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Reflections on the legal nature of SWFs: public or private investment beasts?

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Introduction

Sovereign Wealth Funds (SWFs) are government controlled and/or owned investment vehicles. Although not a novel phenomenon, they have come in the fore since the economic crisis of 2007-2008. Sources of financial fluidity in times of financial scarcity, SWFs were initially hailed as 'white knights' coming to the rescue of Western financial institutions, only to be later faced with mounting criticism concerning the true nature of their investment objectives. These criticisms were linked to their sovereign nature, being owned and/or controlled by non-Western and non-democratic countries.[1] SWF recipient countries – countries in which SWF investments take place- are concerned that SWFs act as the long arm of the government to which they belong, pursuing a geopolitical agenda, rather than a profit maximization one. Consequently SWF recipient countries have raised protectionist barriers against SWF investments. The responses however have not been uniform. Some countries have tried to include the treatment of SWFs in existing legislation, whereas others have adopted legislation specific to SWFs. Still other countries have amended their existing legislation, making special reference to SWFs as a special category of foreign investors. To complicate matters further SWFs are not consistently treated as either public or private entities. The United States for example treat them as public for tax purposes, yet as private bodies for immunity purposes and as a foreign investor.[2] The law treats private entities differently from public entities. Private entities are those that participate in the market under competitive market terms and seek commercial objectives of profit maximization. Their operations are governed by private law. Public entities do not pursue pure profit maximization purposes but rather carry out governmental functions and are thus subject to different legal requirements and are governed by public law. They

[1] The vast majority of SWFs are not held by traditional capital-exporting Western countries.
[2] L.Catà Backer, Sovereign Wealth Funds as Regulatory Chameleons: the Norwegian Sovereign Wealth Funds and Public Global Governance Through Private Global Investing, *Georgetown Journal of International Law*, vol. 41, is. 2, 425, 428-429.

will only receive the same treatment as private entities and will be governed by private law, when they satisfy the 'private creditor test', that is when they participate in the market on the same terms and conditions as private entities and pursue the commercial objective of profit maximization. Their actions therefore need to be commercial in nature. In satisfying the private creditor test, the purpose of their actions is not considered as determinative of their nature. The private/public divide is carried on to the international level as well. More specifically in the field of International Investment Law it is the 'private investor model' which is applicable in order to determine the nature of the investing entity. The nature of SWFs investment vehicles as either public or private has important implications in terms of applicable substantive law and in the choice of forum where a dispute involving SWFs can be brought. In substantive terms, their nature as public or private will impact on accountability rules. It might furthermore affect the application of national treatment obligations by providing a comparator. From a procedural point of view, clarifying the nature of SWFs will determine the international courts and/or arbitral tribunals in which SWFs have *locus standi*. The aim of this brief contribution is to examine the nature of SWFs as public bodies or as private bodies. To this end, an attempt will be made to delineate criteria leading to their characterization as public or private or as a hybrid entity. The **first** part will look into the definition and the principles contained within the Santiago Principles for guidance. The **second** part will briefly present the stances taken in academic literature. The **third** part will offer critical observations and criteria for classification. The ***last*** part concludes.

1.1. What are SWFs?

A number of definitions have been advanced in the attempt to explain what SWFs are. Academics, practitioners, state officials, the International Monetary Fund (IMF) and the European Union (EU) have all attempted to provide a commonly accepted definition for SWFs, but to date their efforts have proven futile.[3] The only common element in all proposed definitions is that SWFs are special investment vehicles controlled and/or owned by a government. The difficulty of agreeing on a

[3] For an overview of the most authoritative definitions advanced for SWFs see, Andrew Rozanov, "Definitional Challenges of Dealing with Sovereign Wealth Funds", in *Asian Journal of International Law*, 2011, vol.1, no.2, p.249; Edwin M. Truman, *Sovereign Wealth Funds: Threat or Salvation?*, Peterson Institute for International Economics, Washington DC, September 2010, pp. 9-33; Stephen Jen, "Currencies the Definition of a Sovereign Wealth Fund", available at http://www.morganstanley.com/views/gef/archive/2007/20071026-Fri.html, last accessed at 28 November 2011; Anne Gelpern, "Sovereignty, Accountability, and the Wealth Fund Governance Conundrum", in *Asian Journal of International Law*, 2011, vol.1, no.2, pp. 289-294; Monk, 2009, pp. 451- 457, see *supra* note 1; International Monetary Fund, "Balance of Payments and International Investment Positions Manual, 6th ed. (BPM6)", 2009, available at: http://www.imf.org/external/pubs/ft/bop/2007/pdf/bpm6.pdf, last accessed at 28 November 2011; Commission of the European Communities, Communication from the Commission to the European Parliament, the Council and the Economic and Social Committee and the Committee of the Regions, "A Common European Approach to Sovereign Wealth Funds", COM (2008) 115 provisional, available at: http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf, last accessed on April 22nd, 2012.

