

## SWFs, Hedge Funds, and the Reach of Transnational Governance

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Though sometimes compared, sovereign wealth funds (“SWFs”) and hedge funds share little common operating ground, but considerable parallel and intersecting interests. They generally differ extensively with respect to stakeholders, mandates, asset allocation, risk profile, and scale. Where the former are public entities investing public assets, the latter invest for the benefit of qualified clients - including in fact SWFs - and so are accountable directly to them. Such distinctions notwithstanding, the activities of SWFs and hedge funds are frequently linked and scrutinized both due to the nested relationship that sometimes exists between them and also for the challenges posed to observing - and certainly too regulating - the investment behavior of both. This short note is a preliminary investigation into the evolution of the bespoke governance frameworks that have emerged to narrow this perceived regulatory gap.

### The Case for Transnational Governance in Finance

Financial crises often breed reactive measures to manage, control, and regulate activities deemed to have contributed to the disruption of financial markets and flows. In the US early 20<sup>th</sup> century financial crises led directly to the creation of the Federal Reserve System and bifurcated banking through Glass-Steagall. Of course more recently the Global Financial Crisis (“GFC”) has spawned an extensive and evolving global regulatory agenda – including Dodd-Frank. Similarly, the Asian Financial Crisis and its aftermath gave rise to a host of regional and international initiatives to increase transparency and reduce the risk of financial disruption.<sup>2</sup>

The evolution of this expanding body of “measures” is interesting in both diversity and innovation. We intentionally use the term “measures” at the outset to refer to a broad base of standards and rule-making that extends well beyond the traditional scope of financial regulation, which itself implies both jurisdiction and coercive enforcement. We seek purposely to draw a distinction between the regulation of financial institutions and the governance of financial processes where the latter extends to a wide variety of actors that might hitherto have been beyond the scope of traditional regulatory regimes, as for example SWFs and hedge funds. Importantly, these actors - specifically investors - exist and engage actively *both within and across* national borders with implications for national and international capital markets and capital flows. We view these structures as innovative in filling gaps in the global financial regulatory body in such areas as transparency and prudential engagement. We find this to be consistent with the evolving body of work on transnational governance, which counts nation-states as one actor among many without necessarily ceding to them a monopoly on financial rules-making or principles- or standards-setting.

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<sup>2</sup> We note for example the Financial Stability Forum (1999) as the predecessor of the FSB, as well as the Principles for Stable Capital Flows and Fair Debt Restructuring, conceived in the wake of the Asian, Russian, and Latin American crises in the late 1990’s and early 2000’s.

Djelic and Sahlin-Andersson<sup>3</sup> draw us into this tradition. They identify a dramatic rise in rule-making at the transnational level. They trace this trend in part to the emergence of new regulatory modes, including contractual arrangements, standards, rankings and monitoring frameworks designed to control human and social activities and interactions “beyond, across and within national territories”. They see the evolution of these governance structures as complementary to the traditional role of the state in law making through its indirect delegation of such authority to subnational or supranational entities, thus clouding the distinction between public and private actors, states and markets. Such “innovation”, they contend, results in a “de-centered view of regulation” that is not dependent either on state authority or the sanctioning power of the state. Instead institutions of transnational governance develop and structure regulatory sets that tend to be less coercive linking voluntary adoption with access to membership, resources or certifications and where compliance is based less on threats of coercion than elements of socialization, acculturation or other normative pressures. Furthermore, they suggest, because such rules are voluntary and beyond the threat of formal legal sanction, they permit considerable interpretation and adaptation to localized circumstances and settings.

The application of such structures to govern the execution of financial or investment processes has precedent through a variety of governmental and non-governmental entities or “networks” that define, disseminate, and promote standards and best practice principles opted into by member organizations with varying degrees of sanction resulting from non-compliance.<sup>4</sup> A key objective of such structures is to enhance the level and consistency of transparency and accountability across members. The focus of this short note is on those that apply specifically and discretely to SWFs and hedge funds, namely – respectively – the so-called Santiago Principles or Generally Accepted Principles and Practices (“GAPP”) negotiated by the members of the International Working Group of SWFs<sup>5</sup> and the Hedge Fund Standards (the “Standards”) promulgated by the Hedge Funds Standards Board.

