foreign enterprises.⁹ Hence, it may be expected that SWF states increase regulation over their SWFs either through legal or structural means to a point so as to allow their SWFs to remain competitive. However, this form of regulatory competition would reach a level of equilibrium and hence, regulatory convergence as SWF states adopt similar levels of regulation.¹⁰

III. Domestic Regulatory Constraints: Legal & Structural

Domestic regulatory constraints facing SWFs can be separated into legal and structural components. Legal constraints are largely more formal in nature and pertain to, *inter alia*, what rights and obligations are owed by SWFs and to whom. Accordingly, legal constraints include formal identification of the government bodies who are the legal owners of the SWFs and consequently, which government bodies have rights against the SWFs and the mechanisms by which these rights are enforced.

Most, if not all, SWFs are subject to some form of legal constraint. Some of which are embedded constitutionally. For example, the Singaporean SWFs such as Temasek Holdings (“Temasek”) and the Government of Singapore Investment Corporation (“GIC”) are regulated under the Constitution of the Republic of Singapore as “Fifth Schedule Compan(ies)”. As Fifth Schedule Companies, their respective boards of directors are accountable to the President of Singapore. The President’s assent is also required for the appointment and removal of members of both their boards of directors and group managing directors.¹¹ However, legal accountability does not equate to transparency and public participation. While Temasek and GIC are accountable to the President, they are under no obligation to report to the Singapore Parliament. In contrast, while the Norwegian Ministry of Finance is the legal owner of the Norwegian Global Fund, significant changes to the

⁸ See Larry Cata Backer, “Sovereign Wealth Funds as Regulatory Chameleons” (2010) *Geo. J. Int’l L.* 425.

⁹ See Henry Hansmann and Reinier Kraakman, “The End of History for Corporate Law”, NYU School of Law Working Paper (2000).

¹⁰ *Id.*

¹¹ Constitution of the Republic of Singapore, Arts. 22A and C.

fund's investment strategy are presented to the Norwegian legislature before implementation.¹²

In addition, legal constraints can also explicitly allocate mandates and jurisdiction between a SWF and other government bodies (such as the central bank or other SWFs in the state). As will be discussed shortly, SWFs have faced increasing competition between sister government bodies or sister SWFs. This has often caused confusion and inefficiency in the overall allocation of financial resources through the government policy mechanism. It will also be argued that legal constraints will reduce such confusion.

In time to come, legal constraints may even evolve beyond such general constitutional provisions to more specific legislation relating to a SWF state's fiscal policy. For instance, the United States uses a sophisticated process of "budgetary scoring" as a mechanism of fiscal discipline.¹³ It is plausible that if public demand for more accountability and transparency within the state increases, some SWF states may adopt similar (albeit, less public) mechanisms in the future.

Structural constraints tend to be less formal, less overt, and less transparent and relate more to the pressures that SWFs face as a result of the positions or roles they play in the states' broader economic policy landscape. Some SWFs have been positioned as "younger siblings of their central banks". This may arise as a result of subordination within a particular political structure of individual members of SWF senior management to officials in central banks. For instance, one Chinese SWF, State Administration of Foreign Exchange ("SAFE"), is directly under the supervision of the People's Bank of China ("PBOC").¹⁴

This raises another structural constraint relating to "sibling rivalry" between SWFs and their central banks or even other SWFs within the same state. Government bodies within a state often have divergent interests. Some commentators have identified a conflict between central banks and SWFs arising from the basic fact that most SWFs derive their initial capital from transfers from central banks. "(SWFs) are able to generate higher investment returns, in order for them to justify further transfers from the central banks. In response, or in anticipation, central banks are likely to raise their risk profile in order to maximise their own investment returns, so as to raise the hurdle for further foreign asset transfers to SWFs."¹⁵ One example of this often complicated relationship between SWFs and their central banks is the CIC. CIC was almost entirely financed by debt owed to the PBOC and under substantial and continual pressure to meet interest repayments.¹⁶ It is also widely accepted that CIC and SAFE share a tense relationship.¹⁷ SAFE, from the outset, held reservations over the establishment of

¹² *Foreign Government Investment in the U.S. Economy and Financial Sector: Hearing Before The Subcomm. on Domestic and Int'l Monetary Policy, Trade & Tech., & the Subcomm. on Capital Mkts., Insurance, and Gov't Sponsored Enterprises* (2008) (statement of Martin Skancke, Director General, Asset Management Department, Norwegian Ministry of Finance).