common definition for SWFs stems from their vast heterogeneity in terms of constitution in law and pursued macroeconomic policies or objectives.[4] It is commonly accepted that 'there is no such thing as a typical SWF'. In 2008, the International Working Group on SWFs adopted the Generally Accepted Principles and Practices- GAPP (Santiago Principles). The International Working Group, composed of SWF holder countries and operating under the aegis of the IMF, produced in a small period of time the only pertinent text specific to these funds. The Santiago Principles define SWFs as:

> "…special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports."[5]

There are three clarifications that need to be made. First, SWFs are funds or arrangements owned by the general government, whether central and/or subnational; second, according to the Santiago Principles only those SWFs which invest abroad, i.e. in foreign financial assets, are to be deemed as SWFs for the purposes of the Santiago Principles; third, SWFs pursue macroeconomic purposes and 'are created to invest government funds to achieve financial objectives'.[6]

1.2. Determining the nature of SWFs: the Santiago Principles

The Santiago Principles do not explicitly deal with the issue of whether SWFs are private or public in nature. The definition of SWFs serves only as a starting point and recourse must be made to the text of the principles as well. The elements of the definition will be analyzed first, whereas the general content of the SP will be outlined next.

Looking at the definition contained within the Santiago Principles one can single out the following criteria that might be of relevance in order to characterize SWFs as either private or public bodies: a) ownership, b) objectives/purposes and, c) sources of funding.

Regarding ownership, SWFs are wholly owned by the SWF holder country. Complete ownership by the government might point towards attributing a public nature to the funds. It differentiates them both from private entities and from state-owned enterprises. Private entities lack any controlling

[4] Depending on the purpose pursued, SWFs can be classified as stabilization funds, pension reserve funds, savings funds, reserve investment corporations and development funds.
[5] International Working Group of Sovereign Wealth Funds, *Generally Accepted Principles and Practices, 'Santiago Principles'*, Appendix I. Defining Sovereign Wealth Funds, available at: http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf, last visited on: April 22nd, 2012.
[6] *Ibid*, p. 27.

government participation in their ownership, whereas in state-owned entities governments are at least majority holders if not the sole owners.

Regarding the purposes pursued by SWFs investments, the Santiago Principles merely state that SWFs are created for macroeconomic purposes, yet seek financial objectives. Neither the term 'macroeconomic' nor 'financial' are defined however. One needs to keep in mind the heterogeneity of SWFs and that the Santiago Principles are purposefully left broad so as to encompass and accommodate the various SWFs. Based on the purposes they strive to achieve, SWFs have been classified in literature as stabilization, pension reserve, savings, reserve investment corporations and development funds.[7] These purposes might provide context to the notion of 'macroeconomic'. They also seem to imply that macroeconomic purposes can be undertaken solely by public actors. The same cannot be held true however for the term 'financial', as financial objectives can be pursued by both private and public actors.

Regarding the sources of funding of SWFs, they definitely vary from one fund to another. Yet since SWFs are owned by the government and financed by the government, their sources of funding seem to be unlimited and explain why SWFs are described as 'investors with deep pockets'. This is in stark contrast with the capital invested into private entities. Sources of funding seem to also point towards the direction of a public nature for SWFs.

In determining the nature of SWFs, the definition contained in the Santiago Principles provides only relative guidance. The content of the Santiago Principles also merits one's attention. The Principles are divided in three thematic areas: a) legal framework, b) institutional framework and, c) investment and risk management framework.

A closer look at the Santiago Principles points largely –yet not definitively- towards a private entity treatment of SWFs. The Santiago Principles do not stipulate any specific legal framework for SWFs, but do require that it be sound and effective in achieving the fund's stated objectives.[8] They provide for a three tier classification of legal frameworks pertaining to SWFs based on existing practice: a) as public law entities, b) as state-owned corporations governed by private law, and c) as assets lacking a

[7] P. Kunzel, Y. Lu, I. Petrova, J. Pihlman, "Investment Objectives of Sovereign Wealth Funds: a Shifting Paradigm", in U.S. Das, A. Mazarei, H. Van der Hoorn (eds.), *Economics of Sovereign Wealth Funds: Issues for Policymakers*, International Monetary Fund, 2010, chapter 11. Also available as an IMF Working Paper, WP/11/19, January 2011, p. 3, available at: http://www.imf.org/external/pubs/ft/wp/2011/wp1119.pdf, last accessed on April 22nd, 2012. See also, U. Das, Y. Lu, C. Mulder, A. Sy, "Setting Up a Sovereign Wealth Fund: Some Policy and Operational Considerations", IMF Working Paper, WP09/179, 2009, pp. 9-10, available at: http://www.imf.org/external/pubs/ft/wp/2009/wp09179.pdf, last accessed on April 22nd, 2012.

