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The Brave New World *of* Sovereign Wealth Funds

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The Rise of Sovereign Wealth Funds

Recent years have witnessed the rise to prominence of a new category of international investors known as sovereign wealth funds (SWFs). The largest include:

- Japan's Government Pension Investment Fund,
- Abu Dhabi Investment Authority,
- Holland's Stichting Pensioenfonds,
- Norway's Government Pension Fund-Global,
- California Public Employees' Retirement System,
- Government of Singapore Investment Corporation,
- Saudi Arabian Monetary Agency,
- Kuwait Investment Authority, and
- China Investment Corporation

Collectively, SWFs managed assets in excess of US$5 trillion as of the end of 2007, although many suffered losses of 30%-40% during 2008.[1] While the phenomenon dates back to the 1950s, the term dates back only to 2005.[2] SWFs have become important players in worldwide portfolio investing, especially in the wake of the economic and financial crisis of 2007-2008, when they took stakes in companies as prominent as UBS, Citigroup, Morgan Stanley, Merrill Lynch, Barclays, Blackstone, Standard Chartered, and the Carlyle Group.

According to the U.S. Department of the Treasury, SWFs are assets that a government (or government-linked entity) holds in another country's currency, with the goal of attaining a long-term return, but that it manages separately from its foreign currency reserves, which it uses for stabilization and short-term liquidity purposes.[3]

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[1] Brad Setser and Rachel Ziembra, "GCC Sovereign Funds: Reversal of Fortune," Council on Foreign Relations, Working Paper, 2009, http://www.cfr.org/content/publications/attachments/CGS_WorkingPaper_5.pdf.

[2] Andrew Rozanov, "Who Holds the Wealth of Nations?" *Central Banking Journal*, 2005. Reprinting by State Street available. http://www.libertyparkusafd.org/lp/Hancock/Special%20Reports/Sovereign%20Wealth%20Funds/Who%20Owns%20the%20Wealth%20of%20Nations%20-%202005.pdf.

[3] U.S. Department of the Treasury, Office of International Affairs, "Appendix III: Sovereign Wealth Funds," in *Semiannual Report on International Economic and Exchange Rate Policies*, 2007, http://ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007_Appendix-3.pdf. Par. 2. For a more lengthy and detailed treatment of both topics, see Simone Mezzacapo, "The So-called

The International Monetary Fund (IMF) states that "SWFs can generally be defined as special investment funds created or owned by governments to hold foreign assets for long-term purposes," [4] while the Organization for Economic Cooperation and Development (OECD) argues that "SWFs are essentially government-owned investment vehicles funded by foreign exchange assets."[5]

Given the difficulties associated with providing a working definition, some suggest that "a practical way to identify SWFs could be to *define them by exclusion*—a useful reference is the fairly comprehensive and inclusive definition proposed by 'State Street', according to which SWFs are essentially sovereign-owned asset pools which are *neither* traditional *public pension funds* nor traditional *reserves assets supporting national currencies*."[6] For its part, the International Working Group of Sovereign Wealth Funds defines them 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.[7]

Finally, the Sovereign Wealth Fund Institute, an organization that studies sovereign wealth funds and their global impact, provides the following definition:

> A Sovereign Wealth Fund (SWF) is a state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets. These assets can include: balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports. Sovereign Wealth Funds can be structured as a fund, pool, or corporation. The definition of sovereign wealth fund exclude [*sic*], among other things, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises (SOEs) in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals.[8]

'Sovereign Wealth Funds': Regulatory Issues, Financial Stability and Prudential Supervision," *European Economy*, Economic Papers 378, April 2009, Directorate-General for Economic and Financial Affairs, European Commission, http://ec.europa.eu/economy_finance/publications/publication15064_en.pdf.

[4]International Monetary Fund, Global Financial Stability Report, October 2007, http://www.imf.org/external/pubs/ft/GFSR/2007/02/pdf/text.pdf.

[5] *Ibid.*

[6] State Street, Sovereign Wealth Funds, Assessing the Impact, Vision, Vol. III, Issue 2, pp. 3-6 (emphasis in the original).

[7]International Working Group of Sovereign Wealth Funds, "Sovereign Wealth Funds: Generally Accepted Principles and Practices ('Santiago Principles'), 2008," http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf. 27.

[8] Sovereign Wealth Fund Institute, "What Is a Sovereign Wealth Fund?" November 16, 2009, http://www.swfinstitute.org/swf.php.

We will define SWFs here as funds owned or controlled by sovereign governments, composed of foreign assets, held for a purpose other than that of supporting the currency, that the government may use

- to support state pensions,
- to manage large surpluses such as profits from oil production,
- to earn a return on capital,
- for the public interest,
- to manage foreign exchange asset reserves, or
- to achieve other objectives.

How Many Sovereign Wealth Funds Are There and How Big Are They?

Two key reasons make this question subtly difficult to answer: (1) the number depends on the definition one uses for SWFs, and (2) many funds are secretive about their holdings, making it difficult to be certain of their sizes.

According to Edward Truman, creator of the "Truman Scoreboard" for evaluating and comparing SWFs, there are at least 32, which range in size from under US$1 billion to possibly US$900 billion.[9] Another revealing list is that of the members of the International Forum of Sovereign Wealth Funds, a forum in which the SWFs of various countries "will meet, exchange views on issues of common interest, and facilitate an understanding of the Santiago Principles and SWF activities."[10] Among the 23 member nations of the forum, there are 25 member SWFs.[11] Interestingly, the "Members Information" page on the website has varying levels of detail about each fund, ranging from explicit declarations of funds' sizes and goals (Norway, among others) to no entry at all (Equatorial Guinea, Iran). Perhaps the most thorough list thus far is that of the Sovereign Wealth Fund Institute, with 56 known or presumed funds[12] (see Exhibit 1.1).

The size of a fund depends primarily on its purpose and the size and wealth of the state funding it. For example, among the largest funds are those of the United Arab Emirates and Norway, most of which manage excess revenues earned from petroleum. Not all oil funds are that large, though. Sudan, São Tomé-Príncipe, and Azerbaijan all have oil-revenue-based funds that manage less than US$2 billion each.[13]

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[9] Edward M. Truman, "A Scoreboard for Sovereign Wealth Funds," Peterson Institute for International Economics, Paper presented at conference on China's Exchange Rate Policy, Peterson Institute, Washington, D.C., 2007, http://www.iie.com/publications/papers/truman1007swf.pdf, p. 10.
[10] International Forum of Sovereign Wealth Funds, "International Forum of Sovereign Wealth Funds," November 16, 2009, http://www.ifswf.org/index.htm.
[11] *Ibid.*
[12] Sovereign Wealth Fund Institute, *op. cit.*
[13] Truman, *op. cit.*, p. 10.

However, there are two primary reasons for the rapid appearance and growth of SWFs: the rapidly increase in oil prices and the accumulation of large balance-of-payments surpluses.[14]

First, many funds came about as an outlet for managing the extreme wealth that came with the rapid rising price of petroleum. Some of these, such as Norway's, double as pension funds. Others, such as many of the funds that belong to members of the Gulf Cooperation Council, are more clearly intended to manage government wealth while earning a return.

These funds can play a valuable role in stabilizing the economy during business-cycle troughs, particularly in these oil-rich countries that can have turbulent economic cycles. According to a report from Booz and Company, a consultancy, "Saudi Arabia's central bank, which had accumulated significant excess foreign reserves since the 1970s, was able to cushion the severity of a decade of slow growth by infusing money into the Saudi economy. Similarly, the Kuwait Investment Authority was instrumental in rebuilding the Kuwaiti economy in the aftermath of the invasion of Kuwait and the 1990 Gulf War."[15]

The combination of increased stability, increased returns, and greater economic power through the concentration of its finances makes the creation of an SWF an appealing policy for such powers. The funds with this background are among both the wealthiest and least transparent in the world, making them powerful as well as elusive.

Second, a number of countries developed their funds on the basis of enormous trade surpluses. China provides a classic example. For many years, China's rapid export growth but relatively limited import growth has caused it to accumulate an ever-growing sum of dollars in its foreign exchange reserve; this reserve reached US$1.2 trillion by March 2007.[16] As a consequence of the rapid increase within the last decade, the government has given much of this to the China Investment Corporation to manage.

Following the onset of the worldwide financial crisis in late 2008, the landscape for SWFs has become even more important. Governments or funds bailed out many politically salient and connected companies and institutions, which either became entities similar to SWFs or became controlled wholly or in part by foreign SWFs.

The American banks and insurance agencies affected most during the beginning of the financial crisis are the best examples of this, as the U.S. government now owns AIG. The Kuwait Investment Authority, Temasek, and the Abu Dhabi Investment Authority all hold significant portions of the stock of Citigroup, Merrill Lynch, Barclays, and UBS (see Exhibit 1.2).

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[14] Mezzacapo, *op. cit.*, p. 18.

[15] Richard Shediac and Hatem Samman, "The Vital Role of Sovereign Wealth Funds in the GCC's Future," Booz and Company, 2009, http://www.booz.com/media/uploads/Vital_Role_Sovereign_Wealth_Funds.pdf, p. 2.

[16] Luan Shanglin, "China's Forex Reserve Tops 1.2 trillion USD," *China View*, April 13, 2007, March 1, 2010, http://news.xinhuanet.com/english/2007-04/13/content_5969028.htm.