¹³ See Derek Lindblom, "The Budget Reconciliation Process" Harvard Law School Budget Briefing Paper No. 25 (2008) available at http://www.law.harvard.edu/faculty/hjackson/ReconciliationByrd_35.pdf.

¹⁴ See Song Yen Ling, "Secretive SAFE" *Energy Compass* (2 May 2008).

¹⁵ Stephen Jen, "A Sibling Rivalry: Central Banks versus SWFs" available at <http://www.morganstanley.com/views/gef/archive/2008/20080421-Mon.html>.

¹⁶ Michael H. Cognato, "China Investment Corporation: Threat or Opportunity" (2008) 19 *NBR Analysis* 9

¹⁷ Zhang Ming and He Fan, "Chinese Sovereign Wealth Fund: Weakness and Challenge" CASS Working Paper (on file).

CIC. Despite the balance of power crafted on CIC's board of directors, "CIC was viewed within the bureaucracy largely as a creation of the Ministry of Finance, and its early publicized investments, such as the \$3 billion stake in Blackstone, created some political space for the central bank to criticize the CIC's investment strategy. In many ways, the creation of the CIC did not resolve the bureaucratic conflict between the PBOC and the MOF. The central bank continued to argue that they were the most experienced institution in managing foreign assets, and the Ministry of Finance continued to criticize the central bank's low rates of return on these reserves."¹⁸ Furthermore, SAFE sees itself as a better conduit for foreign investment having a greater pool of experienced investment managers in international markets.¹⁹

There is a relationship between structural constraints and legal constraints to the extent that the positions or roles particular SWFs play domestically in the national economic policy landscape can be translated into a form of legislative instrument. However, it would appear that most SWF states prefer more tightly knit, less transparent, less public and less clear forms of constraining SWF activity. Hence, structural constraints tend to be more popular tools used by SWF states. There is nonetheless a case for transforming structural constraints into legal ones.²⁰

IV. Legal Constraints as a Tool for Resolving Competing Politics

There are several good reasons why SWF states may wish to adopt more robust legal constraints and/or transform existing structural constraints into legal ones.

First, complexity and lack of transparency with respect to SWF structural constraints can create confusion and controversy among both the public and policy-makers regarding the nature and methods of SWF investments. Simply put, these structural constraints obscure why SWFs make certain investment decisions. The domestic public does not know or understand the limitations that SWFs face in the course of making such decisions and most importantly, the domestic public does not know which government agencies or policy makers (and ultimately, politicians) should account for poor investment decisions made by SWFs. For example, CIC came under strong domestic criticism for poor investments in Blackstone and Morgan Stanley from the Chinese public. Should the Chief Executive Officer of a SWF be sacked if a SWF makes an investment that loses billions of dollars? What if he was directed to make the investment by the President? Should the President be made to answer to his electorate? Clear distinctions between public and private market aspects of SWF investment behavior may alleviate confusion and controversies in the future.

Following from this, legal rules may be also used to insulate politicians from domestic criticism over SWF investments. In Singapore's case, the position of Temasek and GIC effectively "erect(s) a firewall between government companies and relevant agencies under strict supervisory legislation for personnel, reporting and

¹⁸ Logan Wright, "CIC and SAFE: Coordination or Bureaucratic Conflict" *Chinastakes* (24 June 2008) available at http://www.chinastakes.com/story.aspx?id=456&bcsi_scan_215278E6F2E44B48=Ipm4p5UHfuXDkGj+cmktbSgAAABGkNAV&bcsi_scan_filename=story.aspx.