[8] International Working Group of Sovereign Wealth Funds, Generally Accepted Principles and Practices, 'Santiago Principles', GAPP 1, available at: http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf, last visited on: April 22nd, 2012.

distinct legal personality and owned by the state or the central bank. The Santiago Principles further require that the SWFs' investment policy and strategy be based on sound portfolio management principles[9] and that investment decisions be aimed at maximizing financial returns based on economic and financial grounds.[10] SWFs are additionally required not to seek or take advantage of privileged information or inappropriate influence in competing with private entities.[11] It seems that the Santiago Principles are trying to level the competition between SWFs and other private actors by eliminating information asymmetries. SWFs should exercise their ownership rights in consistency with their investment policy and in a manner that protects the financial value of their investments.[12]

From the above mentioned analysis it seems that neither the definition not the principles contained within the Santiago Principles can provide us with a definite answer on the private or public nature of SWFs. The next section will proceed to examine the views advanced in literature.

2. Academic views on the nature of SWFs

The nature of SWFs as private or public investors has only briefly come up in academic writing. The views of three scholars will be presented in turn. Sornarajah claims that SWFs are private in nature, Bassin claims that they are sovereign in nature and Catà Backer describes them as formally public but functionally private. Their views will be presented in turn.

Sornarajah is of the opinion that despite their sovereign nature, SWFs must be treated like multinational corporations (MNCs) as concerns their international status and legal personality.[13] He claims that SWFs are akin to state entities operating as monopolies and performing a commercial function. Despite their affiliation with the SWF holder government, their purpose is to invest funds rendering thus their actions commercial in nature. Therefore, SWFs cannot benefit from sovereign immunity and should a dispute involving SWFs arise, their liability would be judged on the basis of private actor considerations.[14] If SWFs are akin to state entities operating as monopolies and conducting commercial actions and since it has been accepted that such state entities should not be treated any differently from MNCs, then SWFs should also receive the same treatment as MNCs.

[9] *Ibid*, GAPP 18.
[10] *Ibid*, GAPP 19.
[11] Ibid, GAPP 20.
[12] *Ibid*, GAPP 21.
[13] M. Sornarajah, *Sovereign Wealth Funds and the Existing Structure of the Regulation of Investments*, Asian Journal of International Law, 2011, vol. 1, is.1, 267, 273.
[14] *Ibid*, p. 272.

Sornarajah thus does not employ an ownership/control criterion, yet he looks at the purpose of SWF investments and the nature of their actions as *iure gestionis* rather than *iure imperii*.[15]

As concerns the settlement of disputes arising out of a SWF investment, Sornarajah, advocates for two avenues: namely, first, state vs. state litigation before the International Court of Justice (ICJ) and; second, making use of dispute settlement procedures contained within International Investment Agreements (IIAs).[16]

Bassan emphatically denies a private nature to SWFs and presents them as a 'genus' belonging to the 'family' of foreign government-controlled investors (FGCIs). Other FGCIs include state-owned enterprises and FGCIs are public in nature.[17] SWFs are not simply public but they are more accurately sovereign, and this is what differentiates them from other FGCIs.[18] According to Bassan, SWFs are not merely public investment vehicles but they are the state. He grounds his view in the fact that either SWFs completely lack a separate legal personality or in case their constitutive document envisages for one, it does not guarantee the fund's independence from the SWF holder country government. It is precisely this lack of independence from the government that makes it impossible to apply any private investor standards to SWFs and to neutralize their sovereign nature.[19] In his attempt to define SWFs he places his emphasis on the ownership and purposes pursued by SWFs.[20]

The phrase 'formally public but functionally private' accurately summarizes Catà Backer's understanding of SWFs.[21] The argument he makes is that a balance has been struck in order to portray SWFs as private actors although they have been set up as public entities. SWFs are formally public, as they are funds held and controlled by a SWF holder country. They are functionally private, as they seek to participate in private markets by behaving just like other private actors. They pursue financial objectives, which should not necessarily be equated with commercial objectives.[22] Hence, SWFs seek profit maximization of the SWF holder country's wealth. In order to achieve this balance of being formally public yet functionally private at the same time, SWFs need to disentangle their ownership and control from the SWF holder government. This can be achieved through a clearly defined and publicly available legal framework and through the acceptance of transparency as well