While many other investors have been particularly cautious, SWFs have been active, seeing this as an opportune time to invest in valuable companies at low prices, for both better returns and more control. It remains to be seen what the future effect of this will be. To be sure, SWFs have not escaped the crisis unscathed. Estimates suggest that during 2008 the Abu Dhabi Investment Authority lost 40% of its fund value, the Kuwait Investment Authority lost 36%, the Qatar Investment Authority lost 41%, the Saudi Arabian Monetary Agency lost 12%, and the Norwegian Government Pension Fund-Global lost 30%.[17]

[17] Setser and Ziembra, *op. cit.*

Exhibit 1.1
The Main Sovereign Wealth Funds

Name	Country	Year Founded	Main Source of Funds	Current Size (US$ bn)
Abu Dhabi Investment Authority	United Arab Emirates	1976	Commodity	875
Alaska Permanent Fund	United States	1976	Commodity	29
Alberta's Heritage Fund	Canada	1976	Commodity	16
Australia Future Fund	Australia	2004	Fiscal surpluses[a]	44
Brunei Investment Agency	Brunei	1983	Commodity	30
Canada Pension Plan[a]	Canada[a]	1966[a]	Employee Contributions[a]	121[a]
China Investment Corporation	China	2007	Forex reserves[a]	200
Economic and Social Stabilization Fund[a]	Chile[a]	2006[a]	Natural resources[a]	15[a]
Government of Singapore Investment Corporation	Singapore	1981	Forex reserves, fiscal surpluses, employee contributions[a]	330
Government Pension Fund of Norway	Norway	1990	Commodity	301
Investment Corporation of Dubai	United Arab Emirates	2006	Commodity	82
Kazakhstan National Fund	Kazakhstan	2000	Commodity	38
Khazanah National	Malaysia	1993	Fiscal surpluses[a]	26
Korea Investment Corporation	Republic of Korea	2005	Forex reserves[a]	30
Kuwait Investment Authority	Kuwait	1953	Commodity	265
Libyan Investment Authority[a]	Libya[a]	2006[a]	Natural resources[a]	50[a]
Oil Income Stabilization Fund[a]	Mexico[a]	2000[a]	Natural resources[a]	5[a]
National Pensions Reserve Fund	Ireland	2001	Noncommodity	31
Qatar Investment Authority	Qatar	2005	Commodity	60
Revenue Regulation Fund	Algeria	2000	Commodity	47
Saudi Arabian Monetary Agency[a]	Saudi Arabia[a]	1952[a]	Natural resources[a]	270[a]
Stabilization Fund (and National Welfare Fund)	Russia	2004	Commodity	225
Temasek Holdings	Singapore	1974	SOEs[a]	134

Exhibit 1.1 (cont.)

Note:[a]Edward M. Truman, "A Blueprint for Sovereign Wealth Fund Best Practices," Peterson Institute for International Politics, Policy Brief, 2008, http://www.petersoninstitute.org/publications/pb/pb08-3.pdf.

Source: Simone Mezzacapo, "The So-called 'Sovereign Wealth Funds': Regulatory Issues, Financial Stability and Prudential Supervision," *European Economy*, Economic Papers 378 (Brussels: European Commission, Directorate-General for Economic and Financial Affairs, April 2009) (unless otherwise noted). http://ec.europa.eu/economy_finance/publications/publication15064_en.pdf.

Exhibit 1.2
Sovereign Wealth Funds That Made Major Acquisitions During the Crisis (January 2007-December 2009)

SWF	Target Company	Stake US$ bn	Stake %
GIC of Singapore	UBS	9.8	8.6
Abu Dhabi Investment Authority	Citigroup	7.6	4.9
GIC of Singapore	Citigroup[a]	6.9	4.4
China Investment Corporation	Morgan Stanley	5.0	9.9
Temasek (Singapore)	Merrill Lynch[b]	5.0	11.3
Qatar Investment Authority	Barclays[c]	3.5	7.7
Kuwait Investment Office	Merrill Lynch	3.4	7.0
Kuwait Investment Office	Citigroup[d]	3.0	1.6
China Investment Corporation	Blackstone	3.0	10.0
Korea Investment Corporation	Merrill Lynch	2.0	4.3
Temasek (Singapore)	Barclays	2.0	1.8
Temasek (Singapore)	Standard Chartered	2.0	5.4
Saudi Arabian Monetary Agency	UBS	1.8	2.0
Abu Dhabi Investment Authority	Carlyle Group	1.4	7.5

Notes:
[a] Sold in September 2009 at a reported US$1.6 billion profit.
[b] Sold at the end of March 2009.
[c] Reduced to a 5 % stake in April 2009.
[d] Sold in December 2009 at a reported US$1.1 billion profit.

Sources: European Central Bank; Sovereign Wealth Fund Institute.

2

History and Concept of Sovereign Wealth Funds

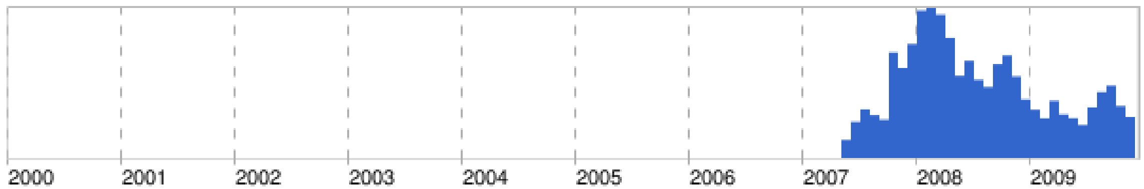
Over the past several years, sovereign wealth funds have grown to occupy a significant position in both the financial markets (the funds are believed hold up to $3 trillion of assets) [18] and in the popular consciousness. The background of these funds is consequently best examined as two separate histories: i) the history of the concept and popular perception of sovereign wealth funds and ii) the history of the actual pools of capital that are classified as sovereign wealth funds.

Concept of Sovereign Wealth Funds

Although the concept of a pool of capital controlled by a government and invested in assets seeking returns above the risk-free rate[19] is not unique enough to claim a specific point of invention, the phrase 'sovereign wealth fund' is popularly believed to have been coined in 2005 by Andrew Rozanov of the Official Institutions Group at State Street Advisors. Although it may be surprising that a term so firmly entrenched in the American lexicon is less than 5 years old, popular usage of the term (and popular focus on the funds on themselves) really only began in the second quarter of 2007. A media search of articles containing the phrase 'sovereign wealth fund shows little to no usage of the phrase prior to 2Q2007, and a huge spike in usage at the end of 2007 and start of 2008.

[18] A Portfolio Analysis Of Sovereign Wealth Funds, Christopher Balding, University of California Irvine, June 6, 2008 Pg. 3
[19] A Portfolio Analysis Of Sovereign Wealth Funds, Christopher Balding, University of California Irvine, June 6, 2008 Pg. 10

Exhibit 2.1: Frequency of search 'sovereign wealth fund' occurring in Google article search

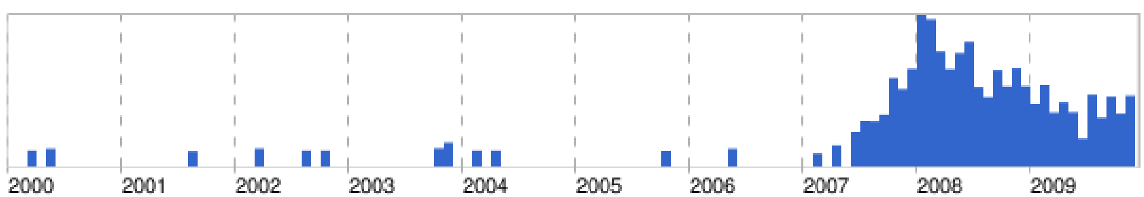


Sovereign wealth fund managers themselves were caught off guard by the largely negative attention suddenly focused on their funds. Bader Al Sa'ad Managing Director of the Kuwait Investment Authority recalled:

> When the whole issue of the size of Sovereign Wealth Funds emerged in 2007… The media was in a frenzy regarding the threat from Sovereign Wealth Funds, with projections of the size of assets under management based on unrealistic expectations.[20]

Examination of written media usage of "sovereign wealth fund" combined with phrases like 'threat' or 'danger' shows a similar increase in usage (10% of articles making reference to sovereign wealth funds contained the word "threat" in January 2008).

Exhibit 2.2: Frequency of search ' "sovereign wealth fund" threat' occurring in Google article search



Popular media, and governmental concerns largely centered on about sovereign wealth funds' lack of transparency, potential for technology transfer, and the potential for governments to influence management decisions that benefit a nation rather than optimize shareholder value.

> The logic of the capitalist system depends on shareholders causing companies to act so as to maximize the value of their shares. It is far from obvious that this will over time be the only motivation of governments as shareholders. They may want to see their national companies compete effectively, or to extract technology or to achieve influence.[21]

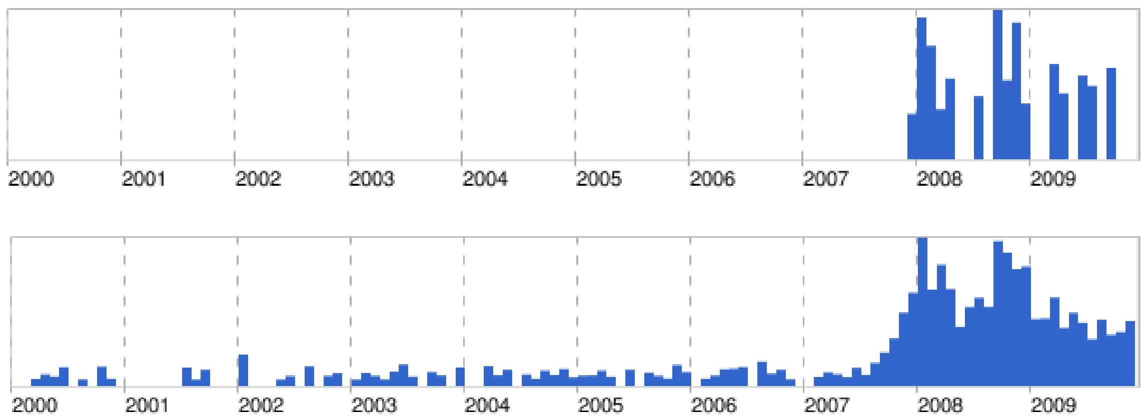
However, as the financial crisis heated up, the liquidity that sovereign wealth funds were able to provide caused the funds to be viewed in a much more positive light, causing a

[20] Bader Al Sa'ad Managing Director of Kuwait Investment Authority, On the Occasion of the Visit of the Working Group of Sovereign Wealth Funds, April 5, 2009

[21] Larry Summers, quoted in The Evening Standard (London), Pg. 27, September 21, 2007

percentage increase in positive media reports on sovereign wealth funds at the end of 2008.

Exhibit 2.3: Frequency of search ' "sovereign wealth fund" savior' (top) and ' "sovereign wealth fund" save' bottom occurring in Google article search



History of Various Sovereign Wealth Funds

Despite the new attention paid to sovereign wealth funds and the recent increase in both the number and size of sovereign wealth funds, the largest funds are not new institutions.

The Kuwait Investment Authority claims to be the oldest[22] sovereign wealth fund, but the oldest significantly sized fund meeting the IMF, Edwin Truman Institute for International Economics, and Balding definitions for a sovereign wealth fund is the California Public Employees Retirement System[23] ("CalPERS). Although CalPERS is different from the popular conception of sovereign wealth funds in the regard that CalPERS serves a state rather than a nation, the fund's history is useful to examine in order to forecast the future behavior of newer more 'prototypical' sovereign wealth funds.