¹⁹ *Ibid.*

²⁰ See also, Saadia M. Pekkanen and Kellee S.Tsai, "The Politics of Ambiguity in Asia's Sovereign Wealth Funds" (2011) 13(2) *Business and Politics*: Article 3.

disclosure, and asset transfer—as well as laying a firm foundation for the purely commercial operation of both SWFs”.²¹ The expectation is that any losses made by Temasek and GIC should be attributable only to Temasek and GIC and not the Singapore Government.

Second, as noted above, conflicts between SWFs and central banks can distort investment strategies of some SWFs. Such conflict can be detrimental to SWF states’ broader economic objectives. Legal rules may be used to resolve conflicts between interest groups within a state. This should apply to SWFs as well. Legal rules which clearly demarcate jurisdictional boundaries between central banks and SWFs can reduce inefficiencies and costs caused by confusion over who has the final say over which investment. If the legal investment mandates of SWFs are not defined clearly, competition with sibling SWFs may cause some SWFs to make investments that they would not ordinarily make and may result in increased investment activity which may be sub-optimal. For example, if a particular sector or industry is considered attractive, SWFs may attempt to outbid each other so as to secure an investment opportunity. Such competitive behaviour may result in risk concentration that the commercial returns of the investment will not meet expectations and the illusion that SWFs investments show a sectoral-bias.

V. Conclusion: Implications on Future Research

There are several implications for an inward analytical turn with respect to the SWF debate. First, further research on the particular domestic legal and structural constraints that each SWF faces is required. A burgeoning literature on the Russian Sovereign Wealth Fund²² and the Norwegian Global Fund²³ has shed some light on the legal and structural factors which determine the investment policies adopted by these SWFs. Broader, more detailed and more comparative research will better inform discussion on how to then construct an international regulatory framework in the future.

Second, future research on building international regimes to regulate SWFs must include at the outset the domestic sphere. Such research should also acknowledge two levels of recursivity in relation to the regulation of SWFs. There is a domestic recursivity between legal constraints and structural constraints. Domestic laws are often a result of coalition building by interest groups with the state as an agent for political forces reflecting conflicting economic/political interests. The same can be said about domestic legal rules which bind SWFs. Much of this coalition building with respect to regulation of SWF investments would take place within the parameters of the domestic structural constraints. We are cognizant of the conflict between SWFs and central banks. It is plausible in the future that some SWFs may be able build coalitions with pro-investment interest groups such as commercial banks. These coalitions may lobby against more conservative central bank interests with the objective of defining their own domestic regulatory space and limiting the

²¹ Li Hong, “Depoliticization and Regulation of Sovereign Wealth Funds: A Chinese Perspective”, (2011) *Asian J. Int’l L.* 403.

