

## THE LAW OF SOVEREIGN WEALTH FUNDS<sup>1</sup>

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No one doubts that the Sovereign Wealth Funds (SWFs) must nowadays be recorded among the major players in the international financial markets and in the global economy. They contribute to global growth and financial stability, by maintaining open flow of resources for long-term investments, by providing liquidity to stabilize rising fiscal deficits, by contributing to recapitalize crisis-stricken banks, by supporting economic activities, by boosting productivity, by investing in strategic financial institutions in critical situations.

In 2009, commodity funds (managing portfolios of financial assets and income coming from the sale of raw materials) hold assets equal to 2 trillion dollars and account for 61% of global sovereign funds, while the assets of non-commodity funds (managing portfolios of financial assets derived from the income of foreign exchange balance of trade surplus and/or payments) amounted to 1.5 trillion dollars and account for 39% of global sovereign funds<sup>2</sup>. Before the crisis, the SWFs assets were expected to reach 12 trillion dollars by 2015, but nowadays, according to some reliable estimates, they are expected to reach between 6 and 10 trillion dollars by the same year<sup>3</sup>.

The phenomenon of SWFs is very complex. In principle, they are special investment vehicles with long-term horizons, created or owned by a sovereign State. All of them belong to the family of Foreign Government Controlled Investors (FGCI), which include similar public entities like State-owned Enterprises (SOEs). They are, however, a non-homogeneous category, with varied and multiple possible purposes. They represent an original mix between government and market, public and private instruments, with different risk profiles.

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<sup>1</sup> It 's the text of the preface to the book by Fabio Bassan, *The Law of Sovereign Wealth Funds* forthcoming from Edward Elgar Publishing.

<sup>2</sup> Sovereign Wealth Fund Institute, 2009

<sup>3</sup> A. QUADRIO CURZIO, *Sovereign Wealth Funds. A complete guide to state-owned investment funds*, Harriman House, 2010, p.39–46. The author analyses the different SWFs growth scenarios.

The complexity of the SFWs' economic and legal issues depends to a large extent on the more or less protectionist reaction of the recipient States which host foreign investments. The host State are interested in boosting foreign direct investment but at the same time they are often worried about foreign investment decisions that could be driven by political objectives, affecting strategic national issues. Obviously, the main host State concern is that a foreign State may take indirect control of (mostly) private companies working in strategic industry or financial sector, like the case of Libyan funds and Unicredit Bank. As a consequence, a potential conflict of interests and laws between home and host States may arise.

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The work of Fabio Bassan contributes significantly to the debate and literature on Sovereign Wealth Fund (SWFs), investigating the legal matter as a whole.

The book focuses on the central issue of the complexity of SWFs regulatory framework. It starts from the assumption that SWFs are a "genus" in the family of FGCI and their common denominator is that they are not only public, but sovereign entities, sometimes with a separate legal personality. The other relevant distinguishing feature of SWFs is the investment element, prominently foreign and with a long-term horizon.

Many scholars talk about a new form of "state capitalism" or recall in mind the public intervention in economy. Bassan rightly stresses out the original mechanism of "State as an investor", in which the State has, at the same time, the role of regulator and shareholder and acts, through the vehicle of SWFs, as a private operator, investing both internally and abroad in foreign companies and banks.

The definition of SWFs proposed by Bassan ("*funds established, owned and operated by local or central governments, with investments strategies including the acquisition of equity interest in companies listed in international markets operating in sectors considered strategic by their countries of incorporation*") is functional to the application of specific rules for SWFs, at least partially different from those applicable to other similar entities, like central banks, pension funds, SOEs, development banks, hedge or private equity funds or other investors.

When a State invests as a private entity it should be treated as such, but the SWFs are characterized by the element of “sovereignty” and their purposes are at the same time private (creating the most value for investors) and public (for instance, stabilizing price volatility or developing resources of the county). So, there is a particular cross-relationship between public and private law, well analysed in the first chapters.

The author analyses in detail also the problematic legal issue of the cross-relationship between international and national law of home and host States, in the framework of European law. At global level, the multilateral approach has been chosen, with the direct involvement of the IMF and the OECD. The former has drawn up 24 guiding Generally Accepted Principles and Practices (GAPPs), also called the “Santiago principles” and has created an International Working Group (IWG) evolved in an international forum (IFSWF). The OECD has provided guidelines and principles mainly for recipient countries, like non-discrimination of foreign investors, transparency and predictability, progressive liberalisation of capital movement, not conditioned on the principle of reciprocity, or commitment to avoid new restrictions. However, GAPPs and OECD guidelines represent a voluntary framework without any sanction in case of failure to comply with. Therefore, as Bassan points out, the multilateral framework is inadequate and SWFs remain subject to national measures. So, there might be a potential problem of regulatory asymmetry or a too high level of host State discretionary in allowing foreign investments in domestic economies: both could be negative for a sound long-term investment flows.