CalPERS was started in 1932 during the great depression after eleven years of political agitation and a necessary state constitution change. CalPERS was initially a bond-only fund, but legislative modifications allowed for the addition of real estate in 1953 and stocks in 1967. Interestingly, the impetus for CalPERS to begin making foreign equity investments mirrors the impetus driving the foundation of oil based sovereign wealth investment funds: the desire to preserve wealth even if domestic economies lose their competitive advantage (oil in the for some funds, or manufacturing for CalPERS) and are supplanted by foreign economies. CalPERS pushed through a proposition allowing for

[22] The Independent (London), February 26, 2008 Tuesday, EU to agree code of principles for sovereign wealth funds

[23] A Portfolio Analysis Of Sovereign Wealth Funds, Christopher Balding, University of California Irvine, June 6, 2008

foreign investment in 1984 after being influenced by U.S. Ambassador to Japan Mike Mansfield's assertion that "[i]f American consumers are going to continue buying Japanese products, then its best for U.S. investors to also invest in these companies." CalPERS in now approximately 20% foreign equities and 26% global fixed income.[24]

Instructively, during its relatively long history, CalPERS has confronted two issues that recur as themes for sovereign wealth funds - the need to take an active shareholder role, and the threat of political interference: CalPERS has fought off efforts by state Governors to tap or privatize the fund, and was a pioneer in unifying public pension funds into the Council of Institutional Investors in order to pressure their portfolio companies into focusing on creating greater shareholder value.[25]

The first sovereign wealth fund, the Kuwait Investment Authority established The Kuwait Investment Office (the fund's London investment office) in 1953 in order to invest oil revenues and reduce Kuwait's reliance on Oil. 10 percent of all state revenues are transferred annually to the Future Generations Fund, including 10 percent of the income generated by the General Reserve Fund. [26] By 1986, government revenue from investments exceeded oil revenue.[27]

> Kuwait… it's probably the oldest sovereign funds in the world… the objective was to transfer non-recurring assets, highly volatile… which was the oil, into a diversified portfolio. To create a social stability in the country. I think [the fund] has worked well during the Iraqi invasion [in] 1990 when Kuwait has been occupied by Iraq… for three years Kuwait does not have a source of income, no revenue at all. $80-85bn was spent from the funds to finance the budget. This is the reason why these funds has been created.[28]

The Kuwait Investment Authority emphasizes the passive nature of their investment strategy, saying, "we have been passive in all our investments. We haven't played an active role or been an activist with [any] of our shares." [29] Although KIA made in 1983 outright acquisition of Autobar, the largest European hot and cold beverage and food vendor, it subsequently disposed of this investment as it contradicted KIA's stated passive investor policy.[30] Taking a more active role in investments is not uncommon for large sovereign wealth funds, and may perhaps become a necessity when shareholdings grow as large as CalPERS's or Kuwait's.

Kuwait's 1953's sovereign wealth fund start, was joined shortly thereafter by another commodity fund: the Kiribati Revenue Equalisation Reserve Fund was founded in 1956. Like Kuwait's sovereign wealth fund, the Kiribati Revenue Equalisation Reserve Fund was established to capture proceeds from the export of a finite resource (guano for fertilizer) and create wealth for future generations. Because most countries which have

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[24] Pension & Investments, May 14, 2007, Raquel Pichardo
[25] Council of Institutional Investors website, http://www.cii.org/about/history
[26] Kuwait Investment Authority Website, http://www.kia.gov.kw/En/KIO/About/Pages/default.aspx
[27] Kuwait Investment Authority Website, http://www.kia.gov.kw/En/KIO/About/Pages/default.aspx
[28] Bader Al Sa'ad Managing Director of Kuwait Investment Authority, at Davos 2008
[29] Bader Al Sa'ad Managing Director of Kuwait Investment Authority, at Davos 2008
[30] Kuwait Investment Authority Website, http://www.kia.gov.kw/En/KIO/About/Pages/default.aspx

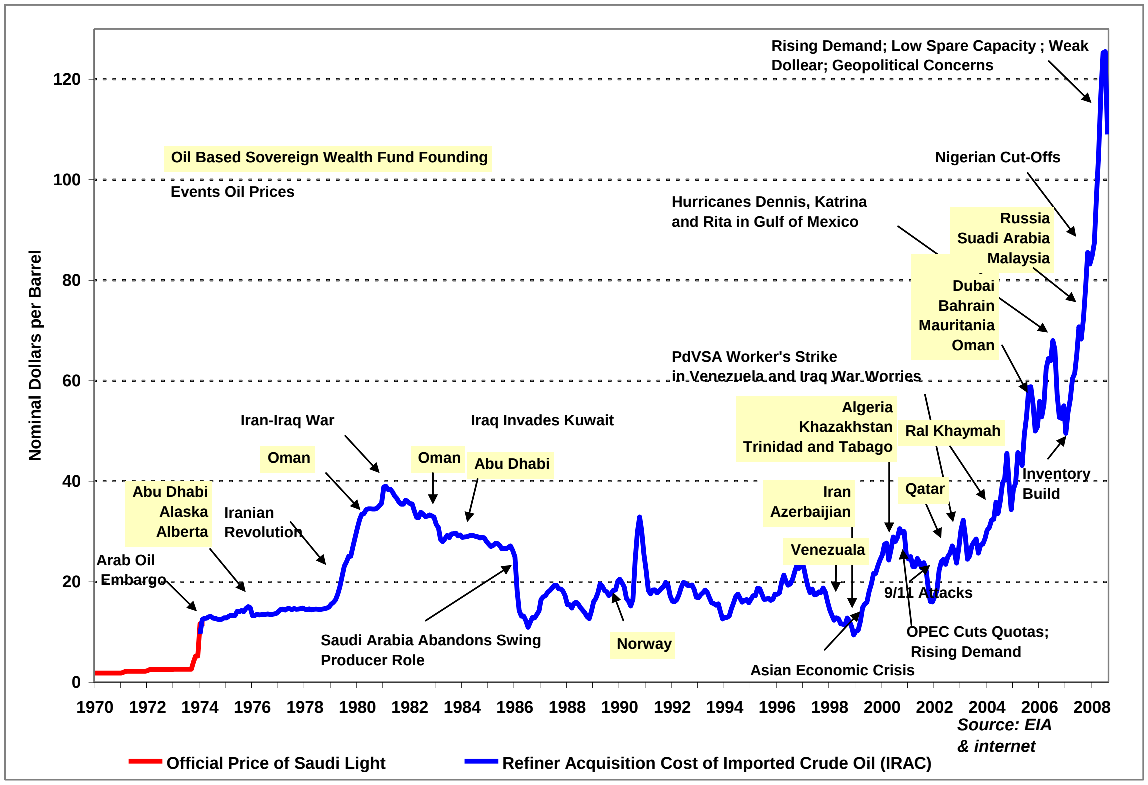
set up sovereign wealth funds in order to preserve finite natural resource wealth are still in the in accumulation phase of their fund lives, the performance of the Kiribati Revenue Equalisation Reserve Fund is an important bellwether – the $400m fund should boost the island nation's GDP by a sixth this year.[31]

The 1970s brought the foundation of several new sovereign wealth funds, including the oil-funded Abu Dhabi Investment Authority (which is now thought to be the largest sovereign wealth fund) and the less prototypical Temasek. Temasek was founded in 1974 with an initial portfolio of approximately $100mm, and was founded as a "sovereign poverty fund,"[32] meaning that rather than serving as a means of preserving wealth across generations, the fund was intended to assist in managing the growth of the Singaporean economy. Temasek vigorously asserts that they are not a sovereign wealth fund owing to the fact that fund does not receive additional funding from the government (it funds new investments by selling old investments) and does not require government approval in its decision making process. Temasek also shies away from the term "activist" but acknowledges that they are an "active" investor and was in fact formed i) take over the investment holdings of an "embattled government" and ii) "provide an independently focused, professionally managed and commercially disciplined approach to investments."[33]

The late 1970s brought emergence of other oil-based Sovereign Wealth funds (the Abu Dhabi Investment Authority, Alaska's Permanent Fund, Alberta's Heritage Fund, and Oman's State General Reserve Fund) and signaled a correlation that would be repeated later: petrol based sovereign wealth funds are founded during periods of high oil prices

[31] The Economist, January 19, 2008,
[32] The Business Times Singapore, acceptance speech of Ho Ching at Asia Society's June 25, 2008 dinner
[33] The Business Times Singapore, acceptance speech of Ho Ching at Asia Society's June 25, 2008 dinner

Exhibit 2.4: Founding Years for Oil Based Sovereign Wealth Funds and Oil Prices



As mentioned in the history of the concept of the sovereign wealth fund, there was anxiety directed towards sovereign wealth funds starting in the second half of the 2000s. This is anxiety was potentially caused both by the rapid increase in the number of funds over the previous decade, by the size of assets under management, and by the perceived character of the countries which where establishing funds: Iran, Nigeria, Saudi Arabia, China, Venezuela, Qatar, Libya, and Oman all established funds after 1998. The depth of these countries image problems can be seen with Iran, Nigeria, and Saudi Arabia capturing the last three places on the Anholt-GfK Roper Nations Brands Index (Anholt-GfK Roper Nations Brands Index is a measure of the global perception of a country).

Over the past several years, the frequency of sovereign wealth fund openings has accelerated. 20 funds were opened by 2000, 20 new funds have opened since 2000 - 10 of which were opened after 2005.[34] Despite the initial concerns, no fund has yet to be seriously criticized for having a more negative impact than traditional investment vehicles but rather the funds have gained credit for their positive role in ameliorating the financial crisis.[35]

> There is a lot of worry about the sovereign funds, but all of these worries are assumptions or expectations; there is no real case [of sovereign wealth funds

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[34] U.S. Treasury Department, Deputy Assistant Secretary for Asia Robert Dohner, Statement before the U.S. - China Economic and Security Review Commission, February 7, 2008 pg. 1

[35] South China Morning Post, Nick Westra quoting David Cohen, an economist at Action Economics, February 12, 2008 Pg. 2

making decisions on a non-commercial basis]; KIA has been a shareholder in Daimler Benz since 1969, a shareholder in British Petroleum since 1986; in terms of governance, we always made decisions on a commercial basis, always been passive and never been activist… there is no real basis for concern.[36]

[36] Bader Al Sa'ad Managing Director of Kuwait Investment Authority, at Davos 2008

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3

Sovereign Wealth Funds in Latin America

While Latin America is a region endowed with vast natural resources, historically it has not historically developed as many SWFs as other regions have. Among Latin American countries, Chile is home to the region's largest and best-managed funds.