### The IFSWF and HFSB in Transnational Relief

Perhaps by no means coincidental, efforts to organize SWFs and hedge funds both date to the heart of the GFC in 2008. In large measure, the GAPP were developed to assure investee firms and host governments that SWFs were professional in orientation and made investment decisions based upon sound economic and financial judgments. They were and are about building trust through accountability and transparency.<sup>6</sup> Adopted in 2008, the GAPP consist of 24 generally accepted principles and practices that are “voluntarily endorsed” by individual members of the International Forum of Sovereign Wealth Funds (“IFSWF”). The GAPP are designed to promote “transparency, good governance, accountability and prudent investment practices”, including the institution and maintenance of operational controls, risk management, and accountability. For its part the IFSWF - which today numbers 31 diverse funds - fosters a peer-to-peer culture among its members and encourages and facilitates knowledge and experience sharing directly and indirectly related to the GAPP to promote both improvement and innovation in member operations.<sup>7</sup> To understand the GAPP requires a review of not simply the 24

<sup>3</sup> This paragraph draws extensively Marie-Laure Djelic and Kerstin Sahlin-Andersson, “Introduction: A World of Governance: The Rise of Transnational Regulation”, in Marie-Laure Djelic and Kerstin Sahlin-Andersson ed, Transnational Governance: Institutional Dynamics of Regulation, Cambridge University Press, 201X

<sup>4</sup> See for example Thomas Hale and David Held, The Handbook of Transnational Governance (Polity Press, 2011) especially Part I

<sup>5</sup> See International Working Group of Sovereign Wealth Funds (IWG-SWF), “Sovereign Wealth Funds “Generally Accepted Principles and Practices: ‘Santiago Principles’”, October 2008. Pls see here - <http://www.iwgswf.org/pubs/eng/santiagoprinciples.pdf>. Last accepted 8 April 2016.

<sup>6</sup> See Afshin Mehrpouya, “Instituting a Transnational Accountability Regime: The Case of Sovereign Wealth Funds and ‘GAPP’”, Accounting, Organizations, and Society, 44 (2015), pp 15-36

<sup>7</sup> See <http://www.ifswf.org/santiago-principles-landing/santiago-principles>; last accessed 24 March 2016

Principles alone, but also both the introduction and accompanying explanatory notes, to the GAPP. The latter - as the 2008 document acknowledges - are in fact integral as a guide to interpretation, implementation, and - potentially - additional rule-making.<sup>8</sup>

Hedge funds similarly faced a 'trust' issue during the GFC. Operating in the shadow-banking sector, their regulation was and has remained modest - and largely reporting-based. In an effort to head off calls for more rigorous scrutiny, the hedge fund community self-organized under the Hedge Fund Standards Board ("HFSB"). This effort was primarily in response to concerns by G8 policy leaders in 2007 over financial stability in relation to hedge funds.<sup>9</sup> Resulting from efforts of 14 hedge fund managers to develop practice standards for hedge funds the Standards were first published in 2008. Similar to issues facing SWFs and the GAPP, the HFSB was confronted by a heterogeneous - though non-sovereign - group of members, operating in multiple international jurisdictions, and without a means to enforce. Today more than 120 hedge fund managers and 60 investors have adopted the Standards.

Despite such foundational similarities considerable differences separate the GAPP and the Standards.

### The GAPP vs the Standards: A Preliminary Comparative Perspective

At the outset it is important to acknowledge that both the GAPP and the Standards are designed specifically to increase both transparency and accountability in member funds - the former vis-à-vis the fund's primary stakeholder(s), its national citizenry, and the global community and the latter vis-à-vis client limited partners and prospective investors.

The Standards extend across five key operating areas: disclosure, valuation, risk management, fund governance, and shareholders conduct. The latter refers to instances where a hedge fund is acting in its capacity as shareholder and so is focused on circumscribing fund engagement through the proxy process to maintain market integrity. The GAPP, because they applied to government-linked entities, begin with provisions related to legal structure and a fund's broader macro-economic role. Also, the GAPP - more so than the Standards - extend to discrete principles of organizational governance vis-à-vis key stakeholders in matters related to both independent and ethical behavior. Beyond these, the GAPP and the Standards share wide areas of coverage including in such matters as disclosure, investment and risk management, and reporting.