Very remarkable is also the Bassan’s study on bilateral relationship between the investment’s home State and the host State. On the one hand, he investigates in depth the questions whether the home State can invoke state immunity for its SWF’s operations and whether a SWF can challenge - on the grounds of immunity - the restrictive measures adopted by host State. On the other hand, Bassan examines the question whether bilateral investment treaties (BITs) can be invoked for the SWFs investments’ protection.

In order to avoid limitations that would distort investment regimes and affect free flow of capital across borders, it will be crucial also the new European legal framework for SWFs, based on free movement of capital (one of the pillars of the single

market), the new Lisbon Treaty provisions<sup>4</sup> and the new Commission communications about foreign investments in EU<sup>5</sup>.

Going forward, a multilateral agreement on investment - agreed by both major developed and emerging countries - could represent the first best solution in the long run in order to favor cross border investment at the global level<sup>6</sup>.

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The main geographical destinations of SWFs stock of capital investment is directed towards Asia (31%) to EU (30%) to US (20%) and to remaining regions (19%). From a geographical point of view, Europe remains the main destination of sovereign wealth fund investment in term of value, while Asia is the first destination in terms of deals. The investment vehicles portfolio is composed mostly by equity (50%), followed by fixed income securities (35-40%) and in only a residual from other forms of investment alternatives and more risky, such as hedge funds or derivatives. In Italy, the foreign SWFs's investments are mainly concentrated in sensitive fields such as energy and infrastructures, followed by finance, real estate and telecommunications. The SWFs are also active in financing long-term projects in research and technological innovation, green economy, environment, alternative energy sourcing. These are all sectors which themselves may yield high investment returns, stimulate follow-on investment and, as a result, create growth and jobs. Investment in such strategic sectors could enhance competitiveness and productivity.

Therefore, the SWFs are crucial long-term investors: they could favour a rebalancing of capital flows from surplus to deficit countries and contribute to re-allocate huge amounts of money towards long-term investments (LTI) in national economies strategic sectors, without weighing on troubled public finances and budgets. These kinds of investments should

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<sup>4</sup> Artt. 206 and 207 TFUE.

<sup>5</sup> COM 2010 n. 343 e 344.

<sup>6</sup> See the G8 Declaration of L'Aquila, *Responsible Leadership for a Sustainable Future*, 2009 ("52. To this end, we commit to enhance cooperation with our major partners to agree upon shared principles which may serve as the basis for a more structured and wider process towards an agreed common multilateral framework in the long run creating a predictable and stable climate for investment.")

play a key role for the global, European and national exit strategies from the economic and financial crisis, because they can stimulate a sustainable growth and contribute to fiscal consolidation and financial stability.

Thus, the role of SWFs is going to rise in the coming years, as well as the role of other long-term investors, with which they can establish important working relationships and partnerships I refer, in particular, to development banks and public saving banks (such as the EIB, the German KfW, the French CDC and the Italian CDP), pension funds and insurance companies which are involved in long-term investments too.

The SWF's direct investments should be encouraged by an appropriate regulatory framework. This legal framework could be constrained by national protectionist barriers, due to the lack of transparency of some SWFs asset allocation, some foreign government practices and more or less sensitive sector in which they invest. These concerns are important and they should be regulated, doing so, however, that the protection of their host countries will not stop the flow of foreign SWFs investments. In fact, SWFs have much to offer not only to their sponsor countries but also to recipient countries, in terms of capital injections for long-term investments essential to boost fiscal recovery, business activity and the job market.

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Although some specific rules for SWFs are needed, I think that a common legal framework for long-term investors and/or for long-term investments should be provided. It should be based on few shared principles. In particular, it is important to keep markets open to foreign capital and create a friendly LTI regulatory framework (or, at least, a regulatory framework not discriminatory against LTI).

The new framework should involve accounting standards, prudential principles, corporate governance' rules, as well as new rules and incentives for PPPs and PFIs, and an "ad hoc" system of fiscal incentives, as proposed by the de Larosière

Group Report on European Financial Supervision<sup>7</sup> and more recently by the Mario Monti Report on European Single Market<sup>8</sup>.

From a fiscal policy point of view, in many European Countries the strategic LTI are disadvantaged compared to financial short-term investments. These discriminatory tax disincentives should be abolished. Considering the important positive externalities of the strategic long-term investments, we may envisage “ad hoc” incentives for financial products and firms investing in the long-term initiatives of general interest, on the lines of the fiscal incentives granted to the US Project Bonds by the American Administration Stimulus Plan and of the incentives awarded to the renewable energy projects by many European tax systems<sup>9</sup>. Following the same logic, however, higher tax rates are frequently provided for the selling back of real estate assets bought few years before (usually less than 3-5 years), presuming a speculative transaction.