Background on Chile's Sovereign Wealth Funds

Chile has two SWFs, the Economic and Social Stabilization Fund (ESSF) and the Pension Reserve Fund (PRF). Both are outgrowths of previous governmental funds and were formalized and codified in 2006, with the passage of the Fiscal Responsibility Law, to become SWFs.

The ESSF is descended from the Copper Stabilization Fund, which was created in 1985 as a means to lessen the effect of fluctuations in the price of copper on Chile's fiscal budget. The Chilean government is highly dependent on copper revenues both directly, through the copper industry companies that it nationalized, and indirectly, through taxation. The ESSF continues to be managed with the same purpose as its Copper Stabilization Fund legacy, with the broader mandate of providing macroeconomic stability. When the price of copper and revenues are high, money flows into the fund. When either declines, the Ministry of Finance can draw on the fund to support government spending and finance fiscal deficits.

The objective of the PRF is to compensate for an expected shortfall in the government's ability to meet future liabilities in pension payments to its elderly citizens. The fund is effectively a vehicle to help supplement and minimize the need for intergenerational wealth transfers from young Chileans to older Chileans in the future.

Philosophically and practically, the ESSF and PRF are similar to Norway's SWF. The similarities stem from both the source and the purpose of the funds. Because the nations' funds differ in age and maturity, their portfolios of assets also differ. Although Chile's funds may be expected to become increasingly similar to Norway's as they mature over time. Like Norway, Chile's SWFs' inflows are funded by the depletion and exploitation of natural resources. They perform the implicit function of preserving and enhancing the national wealth that belongs to all Chileans, both present and future, in addition to the ESSF's more immediate and explicitly stated function of serving as a countercyclical fiscal policy tool. Exhibit 3.1 summarizes some of the most relevant details of the ESSF and the PRF.

The funds were formally established by the Fiscal Responsibility Law in 2006. The Concertación coalition in power at the time, which was responsible for enacting this legislation under President Michelle Bachelet, can be broadly characterized as center-left. This government, in power until January 2010, marked a continuation of center-left rule in Chile since the end of Augusto Pinochet's right-wing military dictatorship in 1990.

The funds owe their genesis, in part, to the fiscal prudence of the ruling Concertación coalition.[37] In 2007, Chile was flush with over 20 years of nearly continuous economic growth. Global copper prices had increased steadily between 2003 and 2006 and, although with more volatility thereafter, still trended upward through 2007 to more than quadruple their 2003 levels.[38] Having accumulated enormous budget surpluses, Concertación opted to save rather than spend much of this wealth and so began the institutionalization process of creating its SWFs.

While these actions seem remarkably prescient in hindsight and a victory for mature and responsible government, the politics surrounding the funds, particularly the ESSF, have been controversial. Critics of these aggressive saving policies have pointed to Chile's persistent income inequality and status as a developing country as a reason to spend more of the revenue of the copper price windfall on projects to improve Chileans' standards of living and other means of furthering economic development more actively. The global financial crisis of 2008 and the subsequent worldwide recession have gone a long way toward quieting such criticism. In the face of the crisis, the ESSF has, first of all, performed well in terms of returns and has been a ready source of capital to carry out its countercyclical balancing purpose.

While the ESSF has already seen one major swing of the economic cycle, its experience of the political cycle is less complete. The same party and ministers primarily responsible for establishing and running the ESSF remained in power until the January 2010 election. Critics have pointed out that, for all of Concertación's success in establishing the ESSF, it may simply be laying up massive amounts of funds for subsequent administrations to spend, allowing the opposition, now elected into office, to reap the benefits of Concertación's fiscal prudence and to use the funds to buy the loyalty, support, and approval of the Chilean electorate. However, today, the idea that it was a good decision to save is widely accepted across the political spectrum.[39]

[37] Interview with Axel Christensen, June 1, 2009.
[38] London Metal Exchange, www.lme.co.uk.
[39] Interview with Andrés Bianchi, June 3, 2009.

Outside observers have praised Chile for its discipline and success in creating and maintaining both the ESSF and PRF. The funds have drawn admiration from various corners for their transparency, organization, and public accountability. The U.S.-based Sovereign Wealth Fund Institute, which ranks semi-annually the world's 45 most significant funds, awarded Chile a perfect score for quality of administration and transparency.[40]

Our Research Approach and Strategy

In the course of our research, we interviewed several high-ranking individuals from various professional backgrounds related to Chile's SWFs. These individuals' perspectives helped imbue our research with a sense of immediacy, given the tumultuous state of the global financial markets. Particularly helpful was the fact that Chile is among the most open and transparent governments in the world regarding its SWFs.

All the interviews took place in Santiago during the first week of June 2009. Consistent with Chile's openness regarding its funds, all those interviewed, government officials included, permitted us to record their interviews and granted us unlimited discretion in quoting them. Several did, however, ask that we get their specific permission before quoting them in any sort of publication. They were concerned that, as individuals representing the government or the Ministry of Finance, they had to carefully craft their remarks to limit the possibility of misinterpretation.

The most significant interviews were conducted with the following individuals:

Andrés Bianchi, former Chairman of the Chilean Central Bank. During his tenure, the Central Bank became independent of the central government toward the end of the military regime. In 2000-2006, Mr. Bianchi was the Chilean Ambassador to the United States. Since that time, he has been Chairman of the Advisory Board to the Ministry of Finance.

Eric Parrado, International Finance Coordinator of the Ministry of Finance of Chile. He reports directly to the Minister of Finance, Andres Velasco, and is the person within the Ministry of Finance most directly responsible for management of the SWFs. He is also responsible for debt management. Dr. Parrado had previously worked for the IMF, after earning his Ph.D. in Economics from NYU, and subsequently for the Chilean Central Bank before being invited to begin building his current office from the ground up.

Axel Christiansen, Managing Director for Barclays Global Investors (BGI), currently starting up a new office for BGI in Santiago. He has both buy- and sell-side experience and an MBA from the Stanford Graduate School of Business. He also chairs an advisory council for the Ministry of Finance on capital markets and works with Dr. Parrado in a less official capacity, advising him on general principles of asset management.

[40] Sovereign Wealth Fund Institute, www.swifinstitute.org.

Ricardo Consiglio, head of the International Trading Desk at the Central Bank, which executes all operations for Chile's SWFs. In this capacity, he is in charge of tactical asset allocation, overseeing a team of nine portfolio managers. He is an economist from the University of Chile with a Master's degree in finance and economics from the University of Warwick in the United Kingdom.

The Effect of the Financial Crisis

The financial crisis of 2008 has had a significant and lasting impact on SWFs globally; and Chile is no exception to this, although it has been the rare beneficiary of the upheaval. With the ESSF's assets invested primarily in the sovereign debt of developed economies, returns have been strong in both relative and absolute terms. Policy changes in reaction to the crisis have been significant, though, as has been the change in the tenor of the national debate surrounding the propriety and usefulness of Chile's SWFs, especially the ESSF.

Unlike the massive losses seen by SWFs invested in riskier asset classes, as of 2Q2009, Chile's ESSF had achieved an internal rate of return of 6.12% since its inception in 2007.[41] This figure is adjusted for all inflows and outflows and is based on both capital appreciation and interest income.

Asset Diversification on Hold

With the onset of the subprime crisis and subsequent volatility in global financial markets, the Ministry of Finance and the Central Bank of Chile, with input from the Financial Advisory Committee, elected to put on hold plans to diversify the holdings of both the ESSF and the PRF. The advisory committee itself had recommended portfolio diversification into corporate bonds and equities, to be managed by external asset managers. The policy was to go into effect as early as the end of 2008, but, for a variety of reasons, is in indefinite abeyance. Andrés Bianchi states the chief reason for this postponement is the fear that further volatility could result in significant accounting losses for the ESSF and, as withdrawals are made for countercyclical funding purposes, potentially realized losses as well. Beyond the objective ills of such potential losses there are further political ramifications in that losses in the ESSF could produce "a real backlash against the idea of having sovereign wealth funds."[42] The advisory committee was thus concerned not only with jeopardizing the value of the assets held by the ESSF but also with endangering its very existence.

From Domestic Criticism to Widespread Praise

The most remarkable shift in the political environment is the change from widespread domestic criticism of Concertación's fiscal prudence to international and domestic praise for its foresight and careful planning. "Such fiscal prudence was highly unpopular, and both Bachelet and Velasco were criticized as tight-fisted. But now … the average Chilean

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[41] Chilean Ministry of Finance, Economic and Social Stability Fund, 2009Q2 report.
[42] Bianchi, *op. cit.*

views Velasco and Bachelet in a different light. Velasco is widely cited as the most popular minister in government while Bachelet's approval ratings top 70 percent, even higher than when she took office in March 2006."[43] As Bianchi notes, this kind of popularity for a Minister of Finance is almost unheard of, as typically the Minister is primarily in the position of saying "No" when it comes to various political spending requests from colleagues. "But now, paradoxically because of the crisis, his popularity has risen continuously. 64% support."[44]

For the time being, Chile's ESSF will stay the course with its conservative strategy of investing primarily in sovereign debt. While this policy will not likely lead to impressive returns over the short- or medium-term, and may even jeopardize asset values should the sovereign debt of Japan, the United States, and EU member nations be downgraded in the future, it is viewed as necessary to prevent undermining the political support that Chileans have for their SWFs.

From Saving to Spending

The ESSF began drawing down its balances for the first time during 1Q2009 and accelerated this program rapidly, withdrawing more than US$4 billion over the course of Q22009 and US$2.5 billion during Q3. Interestingly, the ESSF is so well-funded that more than one official suspected the government would have difficulty spending effectively even the US$4 billion it withdrew in Q2.

Who Calls the Shots?

The key decision-making institutions with regard to Chile's SWFs are the Ministry of Finance and the Central Bank, with the Financial Advisory Committee exerting heavy influence on the decisions. The framework for the existence of all three institutions is established in the legislation passed by Congress. Within the constraints laid down by the legal framework, the final arbiter is the Minister of Finance, who is beholden to the President of the Republic. What follows is a description of the role of each institution, followed by a discussion of the process by which decision makers are selected by the President and the Minister of Finance.