Figure 1 provides a mapping of the GAPP against the Standards. The exhibit demonstrates considerable overlap around core concepts noted above (e.g. disclosure), but limited overlap in more operational areas, such as - in the case of hedge funds - asset valuation and shareholder conduct.

Generally, the Standards provide a more defined level of operational detail than the GAPP, thus offering somewhat less room for adaptation. Many standards are quite explicit as for example in recommending reporting coverage, such as biographies of directors to disclose relevant experience and to demonstrate ability to serve independently. The GAPP in some respects lack a similar level of operational detail. They tend to be broader in scope than the Standards, a consequence that may afford greater latitude in their interpretation and implementation and so which can result in disparities in operational effectiveness. However, interpretative differences due to definition tend to narrow when the GAPP are considered in conjunction with their explanatory notes.

<sup>8</sup> See IWG-SWF, 'Santiago Principles', p 5

<sup>9</sup> See <http://www.hfsb.org/?page=12430> accessed 4 April 2016

Figure 1: Mapping the GAPP to the Hedge Fund Standards

|                                    |                                       | Hedge Fund Standards – key sections |           |                  |               |                     |
|------------------------------------|---------------------------------------|-------------------------------------|-----------|------------------|---------------|---------------------|
|                                    |                                       | Disclosure                          | Valuation | Operational risk | Governance    | Shareholder conduct |
| Santiago Principles – key sections | Legal basis and form                  | Heavy overlap                       | Limited   | Limited          | Light overlap | Limited             |
|                                    | Objectives and macroeconomic linkages | Heavy overlap                       | Limited   | Limited          | Heavy overlap | Limited             |
|                                    | Statistics compilation & reporting    | Heavy overlap                       | Limited   | Limited          | Light overlap | Limited             |
|                                    | Funding and withdrawal rules          | Heavy overlap                       | Limited   | Limited          | Light overlap | Limited             |
|                                    | Governance                            | Heavy overlap                       | Limited   | Light overlap    | Heavy overlap | Limited             |
|                                    | Accountability                        | Heavy overlap                       | Limited   | Light overlap    | Heavy overlap | Limited             |
|                                    | Integrity of operations               | Heavy overlap                       | Limited   | Heavy overlap    | Heavy overlap | Limited             |
|                                    | Investment policy                     | Heavy overlap                       | Limited   | Heavy overlap    | Heavy overlap | Limited             |
|                                    | Risk mgt. and performance measurement | Heavy overlap                       | Limited   | Heavy overlap    | Light overlap | Limited             |

Source: Author's qualitative assessment

Level of overlap: Heavy Light Limited

The key area of disclosure offers an illustration of some of these differences. Disclosure is addressed under the Standards in a full section with 4 discrete Standards and in at least nine other provisions. Generally, the targets of disclosure under the Standards are fund investors, prospective investors, lenders, and service providers, where disclosures take place through offering memoranda, annual reports distributed to investors, or in private correspondences upon request and/or as a result of a material operating changes. By contrast, the theme of disclosure is woven throughout the GAPP, appearing in at least 10 GAPP. In addition, the disclosure targets of the GAPP tend to be key stakeholders and the general public, i.e. the GAPP – in fact widely – call for public disclosure of certain information related to SWF operations. Specific references in fact are made to reinforce compliance with both host and home country disclosure requirements, as for example in the case of GAPP 15, which specifies that “SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and *disclosure* requirements of the countries in which they operate.” Formal regulatory and disclosure notwithstanding, the GAPP call for SWF public disclosure of 1) the legal relationship between the SWF and the state, 2) its policy purpose, 3) any funding and withdrawal rules and sources of funding, 4) its investment policy and any non-economic or financial investment criteria, 5) its general approach to voting shares, and 6) its risk management framework.