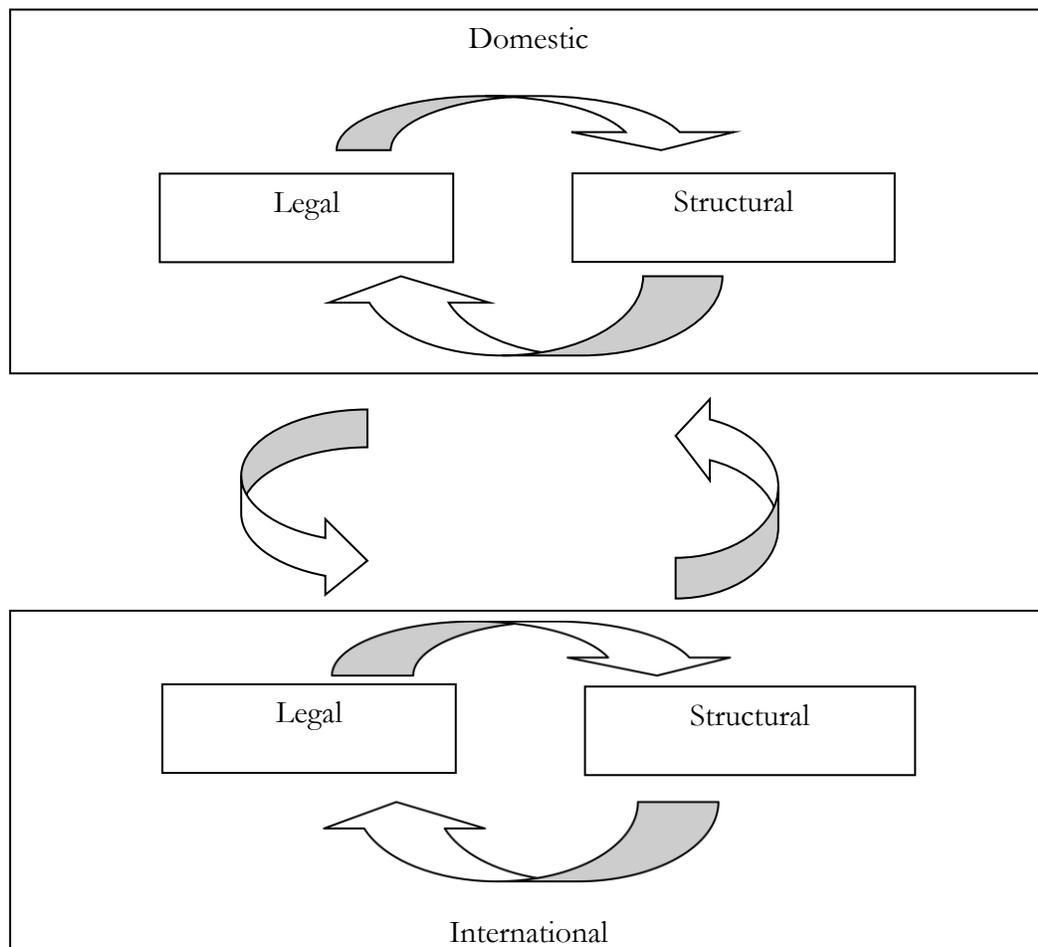
²² Arina Popova, “We don’t want to conquer you” YLJO Essay available at <http://yalelawjournal.org/the-yale-law-journal-pocket-part/scholarship/we-don%e2%80%99t-want-to-conquer-you;-we-have-enough-to-worry-about:-the-russian-sovereign-wealth-fund/>.

²³ Larry Cata Backer, “Sovereign Wealth Funds as Regulatory Chameleons” (2010) *Geo. J. Int’l L.* 425.

domestic legal constraints to which they may become subject. At the same time, new legal constraints can possibly affect the positions or roles that SWFs play in a SWF state's broader economic policy landscape. This may then define a new round of coalition building and rule making.

The second level of recursivity takes place between the domestic sphere and the international sphere. We understand that domestic politics can influence international law. Similarly, international politics can affect domestic law. International trade law, for example, is often the result of coalition building between the consumers from an importing state and producers from an exporting state. Hence, the evolution of domestic legal and structural constraints can determine whether and how international rules relating to SWFs are shaped in the future. For example, convergence in domestic regulation of SWFs between SWF states can facilitate the creation of international rules and standard setting. The argument is, given that some SWFs are already bound to certain common rules under domestic law, there is no disincentive against adopting the same rules under international law. Further, international rules can, in turn, shape domestic legal and structural constraints. For example, accepting that a set of common international governance standards is emerging for SWF, to the extent that certain SWF states do not adopt or comply with such standards, domestic coalitions may form within them to lobby non-conforming governments for adoption.

A schematic view of these two levels of recursivity is depicted as follows.



Each SWF is unique in its own way. Its investment policies are shaped by its own policy objectives, which arise out of the idiosyncratic political and economic demands of home state. Accordingly, SWFs exist in their own domestic regulatory environments to conform to the broader political and economic ecology and advance the investment objectives of home governments. We suggest that future research, which embraces and critically examines this domestic dimension of legal and regulatory oversight of SWF, will yield productive benefits in the broader quest to treat SWFs in the international legal regime that supports global investment.