Delineation of Power Between the Ministry of Finance and the Central Bank

The Ministry of Finance defines the policies that guide Chile's SWFs, and the Central Bank executes them. According to Eric Parrado, "the recommendations (made by the financial advisory committee) go to the ministry of finance. ... [W]e study all the recommendations, and then we send instructions to the central bank of Chile."[45] The Ministry of Finance chose to use the Central Bank as its "fiscal agent" for managing the funds because, according to Andrés Bianchi, the Central Bank "is the only organization

[43] Gideon Long, "Innovative Leader of the Year: Andrés Velasco – Steward of Chile's Wealth," 2009, http://latintrade.com/2009/10/innovative-leader-of-the-year-andres-velasco-steward-of-chile's-wealth.
[44] Bianchi, *op. cit.*
[45] Interview with Eric Parrado, June 6, 2009.

in the public sector that has the technical expertise in management of funds abroad."[46] And given that, at the time of this writing, Chile's funds have been exclusively in currency deposits and government paper, the Central Bank was able to leverage its experience in managing fixed-income assets in the management of the funds. According to Bianchi, their "expertise is concentrated in short term investments—the international reserves of the central bank are very liquid. ... [T]he central bank became a kind of executive body to manage these funds."[47]

According to Ricardo Consiglio, of the Central Bank,

> we are in charge of the asset allocations of all the reserves. The finance ministry decides the benchmark. They decide all of the asset classes we are allowed to invest [in] … they decide the limits. [However,] all the decisions of buying and selling are taken by the central bank … the ministry of finance just defines the limits of what we can move. …We can move 5% up and down [within the asset allocation guidelines put forward by the finance ministry].[48]

The Central Bank decides on the best tactical procedure for investing and liquidating assets on a day-to-day basis.[49]

Should the Ministry of Finance decide to diversify the funds' assets into corporate stocks and bonds, however, these would likely be managed by an external fund manager, not by the Central Bank. As Consiglio explains, "we don't have the capability to manage equity and corporate bonds … we know fixed income, we know banks, but we don't know about equities and corporate bonds."[50] That said, the Central Bank was highly involved in the process of selecting potential external managers for the shelved equity-investment policy. According to Consiglio, "we [the Central Bank] also know about external managers because a portion of our reserves are managed by external managers."[51] However, as Bianchi explains, the Ministry of Finance maintained close involvement with this process: "When the process of hiring external mangers took place … I personally was very insistent that those presentations be made not only at the central bank but that there should be people from the ministry of finance because, after all, it is the government's money."[52]

As for the Central Bank's role in crafting policy, "we [the Central Bank] give to the ministry of finance our advice … we say what we believe is the best for the fund. But this must be defined by the ministry of finance. … [W]e can help them in anything that they ask, but the final decision is on them."[53] The Central Bank also has the freedom to refuse

[46] Bianchi, *op. cit.*
[47] *Ibid.*
[48] Interview with Ricardo Consiglio, June 3, 2009.
[49] *Ibid.*
[50] *Ibid.*
[51] *Ibid.*
[52] Bianchi, *op. cit.*
[53] Consiglio, *op. cit.*

to serve as the fiscal agent of the Ministry of Finance: "we can say yes or we can say no."[54]

The Financial Advisory Committee

The Financial Advisory Committee was created in 2007 with the stated function of advising the Minister of Finance in matters relating to Chile's ESSF and PRF. The existence and role of the committee are stipulated in the laws passed by Congress that created the funds.[55]

The advisory committee debates the investment options for the funds, with technical support from Eric Parrado's group in the Ministry of Finance.[56] After reaching an agreement, the committee makes its recommendations to the Minister of Finance, which he can choose to accept or not. Parrado states that, "I am the link here between the financial committee and the minister of finance. I report to the minister of finance whatever recommendations that the financial committee makes."[57] According to a senior Ministry of Finance official involved with managing Chile's funds, the committee "is just an advisory board, they do not make decisions, but we like to consider them very seriously, that if they make recommendations, it will be the general case that we will accept all the recommendations, and so far we have accepted all their recommendations."[58]

Although the law stipulates the role, number of members, and meeting frequency of the committee, the current Minister of Finance selected its initial membership. According to Bianchi, chairman of the committee, "members [were] selected not only for their technical capabilities, but also because they represented the whole political spectrum in Chile. This we regard as crucially important to the legitimacy of the suggestions they make to the government."[59]

The law also stipulates that the mandate of the committee is to meet twice a year, but in practice they have been meeting more frequently. When asked to comment on the mandate, Bianchi asserted "that would have been preposterous. We meet around 10 times a year."[60]

How the Decision Makers Are Selected

The President of the republic, the final arbiter with regard to Chile's funds, is elected directly by the voting population of Chile. The President appoints the Minister of Finance, who must be confirmed by Congress. The minister then hires key decision makers in the

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[54] *Ibid.*
[55] Informe Annual, Comité Financiero 2008.
[56] Bianchi, *op. cit.*
[57] Parrado, *op. cit.*
[58] Interview with a senior finance ministry official, June 2009.
[59] Bianchi, *op. cit.*
[60] *Ibid.*

Ministry of Finance. The Central Bank is independent of the government. The members of the Financial Advisory Committee are confirmed by Congress on a rotating basis. What follows is a description of how the members of the Financial Advisory Committee and the technical decision makers in the Ministry of Finance are selected.

Selecting the Members of the Financial Advisory Committee—Fostering Political Independence and Technical Credibility

According to Bianchi, the members of the Financial Advisory Committee "are selected by the minister of finance, but so far no one has questioned the independence of these groups, because … this is a very small country and everyone knows everyone and there are a number of think tanks, which range from center right to left of center, which are technically very good. From these think tanks, come the members of these groups."[61]

Although the Minister of Finance came from the ruling Concertación coalition, the members of the committee represent a broad range of Chile's mainstream political spectrum. (Exhibit 3.2 provides a detailed summary of each member and his or her background.) According to Bianchi, a politically diverse committee "provides a good way of shaping decisions … [although] it takes a lot of time to reach a decision … when we suggest something to the minister of finance, that suggestion has a certain technical weight, but also a certain political weight."[62] As Bianchi further elaborates, "the makeup of the committee provides a sort of protection. I mean, I'm sure that people on the Right say, if Martin Cristóbal is there and he agrees then we can be sure that nothing foolish is going to be done, and the same can be applied with respect to the others."[63]

Hiring into the Ministry of Finance—Creating a Technocracy Based on Transparent Hiring Practices

The direct advisors to the Minister of Finance are appointees hired directly by the minister himself. Accordingly, Eric Parrado, the minister's chief advisor on Chile's SWFs, was hired directly by Minister of Finance Andrés Velasco in 2007. Parrado had studied under Velasco during his doctorate period at Yale. As he attested, "I worked closely with Andrés Velasco; he was a full professor there; I did my thesis with him so … he believes in me."[64]

However, with regard to the technical staff, the Ministry of Finance put in place a process designed to be systematic and meritocratic. Parrado states that in their hiring processes,

> we are trying to be super-formal, super-transparent. We said we would like to work like a Swiss watch in terms of nobody can complain that there are differences in terms of "you prefer this guy because he has a political background

[61] *Ibid.*
[62] *Ibid.*
[63] *Ibid.*
[64] Parrado, *op. cit.*

> similar to me"… this is a really technical division, so in terms of the guys that I hired recently, I put ads in the newspaper to look for them. And we did a formal process with … 100 candidates.[65]

Putting in place a transparent and systematic process also extended to the selection of external fund managers for the currently shelved equity investment policy. According to Parrado, "this transparency is also reflecting [*sic*] in the process when we try to get external managers. We invited everybody in the world, we invited … 110 external managers to be in the process."[66]

Still, the ultimate architect of the current institutional structure "is the minister of finance [Andrés Velasco], with the support of the president."[67] It remains to be seen whether the institutions and decision-making mechanisms will transcend political administrations. We examine this question in the next section.

The Future of Chile's Sovereign Wealth Funds

Building Institutions That Transcend Political Administrations

Because laws stipulate the basic framework that underlies Chile's SWFs, the executive branch of the government cannot unilaterally change the funds' framework. According to Parrado, "everything is backed by law… so it's not just a matter to change every other year whatever you want in terms of your objectives."[68] The consensus behind establishing this legal framework grew out of the wide acknowledgement of the economic policy mistakes Chile had made in the past. According to Bianchi, due to "prior bad experience with procyclical fiscal policy … the institutional reaction was to establish a fiscal rule, so that government expenditure would increase … [in line with] permanent incomes."[69] In addition, those responsible for interpreting the law are, by design, independent from the government. According to Bianchi,

> both the estimate of the economic growth rate over time and the estimate of the mid-term price of copper are not established by the government, but by two panels of experts that are independent from the government, and include economists from the opposition as well as economists from the government. This provides legitimacy to the estimates. With their advice, the government then decides what are the permanent incomes it can expect to have during the next fiscal year, and which are transitory incomes. These transitory incomes are those which are saved in order to finance and increase the sovereign wealth funds.[70]

The establishment of Chile's funds in law and the nonpartisan technocratic make-up of the advisory bodies contribute to the development of institutions that have the capacity

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[65] *Ibid.*
[66] *Ibid.*
[67] Senior finance ministry official, *op. cit.*
[68] Parrado, *op. cit.*
[69] Bianchi, *op. cit.*
[70] *Ibid.*

to transcend political administrations. When asked if they have been able to build institutions capable of transcending politics, Parrado responds, "I think so. I never had any political pressure. Never never ever."[71] That being said, although it is likely that much of the technical staff will not change, it is possible that those closest to the executive branch may see their jobs given to new political appointees, should there be a change in administration. According to Bianchi, "I think, given the political traditions in Chile … for instance I think that Eric Parrado—who I insist is an excellent economist and most reliable person—if there were a change in government he would probably move to the central bank."[72] However, it is significant to note that "there is an interesting process of exchange of technicians between the central bank and the Ministry of Finance, the central bank being independent and paying much better salaries. … Eric Parrado started at the central bank, moved to the Ministry of Finance and, if a change of government took place he would go back to the central bank and some new people would come in."[73] Therefore, even if Parrado were to leave the ministry, he would likely remain involved in the decision-making process, resulting in continuity with regard to the investment decisions pertaining to Chile's funds. With regard to his own position as chairman of the Financial Advisory Committee, Bianchi states that, "if we had a new government, I personally would say, 'If you want I can leave' in order to have someone closer to the minister in place. But they may tell me to go ahead and stay on."[74]