[15] Anne Gelpern also accepts SWFs as 'private market actors'. See, A. Galpern, Sovereignty, Accountability, and the Wealth Fund Governance Conundrum, *Asian Journal of International Law*, 2011, vol. 1, is. 1, 289, 290.
[16] The term IIAs is used as a blanket term covering both bilateral investment treaties (BITs) and regional investment agreements or regional trade agreements which include investment provisions.
[17] F. Bassan, *The Law of Sovereign Wealth Funds*, 2011, Edward Elgar Publishing Limited, UK, p. 5.
[18] *Ibid*, p.14.
[19] *Ibid*.
[20] *Ibid*, p. 25.
[21] L. Catà Backer, see *supra* fn. 1.
[22] Ibid, p. 439.

as disclosure requirements on the part of SWFs. Catà Backer supports that this balance is evinced by the Santiago Principles. He criticizes it however as it fails to take into consideration a number of realities regarding traditional private and public actors. As concerns traditional private actors, such as MNCs, they are not restricted to a merely participatory role in the market and oftentimes have been considered to advance their own regulatory agenda. Furthermore, private actors pursuing a corporate social responsibility agenda can also be seen as transgressing the lines of mere market participation and as attempting to influence the behaviors of other market participants and of the entities in which they invest. The construction of 'formally public yet functionally private' additionally fails to restrict the ability of state investment entities to regulate or to project state power abroad. Catà Backer thus deconstructs the presumption that private actors are merely participating in markets, whereas public actors are simply regulating them. He supports that the strict dichotomy between public/private is no longer sustainable. He proposes that a distinction of entities based on their participatory or regulatory nature is better equipped to deal with contemporary changes in the role of the state.

Both Bassan and Catà Backer challenge the dichotomy of public/private as obsolete. Such a dichotomy presumes that public entities regulate in a market, whereas private entities participate. Bassan underscores SWFs as being sovereign in nature and Catà Backer advances the construction of formally public but functionally private. He does not however elaborate on the practical implications of bringing down this dichotomy. In his determination of SWFs constituting sovereign actors, Bassan places his emphasis both on ownership and on purposes pursued. Catà Backer seems to consider ownership and control as well as the nature of their actions. He accepts however that although SWFs pursue profit maximization they do so in order to increase the wealth of the SWF holder country. In rejecting the relevance of the public/private dichotomy, he does not attach a commercial character to the actions of SWFs. Sornarajah disregards the ownership/control criterion and deems only the nature of the actions of SWFs as relevant in determining their nature. Since SWFs pursue commercial actions they are to be treated as private entities. In his determination he does not consider the purposes pursued by SWFs investments.

3. Observations

The above analysis has shown that there is no agreement on the nature of SWFs, although their complicated nature seems to be recognized and uncontested. The Santiago Principles do not assume a clear position and arguments can be drawn both in favor of a public nature and in favor of a private nature. There is currently no case brought by or against SWFs in international *fora* alleging a violation of international law and requiring the examination of their nature as public or private entities. Trying

to fill this *lacuna*, academic literature has advanced arguments in favor of a private, a sovereign and a hybrid nature, employing different criteria to support their arguments. It will be argued that due to their complex and heterogeneous nature, no criterion should be disregarded in the examination of the nature of SWFs.

As discussed previously, the criteria of ownership/control over the activities, the nature of activities (commercial vs. governmental) and purposes pursued have been considered in the attempt to determine the nature of SWFs. To these criteria, one could add the applicable legal framework in the legal order where the SWF is constituted as well as the pursuit of governmental policies or public policy objectives.[23] The ownership criterion will be examined first, followed by the nature of activities and the legal framework. The criterion of governmental functions will be subsequently presented, leaving for last the criterion of purposes pursued. For economy purposes the criterion of pursuit of governmental policies or public policy objectives will be examined under the criterion of purposes pursued.

As concerns ownership, it should be pointed out that examined on its own, this criterion is not considered as determinative. An entity might be wholly or partially owned by a government, but it might still conduct commercial actions, i.e. pursue profit maximization. Under international law, it will then not be treated as a public entity and enjoy the protection vested in such entities. Only an entity performing sovereign or governmental functions will be considered a public entity. The significance of purposes pursued becomes immediately apparent.