Tax expenditures for LTI should not be considered in the Maastricht criteria. Moreover, in the rethinking of the European Growth and Stability Pact, some kind of new “Golden Rule” should be applied to the duration of investments. Long-term strategic investment with over 25/30-years time span, and/or the related guarantee schemes, should be considered not under primary spending, but as a fixed investment having a special accounting treatment within the European statistical framework.

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As for the accounting standards, the “mark to market” principle, if applied to typical long-term investors, does not permit distinctions between short-term and long-term investment values in balance sheets. There is need to i) introduce accounting criteria that reflect long-term investors specific business model; ii) distinguish between different temporal durations/matching liabilities and investments; and ii) take into account the value of future cash flow over the long-

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<sup>7</sup> *The High-Level Group on Financial Supervision in EU, chaired by J. de Larosière, Report, 25<sup>th</sup> February 2009.*

<sup>8</sup> MARIO MONTI, *A new strategy for the single market at the service of Europe’s economy and society*, May 2010.

<sup>9</sup> The very rapid growth of European private investment in renewable energy plants is commonly attributed to these tax or price incentives: *quod erat demonstrandum!*

term. Appropriate accounting rules for long-term investors would also make a substantial contribution towards stabilising global financial markets and reducing short-term volatility.

The prudential treatment of financial assets giving priority to their mark to market value is also standing in the way of long-term investment. The mark to market accounting rules applied to typical long-term investors do not incorporate in their ALM distinctions between short-term and long-term investments. Therefore, a change in the prudential principles might be recommended. Due to the mark to market rule, the contingencies affecting the value of these investments over the short-term are having repercussions over time on the financial statements – higher earnings volatility and additional solvency requirements – although the actual horizon for these investments goes beyond that for the publication of the accounts.

Similar proposals have been put forward – after the De Larosière’s and Mario Monti Reports - by the Eurofi Financial Forum 2010<sup>10</sup>, by the two conferences organized by the Long Term Investors’ Club and the OECD in Rome and in Venice<sup>11</sup>, and by a working paper presented to the EU Commissioner Michel Barnier by four prominent European long-term public investors (EIB, KfW, CDC and CDP) in September 2010<sup>12</sup>.

At the international level, in the recent New York Conference on SWFs and other Long-term Investors<sup>13</sup>, Augustin de Romanet, the CEO of CDC, announced that the need of a more favourable regulatory framework for the LTI will be supported by the French Government and will be included in the G20 Agenda of the 2011 French Presidency. The Italian Government shares

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<sup>10</sup> *Optimizing EU financial reforms for achieving resilience, growth and competitiveness. What priorities? What roadmap?*, 27<sup>th</sup> – 30<sup>th</sup> September 2010, Brussels. See especially the paper *For an EU action plan to remove the disincentives to long-term investment*.

<sup>11</sup> *The Long-term Investment in the Age of Globalisation*, Rome, 17<sup>th</sup> June 2010 (all papers in <http://www.astrid-online.it/Dossier--d1/DISCIPLINA/The-Long-T/index.htm>) and *Towards a Sustainable Future: The Role of Long-Term Investment*, Venice, 28<sup>th</sup>-29<sup>th</sup> Oct. 2010 (all papers in <http://www.astrid-online.it/Dossier--d1/DISCIPLINA/Studi--ric/index.htm>).

<sup>12</sup> Letter to Mr. BARNIER, *Proposals to adapt the EU’s financial regulatory framework to long-term investments requirements*, 20<sup>th</sup> September 2010, with annex *Proposals to promote Long-term investments in Europe – Conclusions of European long-term financial institutions’ working group on banking supervision*.

<sup>13</sup> Conference “Wealth Funds and Other Long-Term Investors”, 4-5<sup>th</sup> October 2010, New York.

the same opinion<sup>14</sup>: in fact, without substantial changes in prudential, accounting and tax regulations, the objectives set in the EU 2020 strategy and in the Mario Monti strategy on the Single Market could not be reached.

At the European political level, the need of a new regulatory framework, more favourable to LTI, has been strongly emphasized by the European Commission in the recent Communications on *A New Single Market Act*<sup>15</sup>, on *A Comprehensive European international investment policy*<sup>16</sup>, and on *The EU Budget Review*<sup>17</sup>. The EU Commission political choice on this issue is therefore explicit and may be very important for a sound European long-term investment policy, but there is, of course, the need of a strong and durable political commitment and of a coherent follow up.