With regard to the Central Bank, the hiring of key decision makers is largely insulated from politics. When asked about the potential effect on the Central Bank of any change in administration, Ricardo Consiglio offers that, "from our perspective there would be no change," while venturing that, "from the side of the ministry of finance [there] would be change."[75]

Offering an outside perspective, Axel Christensen acknowledges that a potential change in personnel at the level of the Minister of Finance and his direct reports may be the weak link in the institutionalization process. According to Christensen, "There's a good chance that Eric won't be there and he's … been the person [in charge] with the knowledge and expertise about that and how do you institutionalize. ... That's probably from my point of view, the weaker spot right now … and historically, every finance minister comes with his or her own team so continuity is an issue."[76]

Even if there is uncertainty with regard to whether those who report directly to the Minister of Finance will transcend political administrations, much has been done to ensure that there is continuity in the key technical decision-making bodies and that that they remain apolitical. This is especially true of the Financial Advisory Committee, where, by law, "every two years two members of the committee should either be replaced

[71] Parrado, *op. cit.*
[72] Bianchi, *op. cit.*
[73] *Ibid.*
[74] *Ibid.*
[75] Consiglio, *op. cit.*
[76] Christensen, *op. cit.*

or confirmed" by Congress on a rotating basis.[77] The first test of this rule came in 2008, when the two members up for confirmation "were confirmed, including Walker who is clearly not aligned with the government"[78] (see Exhibit 3.2 for a description of Eduardo Walker Hitschfeld's background). The fact that Congress confirmed a technocrat aligned with the opposition bodes well for long-term institutional stability and speaks to a certain level of political maturity among the decision makers. According to Bianchi, "things depend more on how they are managed in practice, more than theoretical institutions that may be the optimal ones."[79]

A Fiscal Policy Tool or a Force on the World Stage?

Chile's ESSF was created to serve as a tool of countercyclical fiscal policy. Although it has been a relatively small fund compared to those of the Arab Gulf states, Singapore's Temasek, or even Norway's pension fund, it is also a relatively young fund and could conceivably become a significant force in international financial markets, as well as a powerful tool for domestic investment.

However, Chile's funds thus far have been managed in accordance with the narrow goal of providing a reliable tool for countercyclical fiscal policy, rather than a strategic investment tool or a mechanism for intergenerational savings. According to Bianchi, "obviously, there is a de-facto intergenerational effect, but that is basically not the reason. The main reason … is to have a countercyclical fiscal policy. Even the name of the fund—economic and social stabilization fund—and the way it is being managed today shows that this is the main purpose."[80] For example, "[on June 2, 2009,] it was announced that the government was withdrawing $1.5 billion from the fund and the central bank is withdrawing every week $50 million, to finance government expenditure this year. … [Spending] is being financed by drawing down the funds, not by going into debt."[81]

With regard to the question of using Chile's funds as a domestic investment tool, there appears to be little appetite among decision makers to go down this path. According to Bianchi, **"**we are forbidden to invest internally. Or at least, there is a strong restriction on that."[82] There appear to be two key reasons behind this, one economic and the other more ideological. In regard to the former, the reason "the funds are invested abroad and not internally is to avoid a sort of Dutch disease. … If the price of copper was as high as it was in recent years, the result would be a very strong appreciation of the Chilean peso and that would hurt tremendously other exporters. But if you keep the money abroad, you don't have this exchange rate problem. That's one of the reasons why they were invested abroad, and in foreign currency not in pesos."[83]

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[77] Bianchi, *op. cit.*
[78] *Ibid.*
[79] *Ibid.*
[80] *Ibid.*
[81] *Ibid.*
[82] *Ibid.*
[83] *Ibid.*

Regarding the idea of strategic domestic investments, Bianchi notes, “it should not be used for those purposes. It should be used for stabilization purposes. This also reflects a very strong reaction to past policies. In Chile, there is a rather important resistance, even among people left of center, against industrial policy. The idea has been generally accepted that to pick winners is a difficult process that lends itself to … corruption. … [Rather] one should try to invest broadly in education, technical training, etc., that would improve the competitiveness of the overall economy, rather than support specific sectors.”[84]

With regard to taking large positions in specific companies should Chile’s funds diversify into corporate stocks and bonds, a senior Ministry of Finance official closely involved with managing Chile’s funds asserts that, “in terms of going abroad, we don’t have the problem that the Middle East sovereign wealth funds have in terms of buying strategic companies, because we don’t want that, and we express that explicitly … we want to invest abroad, but … in terms of our investment policy, it’s going to be really well diversified, we’re not going to take any huge chunk or piece of any company at all.”[85]

Regarding the future of Chile’s SWFs, the overall mood within the Ministry of Finance is one of optimism. According to Parrado, “We are a really young SWF, but we have all the resources to [hire] more people to get space. … We have big hopes for our funds.”[86]

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[84] *Ibid.*
[85] Senior finance ministry, *op. cit.*
[86] Parrado, *op. cit.*

Exhibit 3.1
Chile's Sovereign Wealth Funds

	Economic and Social Stability Fund (ESSF)	**Pension Reserve Fund (PRF)**
Year Established	Early 2007 (Copper Stabilization Fund: 1985).	2006 **(Ancestor?)**
IRR Since Inception	6.12%	6%
Purpose	To provide public funding and/or pay back fiscal debt	Supplementary source to fund future pension liabilities
Time/Investment Horizon	Tied to business cycle: 3-10 years	Long term: 20-40 years
Investable Asset Classes	Sovereign debt, bank deposits	Sovereign debt, bank deposits, agency bonds

Source: Ministry of Finance of Chile, "Sovereign Wealth Funds—Background," January 17, 2010. www.minhda.c./english/fondos_soberanos/.

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Exhibit 3.2
Political Affiliations of the Members of the Financial Advisory Committee

Andrés Bianchi **President**	**Education:** Law, Universidad de Chile; Master's in Economics, Yale University **Background:** Served as chairman of Chile's central bank during the final years of the military regime. During his tenure, the Central Bank became independent. Served as Chilean Ambassador to the United States (2000-2006). Affiliated with the center-left Concertación.
Ana María Jul Largomarsino **Vice-President**	**Education:** Commercial Engineering, Universidad de Chile; Ph.D. in Economics, University of Pennsylvania **Background:** Had a 27-year career at the IMF. She lives inWashington, D.C., and flies to Santiago for committee meetings. Characterized more by experience and expertise than by any strong political affiliation.
Eduardo Walker Hitschfeld **Advisor**	**Education:** Commercial Engineering, Universidad Católica; Ph.D. in Business, University of California at Berkeley **Background:** Currently a professor of finance at the Catholic University. Characterized as a strong technician, slightly right of center politically but unaffiliated with any political party.
Martín Cristobal Llona **Advisor**	**Education:** Commercial Engineering, Universidad Católica; MBA, University of Chicago **Background:** Served as the last Minister of Finance of the military regime. Characterized by a strong background in pension funds.
Oscar Landerretche Moreno **Advisor**	**Education:** Commercial Engineering, Universidad de Chile; Ph.D. in Economics, MIT **Background:** Leading advisor to Eduardo Frey, the ruling Concertación presidential candidate in the 2009 **[2010?]** election. Reputation as a "maverick" and affiliated with the Socialist party.
Andrés Sanfuente Vergara **Advisor**	**Education:** Commercial Engineering, Universidad de Chile; Master's in Economics, University of Chicago **Background:** Leading economist in the Christian Democratic Party. Not one of the "Chicago boys" and has an anti-neoliberal disposition.

Sources: Informe Annual, Comité Financiero 2008 (need full info); and interview with Andrés Bianchi, June 3, 2009.

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Sovereign Wealth Funds in the Middle East

The Middle East is the home to the highest concentration of sovereign wealth fund (SWF) money in the world. From what is reported to be the world's largest sovereign wealth fund to government investment vehicles focused on regional economic development, the Middle East boasts more than thirteen major funds.

In this chapter we describe the current state of SWFs in the Middle East and examine the effect of the financial crisis on the SWFs in the region. In this analysis we maintain a broad definition of sovereign wealth fund. Our research covered traditional SWFs, such as the Kuwait Investment Authority (KIA) and Abu Dhabi Investment Authority (ADIA), as well as newer investment vehicles, such as Mubadala and the Bahrain Mumtalakat Holding Company. In total, our research covered the Kuwait Investment Authority, the Abu Dhabi Investment Authority, Bahrain Mumtalakat Holding Company, the Investment Corporation of Dubai, the Mubadala Development Company, the joint venture between Mubadala and General Electric, and the Qatar Investment Authority. We visited a subsection of these funds in our travels to the Middle East in August 2009 as part of the GKL research.

Most SWFs are infamously guarded in terms of the information they release publicly. Most of our interviewees requested that our conversations be "off the record." To preserve anonymity, none of the information obtained during interviews or quoted in this paper is attributed to individual funds or industry experts.

We begin our analysis with an overview of the economies in the Middle East and a description of the funds in the region including their histories, mission, and relationship with the local economy. We then give a brief overview of the current literature on SWFs in the Middle East, in particular focusing on what experts have already written about the funds' responses to the financial crisis. The third section covers our findings based on primary and secondary research.

Middle Eastern SWFs are a diverse group of investors. While it is clear that the financial crisis has touched all the funds and influenced their strategic choices, the impact on each fund and their responses have been far from uniform. During the crisis, funds have reevaluated their investment decision process and asset allocation (across classes and geographies), invested in the Middle East region, and instituted new partnerships among other strategic shifts. As the extensive media coverage on Middle Eastern SWFs shows, it is impossible to generalize and succinctly answer how the financial crisis may have affected Middle Eastern SWFs? In this paper, we provide a description of the funds, the financial crisis, and effects of the financial crisis, which we hope begins to answer this complex question.

Overview of Middle Eastern Economies and Sovereign Wealth Funds

To understand SWFs in the Middle East and the effect of the financial crisis on their operations, it is important to begin with an understanding of the regional economy, politics and the history of the funds. In this section we give a brief overview of the countries and funds covered in our research: Bahrain, Qatar, the UAE (Abu Dhabi and Dubai), and Kuwait. All of these countries are members of the Gulf Cooperation Council (GCC).