If one considers the nature of activities undertaken by SWFs as being purely commercial, SWFs would be considered as private bodies. This view becomes immediately attractive as it provides a clear course of treatment for SWFs as private actors. It might however, lead to an oversimplified representation of SWFs. What differentiates SWFs from other private investment and financial actors such as MNCs and hedge funds is their sovereign nature coupled with the fact that they pursue financial objectives in order to advance macroeconomic purposes. The criterion of purposes pursued therefore, deserves our consideration and should not be disregarded.

The examination of the legal framework that establishes a SWF might provide useful insights to its nature. The question that arises is however whether a domestic law characterization is binding at an international level. The characterization of an entity under national law as public or private might be indicative of its nature under international law. It is not however determinative. It is the functions of an entity that assume a prominent role and differentiate public from private entities and not their

[23] These criteria have been argued in cases of International Economic Law.

legal form or the nature of their actions. Whereas both private and public entities can strive for profit maximization, it is only public entities that are able to exercise governmental authority. They can regulate, control or supervise individuals, or otherwise restrain their conduct through the exercise of lawful authority. The relevant question becomes therefore whether the entity in question – *in casu* SWFs – irrespective of its assigned nature under domestic law, actually pursues governmental functions.

The pursuit of governmental functions is closely linked to the purposes SWFs pursue. However, before examining whether SWFs pursue governmental functions, a few preliminary remarks are in order. Unfortunately, there is no international legal text or case law prescribing the content of governmental functions or providing a list of activities that can be considered as governmental in nature. To date, the question of whether an entity carries out 'governmental functions' has only been determined on a case by case basis. The imposition of taxes for example has been considered as a governmental function, whereas the provision of services such as electricity has not. Inquiring however, whether SWFs can pursue governmental functions, has important legal and practical implications. An affirmative answer to the question would lead to the paradox of denying 'special purpose investment funds or arrangements' investor status. In *CSOB v. Slovak Republic*, the arbitral tribunal held that the notion of investor is not exclusively preserved for private entities with private capital but can also include entities partially or wholly controlled by the state.[24] However, such entities partially or wholly controlled by the government, must not act as a state agent or undertake a governmental action. It is therefore worth examining whether SWFs pursue a governmental function.

In order to determine this, one should look at the mandates of SWF. The Santiago Principles attribute to SWFs the pursue pursuit of macroeconomic purposes by setting financial objectives.[25] They do not however further specify what these macroeconomic purposes are. This could be explained by the need to maintain a broad enough definition so as to encompass existing SWFs but also to be able to include future ones. The economic literature has however classified SWFs on the basis of the objectives they seek to attain: pension reserve, savings, development, stabilization funds and reserve investment corporations. With the possible exception of stabilization funds that are used to insulate the economy and the budget from volatile commodity prices, other types of funds cannot necessarily

[24] International Center for the Settlement of Investment Disputes, *Ceskoslovenka Obchodni Banka, A.S. v. The Slovak Republic*, Decision on Respondent's Further and Partial Objection to Jurisdiction, ICSID case no. ARB/97/4, available at: http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=showDoc&docId=DC558_En&caseId=C160, last visited on: April 22nd, 2012.
[25] See *supra*, p. 3.

be said to perform governmental functions as these objectives can otherwise be pursued by private actors. They do not regulate or restrict the conduct of private individuals through the exercise of lawful authority. A uniform answer on whether SWFs pursue governmental functions cannot therefore be provided offered but rather requires a deeper examination. A relevant consideration would be whether the insulation of the economy and the budget from volatile commodity prices is a governmental function or a public policy objective. Should it be deemed a public policy objective, then SWFs can be considered investors. The pursuit of a public policy objective is however not restricted to private actors and will not resolve the question of the nature of SWFs.

As can be attested from the observations submitted above, no one criterion can conclusively and definitely answer the question whether SWFs are private or public entities under international law. They should therefore be applied together.

4. Concluding Remarks

SWFs are fascinating and extremely complex constructions. Set up and owned by governments of SWF holder countries they seek to invest in the territories of SWF recipient countries. They pursue macroeconomic purposes yet strive to achieve them by employing financial objectives. Questions concerning the determination of their nature as public or private entities under international law have far reaching implications regarding the applicable substantive law provisions as well as the international *fora* that can adjudicate disputes arising from their investment activities. The Santiago Principles, the only international SWF specific text is silent on their nature. In academic literature arguments have been advanced to regard them as purely private, purely sovereign or as a hybrid form of formally public but functionally private. Each of these proposals considers different criteria in the quest to determine their nature, while disregarding others. SWFs' complex and unique nature warrants however a holistic consideration of the various criteria on a case by case basis.