However, critics have objected that the European Union has no powers to decide in this matter, since it relates specifically to the introduction of some exceptions and additions to the set of rules laid down by Basel III, Solvency II and the IAS 39. But the rules of Basel III will be implemented in Europe by a European Union directive (CRD IV) and Solvency II is itself an European directive. As for the international accounting standards, though they are defined by an independent NGO (the IASB), they can be effective only if they are recalled by the European and national legislation. So the EU institutions have in fact some power to influence and even to negotiate with the IASB less penalizing rules for LTI, and to directly enact better rules for insurance companies and pension funds through changes to Solvency II.

More difficulties must be faced as regards Basel III. In principle, the European Commission is not obliged to transpose the Basel rules mechanically, but could provide for exceptions and integrations, as the U.S. did for Basel I and II. However, strong political and practical reasons suggest not to reopen the

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<sup>14</sup> GIULIO TREMONTI, *The crisis, Europe and the Long-term Investors, LTIC Venice Forum: "Towards a Sustainable Future: The Role of Long-Term Investment"* organized by Cassa Depositi e Prestiti - Venice, 28-29th October 2010. See also, F. BASSANINI, E. REVIGLIO, *A New Regulatory Framework and Instruments for European Long Term Investments after the Crisis*, in "Astrid Rassegna" n. 20/2010 ([www.astrid.eu](http://www.astrid.eu)).

<sup>15</sup> EUROPEAN COMMISSION COMMUNICATION, *Towards a new Single market Act*, 27<sup>th</sup> October 2010 – COM(2010)608.

<sup>16</sup> EUROPEAN COMMISSION COMMUNICATION, *Towards a comprehensive European international investment policy*, 7<sup>th</sup> July 2010, COM(2010)343.

<sup>17</sup> EUROPEAN COMMISSION COMMUNICATION, *The EU Budget Review*, 19<sup>th</sup> Oct. 2010, COM(2010) 700



Pandora's box of Basel III, the result of a difficult and complex negotiation. A compromise solution may perhaps be found in the framework of the new mission given by the Seoul G20 summit to the Financial Stability Board, to propose the extension of the Basel rules to other parties (shadow banks). An integrative protocol could perhaps be envisaged, that, without changing the Basel III rules as regards banks, could integrate and refine them in respect of long-term investors. *Stricto jure*, in fact, the rules of Basel III apply to banks, but do not apply to long-term investors such as insurance, pension funds, SWF's and public savings and development banks (like EIB, CDC, CDP, KfW). But, *de facto* and by default, the same rules are frequently applied by the markets to these investors, dramatically reducing their firepower in the financing of long-term investment. There is good reason to fill the void, with an additional or integrative protocol to Basel III establishing special rules adapted to the specific mission and business model of these institutions.

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Aside of new International and European sets of rules to favour LTI (and to attract SWF's investments), new financial instruments such as Project Bonds, European equity Funds and Guarantee Schemes may be contemplated.

Many SWFs invest most of their resources in U.S. bonds, while at European level they find only fragmented markets. So, it's clear that the lack of an European bond market is now an obstacle for attracting foreign investments. Thus, the construction of an European sovereign debt market by issuing E-bonds would be an interesting opportunity for SWFs investment in EU. Moreover, EU would ensure a significant flow of foreign capital, especially from emerging economies, essential for long-term investments in strategic areas. The issuance of E-bond would enrich the positive experience of other new financial instruments, such as the 2020 European Fund for Energy, Climate Change and Infrastructure ('Marguerite'), set up in 2009.

The world's financial markets will likely show an extraordinary growth in the quantity of savings of emerging economies. During the recent crisis, there has been a marked intensification of competition for funds by governments of

economically-advanced countries seeking to finance swelling public debt. In this competition, sound, socially-cohesive economies boasting achievements in technology and environmental stewardship will have the advantage, inspiring global investors' confidence and so attracting resources. In this context, the solid reputation of Europe as a reliable economic area - partly a result of the Stability and Growth Pact and the ECB's rigorous anti-inflation policy - will play to the EU's favour.

However the demand for infrastructure, energy, climate change, strategic and urban infrastructure is very large all over the world and will grow rapidly in the next years. For instance, the overall cost of the Trans-European Transport Network (TEN-T) still to be financed has been assessed at around 500 billion euro by 2020. The overall cost of the European investments in Energy and Climate Change is estimated in over 2,500 billion by 2020. To finance such an ambitious program the EU needs to increase its capability to attract long-term private and public-private capital from global markets, the SWF's investment included.

For doing so, the EU should bolster the euro's leverage, providing for LTI a new favourable regulatory framework and using a better combination of long-term capital and debt instruments (such as EU equity funds, project bonds and common guarantee schemes) issued by large European funds and other similar long-term public and private financial institutions and investors. These actions, together with the issuance of European Sovereign Debt securities, will also strengthen the alliance of European peoples and secure the political cohesion of the Union.