<u>Bahrain</u>

Bahrain, a constitutional hereditary monarchy, has one of the most diverse economies in the Persian Gulf region, although its economy is still largely focused on the production of crude oil. Ranked 28th by size of GDP, it has enjoyed growth of around 6% during recent years.[87] Oil revenue represents a large portion of Bahrain's GDP (13.1%), and the country is therefore very sensitive to fluctuations in the demand for and price of oil.[88] However, Bahrain's government has gone to great efforts to reduce the country's reliance on oil and has been relatively successful in developing other areas of industry. For instance, manufacturing represents about 12% of Bahrain's GDP and with aluminum representing Bahrain's second major export.[89] Other major industries are shipping and commerce, ship repair, and light manufacturing.[90]

Bahrain has also sought to diversify its economy through focusing on the development of its financial sector. Financial companies are the largest employers in Bahrain, providing jobs for 80% of the national workforce. With a well-developed and diversified sector including both Islamic and conventional banks as well as a wide variety of finance companies and investment advisors, Bahrain is situated as a worldwide banking center and is the leader in the Gulf region.[91]

Mumtalakat[92]

Mumtalakat, the "investment arm of the Kingdom of Bahrain," was created by royal decree in 2006 as a holding company and is dedicated to creating wealth for its sole shareholder, the government of Bahrain. Chaired by Sheikh Ahmed bin Mohammed Al Khalifa, Bahrain's Minister of Finance, the government essentially acts as the board of directors for the fund due to this shareholder relationship. With a portfolio of over 30 companies, Mumtalakat seeks to hold a balanced portfolio, diversified by

87 Central Intelligence Agency, "CIA – The World FActbook – Bahrain," *CIA World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/geos/ba.html>.
88 *Ibid.*
89 *Ibid.*
90 "Bahrain," *Encyclopædia Britannica*, 15 Dec. 2009, <http://www.britannica.com/EBchecked/topic/49072/Bahrain>.
91 Central Bank of Bahrain Website
92 Mumtalakat's website

geographic region and by industry. The fund holds both majority and minority positions in various companies, but has been primarily focusing on its domestic portfolio recently due to the global financial crisis. The company's most notable holdings include Gulf Air, Bahrain's national airline, ALBA, an aluminum processing company, Batelco, the national telecommunications company, and the National Bank of Bahrain.

Although a holding company and not technically a sovereign wealth fund, Mumtalakat is different in that it is fairly transparent, aiming to be best in class for corporate governance. Open to all kinds of investments, Mumtalakat hopes to continue to diversity its holdings after strengthening the position of its current portfolio.

<u>Kuwait</u>

Kuwait, ranked 6th in the world by GDP per capita, owes its wealth to the production of crude oil. A small country with a relatively open economy, Kuwait's economy is defined by its huge oil reserves, self-reported at 104 billion barrels, or 8% of the world's reserves.[93] Oil accounts for 95% of export revenues and well over half of the GDP.[94] Thus, the strength of the country's economy is closely tied with world prices, and the government has reported surpluses for the last ten years, however the drop in prices in 2008 may reduce the size of reported surplus for 2009.[95] While this dependence on oil leads to economic volatility, Kuwait's reserves are thought to be large enough to allow for production to continue at current levels for the next 150 years.[96]

Other industries in Kuwait include agriculture, manufacturing and trade, but these each represent a very small portion of GDP. The government has not been focused on the development of other non-oil sectors because of the size of their reserves, but has promised to use their considerable surplus to stabilize the economy if necessary because of the world financial crisis.[97]

Kuwait Investment Authority[98]

The Kuwait Investment Authority (KIA) is the oldest sovereign wealth fund in the world and is dedicated to maximizing long-term investment returns to create wealth for future generations. The fund is divided into two divisions: the General Reserve Fund and the Fund for Future Generations. The government invests 10% of all state revenues, including 10% of the income earned by the General Reserve Fund, every year into the Fund for Future Generations. The government is not to use this fund for

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93 Central Intelligence Agency, "CIA – The World Factbook – Kuwait," *CIA World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/geos/ku.html>.
94 *Ibid.*
95 *Ibid.*
96 "Kuwait," *Encyclopædia Britannica*, 15 Dec. 2009, <http://www.britannica.com/EBchecked/topic/325644/Kuwait>.
97 Central Intelligence Agency, "CIA – The World Factbook – Kuwait," *CIA World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/geos/ku.html>.
98 KIA's website

any purpose except an emergency, and the fund has only been used in one case: the Iraqi invasion.

The KIA was established in 1953 by the government with the goal of achieving long-term investment returns to ensure economic stability for the state of Kuwait. Widely regarded as one of the most sophisticated sovereign wealth funds, KIA invests across all asset classes and in all geographic areas. Its board of directors is headed by the Kuwaiti Finance Minister and is otherwise composed of both governmental officials as well as those not holding public office.

United Arab Emirates: Dubai and Abu Dhabi

The United Arab Emirates, a federation composed of seven emirates, has a large and open economy with a trade surplus and a high per capita income. Each emirate is largely self-governed, although a Federal Supreme Council meets four times a year to establish general policies for all the emirates.[99] The economy of the UAE is ranked 21st in the world by GDP, although each emirate has differently sized oil reserves and thus has pursued different economic development plans.

Dubai's wealth may have begun through the sale of its oil reserves but its reserves were rapidly consumed and are now estimated as being one-twentieth of its neighbor, Abu Dhabi.[100] Accordingly, Dubai has focused on developing its economy through tourism, trade and financial services and has been fairly successful in this regard, although it has been recently hurt by the economic recession. The government has thus focused on building projects, like the port of Jebel Ali, built in the early 1980's and declared a free trade zone.[101] The use of free trade zones has been an integral part of Dubai's attempt to attract international business, and the emirate has begun to threaten Bahrain's place as the Middle Eastern headquarters for international corporations.

In contrast, Abu Dhabi has large reserves and its economic development model has more closely resembled Kuwait in the past. However, more recently the government has been focused on developing Abu Dhabi's other industries, most notably through the creation of Mubadala, discussed below. The government, through this project, is seeking to diversify away from oil not just in its wealth and holdings, but also through sustainable industries in which the local population can participate.

Investment Corporation of Dubai[102]

The Investment Corporation of Dubai, or ICD, is the investment arm of the government of Dubai and was formed in 2006 after the Department of Finance transferred its portfolio to ICD. Its investment portfolio composes of companies in the financial, transportation, utilities and energy, industrial and real estate sectors and

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99 Central Intelligence Agency, "CIA – The World Factbook – United Arab Emirates," *CIA World Factbook*, <https://www.cia.gov/library/publications/the-world-factbook/geos/ae.html>.
100 "Dubayy (emirate, United Arab Emirates)," *Encyclopædia Britannica*, 15 Dec. 2009, <http://www.britannica.com/EBchecked/topic/172717/Dubayy>.
101 *Ibid.*
102 Investment Corp. of Dubai Website http://www.icd.gov.ae/index.html

is dedicated to the promotion and growth of Dubai. ICD's focus has been primarily local, although it hopes to expand its geographic range of investments over time. The board of directors is composed exclusively of members of the government. ICD, as a holding company, is not technically a sovereign wealth fund and is more comparable to Mumtalakat in its mandate and strategy. By managing and developing a diversified portfolio, ICD hopes to continue to increase the prosperity of the entire community of Dubai by successfully managing its current local portfolio and eventually expanding into international holdings.

Abu Dhabi Investment Authority[103]

The Abu Dhabi Investment Authority, or ADIA, was established in 1976 to ensure the future wealth of Abu Dhabi. Its investment strategy is similar to the KIA in that it invests across a broad range of investment classes and geographic areas. Focusing entirely on passive investments, ADIA's investment decisions are based solely on achieving long-term superior returns. ADIA is managed by its board of directors composed entirely of government ministers and officials, who have absolute control over the fund's offices and business. As a traditional sovereign wealth fund, ADIA, like KIA, has been reluctant increase transparency beyond their compliance with the Santiago Principles. It is widely believed that ADIA is the largest sovereign wealth fund in the world.

Abu Dhabi Investment Council[104]

The Abu Dhabi Investment Council was established as a subsection of ADIA and was created to focus on regional investment opportunities. It is a joint stock company primarily owned by ADIA. Investing primarily in real estate, private equity, and infrastructure, it also owns about 73% of the Abu Dhabi National Bank.

Mubadala Development Company[105]

Mubadala Development Company, or Mubadala, is dedicated to creating growth in Abu Dhabi and diversifying the economy beyond oil wealth. It is a business development and investment company whose mandate is to expand not just the emirate's wealth but also to create industries that will develop the economy. The board of directors is composed of government members to whom the company is accountable. Its current investments have been centered in the fields in which it feels it has a competitive advantage: aerospace, energy, healthcare, information and telecommunications, infrastructure, real estate and hospitality, and services. Its goal in making international investments has primarily been to bring business back into Abu Dhabi. For instance, Mubadala owns a 5% state in Ferrari and under their agreement the Mubadala logo will appear on all Ferrari's Formula One cars. By raising its international profile and taking larger stake in companies, Mubadala hopes to bring business to Abu Dhabi to create a fully diversified economy independent of its vast oil wealth.

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[103] ADIA website http://www.adia.ae/
[104] SWF institute ADIC http://www.swfinstitute.org/fund/adia.php
[105] Mubadala Website http://www.mubadala.ae/

Another example of Mubadala's investment strategy is its joint venture with General Electric. Under this project, a multi-billion dollar venture, Mubadala will become a long-term large stakeholder in GE and GE will bring its technology and expertise to Abu Dhabi to help develop the emirate's expertise in clean energy, project finance, and aviation.[106]

Qatar[107]

Qatar's economy is dependent on its production of crude oil, and while suffering from fluctuations in world oil prices, has experienced a budgetary surplus for the last eight years. The economy ranks 69th by size of GDP, with oil accounting for more than 50% of this . Oil also represents over 70% of government revenues and about 85% of export revenues. With over 14% of the world's total reserves, Qatar's economy is likely to continue to grow until its reserves are exhausted, which will be in about 37 years if production continues at its current levels. Qatar's other industries include petrochemicals and cement, but these industries are all relatively unimportant. The Qatari government has sought to diversify its economic position through the creation of their sovereign wealth fund, described below, in 2005.

Qatar Investment Authority

The Qatar Investment Authority, or QIA, was created by the Qatari government in 2005 to manage the government's current investments as well as diversify across asset classes. The government hopes to develop the county's infrastructure, education and health facilities.[108] The Qatari government's goal of economic diversification is certainly not unique, but its fund has followed a slightly different investment strategy than some of its older counterparts. By pursuing flashier investments and taking larger stakes in companies like Volkswagen, the QIA is perceived by many as "the new kid on the block" and some expect the fund to change its investment strategy as it matures.