As noted, transnational governance frameworks reflect a disparity of approaches to compliance and enforcement, but often eschew formal sanction. Both the Standards and the GAPP are based upon a similar paradigm. The GAPP are formally defined as “a voluntary set of principles and practices that the members of the IWG support and either have implemented or aspire to implement...subject to applicable home country laws”. Thus the GAPP themselves offer no guidance with respect to enforceability beyond what may be prescribed under local or host country law. By contrast, the HFSB has adopted a “comply or explain approach” to implementation and adherence. This is an interesting “innovation” that requires funds to explain to investors under what circumstances a manager does not comply with a given Standard. In justifying this approach, the HFSB emphasizes that “the hedge fund industry is diverse by size, strategy and jurisdiction...” and that as a result “...a one-size-fits all approach is not suitable”. Central to the “comply or explain” approach is the understanding that ‘explaining’ is not inferior to ‘complying’.

A common challenge of both frameworks remains implementation. To facilitate, the HFSB has begun development of a “toolbox” against which hedge funds can baseline best practices. Thus far, this consists of a standardized board agenda, an administrator transparency reporting structure, and a cyber security memo. For its part, the IFSWF has begun to accelerate knowledge- and experience-sharing among its members and others on matters related to the GAPP. This has been facilitated through various means including workshops and the development of fund-centric case studies.

An extension of implementation is engagement, both among respective memberships and with stakeholders/investors and the wider investor and global financial communities. The HFSB has established a baseline for accessibility and openness. For example, in addition to English, the Standards are available in both Chinese and Japanese and are easily accessed on the HFSB website in multiple formats. Also, the Standards include references and links to external guidance from other bodies, such as the Alternative Investment Management Association (AIMA), as the HFSB openly welcomes wider adoption within the asset management industry. This collaboration has in fact extended formally to the SWF community itself.<sup>10</sup>

These collaborative developments reflect both a pursuit and convergence of institutional interests and suggest a rebalancing in recent years away from concerns about formal matters of compliance and toward an acknowledgement of potential benefits from knowledge sharing and engagement. This approach will certainly not displace rule-making. Rather, it forms a necessary complement to principles and standards to gap issues of ‘trust’ that originally motivated the creation of these voluntary codes.

### Conclusion and Opportunities Future Research

In this short note we have attempted to outline the case for the Santiago Principles and Hedge Fund Standards as institutional innovations of transnational governance that were designed to fill gaps in the global regulatory repertoire that is generally the domain of states. We find similarities in motivation. For example, opacity in the face of crisis amplified calls for greater transparency and accountability for the benefit of the stability of the global financial system. Importantly, the initiative to close gaps, while induced by governments and multilateral finance organizations<sup>11</sup>, was ultimately left to these investor communities themselves to prescribe the scope and coverage of best operating practices, as well as the terms of enforcement. The resulting frameworks – the GAPP and the Standards - serve as the centerpiece of each member organization to define the basis for participation and to serve as a baseline for member engagement. In stating this we acknowledge that the development of both frameworks – in the tradition of transnational governance – will continue to evolve.

Moving forward we see three areas of particular promise to monitor and which may serve future research. First, as membership of both organizations widens we expect both the GAPP and the Standards to adapt along with the diversity of member mandates. Monitoring and mapping this evolutionary process will help to inform the drivers of regulatory change. Second, we believe that other classes of institutional investors may leverage the investment made in building these regulatory frameworks in whole or in part. Thus, tracking the scope of adoption can itself serve as a form of validation or certification and inform of the efficacy of the rule-making process. Finally, as self-adopted best practices, will either or both frameworks cross the regulatory divide to be applied by third parties - including governments – to

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<sup>10</sup> This is in fact underway between these organizations as the IFSWF and HFSB have signed a mutual observer agreement under which the former will have a voice in the standards-setting process of the latter. See Chris Flood, “Sovereign Wealth Funds Push for Higher Hedge Fund Standards”, *Financial Times*, 3 April 2016

<sup>11</sup> See Mehrpouya, “Instituting a Transnational Accountability Regime”

benchmark or even circumscribe member behavior?<sup>12</sup> Thus we view the boundary between transnational governance and formal regulation as especially interesting in defining future frameworks for rule-making.

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<sup>12</sup> Here we acknowledge the prior work of Sven Behrendt of GeoEconomica.