In general, the majority of these countries are dependent on their oil wealth and have sought to use their sovereign wealth funds as a means to diversity their economies.

Views on the Middle Eastern SWFs

"Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis," by Victoria Barbary and Edward Chin, published by the Monitor Group consultancy in May 2009, is a helpful introduction to the current

[106] General Electric, "GE and Mubadala Launch Multi-Billion Dollar Global Business Partnership," Press Release, <http://www.genewscenter.com/content/detail.aspx?releaseid=3873&newsareaid=2&menusearchcategoryid=>.
[107] Central Intelligence Agency, "CIA – The World Factbook – United Arab Emirates," *CIA World Factbook*,<https://www.cia.gov/library/publications/the-world-factbook/geos/qa.htm>.
[108] QIA website

debates about SWFs.[109] It describes in detail the authors' and other industry experts' view of the response of Middle Eastern funds to the financial crisis of 2007-2008. At over 100 pages, it is one of the most thorough treatments how the financial crisis has affected MENA SWFs?[110]

The report covers thirteen funds in the region including the Abu Dhabi Investment Authority, Abu Dhabi Investment Council, DIFC Investments (Company) LLC, Investment Corporation of Dubai, Istithmar World, Emirates Investment Authority, Kuwait Investment Authority, Libyan Investment Authority, Mubadala Development Company, Mumtalakat Holding Company, Qatar Investment Authority, RAK Investment Authority, and Oman's State General Reserve Fund. In its study of these funds, the Monitor report presents a number of interesting findings that we summarize below:[111]

- According to Monitor's data, during the financial crisis, MENA SWFs have performed significantly better than SWFs based in the Asia-Pacific region as well as some North American and European funds/endowments.
- Investment data suggests that older funds with large and diversified portfolios were more protected, while those that had pursued aggressive investment strategies and participated in significant leveraged transactions were more affected by the crisis.
- The Monitor report also suggests that MENA SWFs maintained the pace of their new investments during 2008. However, this slowed in 1Q2009 and most new investments were smaller, domestic or in-region, and focused on helping local economies.
- The Monitor report suggests that the crisis exposed gaps in the risk management and forecasting capabilities of the Middle Eastern SWFs. Going forward the MENA SWFs may place more emphasis on improving systems and creating more sophisticated ways of managing risk.
- Going forward, MENA SWFs may face increased pressure to improve governance and accountability.
- In conclusion, the Monitor report suggests that the crisis may have implications for MENA SWFs' investment strategy going forward:.
    - Increased domestic investment might only make sense for the SWFs if this investment is directed at sectors of the economy where a competitive advantage can be sustained.
    - SWFs may move beyond passive investing towards a focus on adding value by getting involved in the management and building of the companies in which they invest.
    - The Monitor authors also suggest that the MENA SWFs would be shortsighted to abandon investment in OECD countries.

[109] Henceforth we will refer to the report as the "Monitor report."
[110] Barbary, Victoria, and Edward Chin. Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis. Monitor Group, 2009.
[111] *Ibid.*

In its detailed discussion of the response of MENA SWFs to the financial crisis, the Monitor report is one of the most thorough discussions of the response of MENA SWFs to the financial crisis. The report touches on diverse topics including the crisis' differential effect on older and newer funds and the resultant change in SWF's investment and risk strategy. The discussion of MENA SWFs and the financial crisis that we present in this paper can be seen in part as a response to the Monitor report.

The themes discussed in the Monitor report and addressed in our own research, have also been discussed in the broader literature about SWFs. Most of the existing literature on SWFs describes SWFs in different geographies with few papers focusing exclusively on the Middle East. The themes discussed in these papers are nevertheless useful to situate our findings about Middle Eastern SWFs' response to the financial crisis in the broader context of SWF research.

Importance of Social and Economic Links for SWF Investment

One of the main themes in current literature on SWFs is the study of investors' tendency to invest in countries that are culturally and/or geographically close to their own. This bias towards investing in regions close to the investor's own location is known as "home bias" in investment literature. As Wioletta Dziuda of the Kellogg School of Management suggests when discussing the investment decisions of mutual fund investors, "When managers differ in their ability to generate substantial returns…investors will learn faster about the domestic funds…as a result, investors will channel more money to the domestic funds."[112]

The academic research on SWFs has examined the effect of this home bias on investment strategy. For example, in their March 15, 2009 paper, "Sovereign Wealth Funds: Their Investment Strategies and Performance," Vidhi Chhaochharia and Luc Laeven analyze the effect of this investment bias on SWFs. Echoing Dziuda's comments, they write comparing SWFs to other investors that, "sovereign wealth funds tend to invest in countries that share similar cultural traits…the cultural bias for sovereign wealth funds is particularly pronounced."[113] Furthermore, this tendency to invest in the familiar and the close-to-home "may indicate the exploitation of informational advantages, or simply a tendency to feel affinity with the familiar."[114]

Since the beginning of the financial crisis, there has also been extensive coverage in the media about the trend amongst Middle Eastern SWF to direct investment towards the Gulf region.[115] The article "Bringing the sovereign wealth back home," published in May 2009, explains,

> For the time being at least, the GCC SWFs are likely to play a less active role globally, reverting instead to a more domestically oriented role.

[112] Perricone, Mike, "There's No Place Like Home: Investment bias toward domestic funds," Kellogg Insight, <http://insight.kellogg.northwestern.edu/index.php/Kellogg/article/theres_no_place_like_home>.
[113] Chhaochharia, Vidhi and Laeven, Luc A. (2009), "The Investment Allocation of Sovereign Wealth Funds," SSRN, <http://ssrn.com/abstract=1262383>.
[114] *Ibid.*
[115] Another detailed discussion of the trend towards MENA regional investment in the wake of the financial crisis can be found in Evans, Sophie, "Sovereign funds narrow their focus," *MEED: Middle East Economic Digest*, 5/1/2009, Vol. 53, Issue 18.

> Nevertheless, there are likely to be exceptions to this rule: the QIA took a further £2bn (US$3.7bn) of convertible stock in Barclays in late October 2008 (which reportedly could pay up to 14% annually), and the Oman State General Reserve Fund bought a 30% stake in the Corporate Commercial Bank of Bulgaria in January 2009.[116]

SWF Partnerships

Current press coverage suggests that SWFs, including Gulf SWFs, are moving towards partnerships with other SWFs or non-governmental partners. Reuters journalist Natsuko Waki, discusses this trend in the article "Sovereign Funds Join Forces for Strategic Investment."[117] One of the leading reasons cited for this trend is the advantage of being able to use a partner's local knowledge. For example, the article mentions that France's governmental investment company, Fonds Stratégique d'Investissement, is looking to invest jointly with Mubadala in the French biotech sector. This trend towards partnerships is expected to increase in the future. Waki writes, "experts predict more funds will join forces. In an Oxford University survey in July (2009), 60% of 149 asset managers who have routine with SWFs expected collaboration or clubbing among SWFs from different countries as these funds consider how best to achieve investment objectives."[118] The trend towards SWF collaboration is also highlighted by Gordon Platt in "Sovereign Wealth Funds Prepare To Take More Active Role In M&A" when he writes that, "SWFs are joining together in "clubs" to cooperate on strategic investments and takeovers."[119]

Generational Differences among SWFs in the Middle East and North Africa

The difference between early and later generation sovereign wealth funds in the Middle East is also a theme frequently discussed in the SWF literature. The Monitor Report provides a detailed overview of the generational development of SWFs in the Middle East. Exhibit 4.1 maps the chronology of the formation of MENA SWFs.

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[116] *Business Middle East*. May 1, 2009: 2-3.
[117] Waki, Natsuko, "Sovereign Funds Join Forces for Strategic Investement," *Reuters*, 18 Aug. 2009, <http://www.reuters.com/article/idUSTRE57H3C820090818>.
[118] *Ibid.*
[119] Platt, Gordon (2009). "Sovereign Wealth Funds Prepare To Take More Active Role In M&A." Global Finance.

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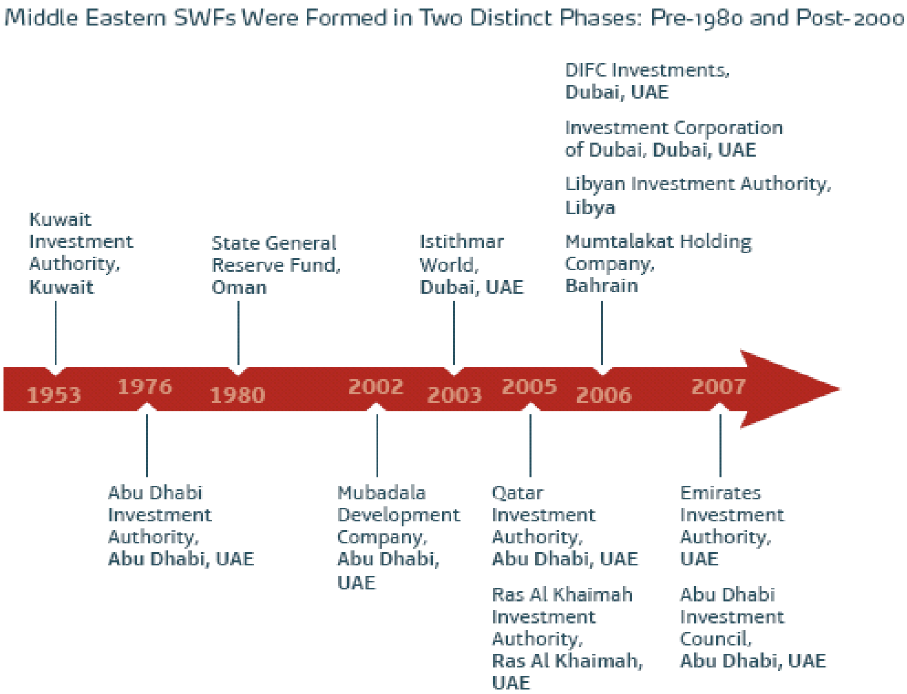
Exhibit 4.1: Chronology of the Middle Eastern and North African Sovereign Wealth Funds



Source: "Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis." *Monitor Group,*

The generations of SWFs are frequently characterized by their different investment strategies and approaches to risk management. As the Monitor Report suggests, "older funds [e.g. those formed between the 1950s and 1980s] have tended to be cautious, discreet, and conservative investors, primarily trading in liquid assets or through brokers to maintain anonymity."[120] The Monitor report says that in contrast, the newer funds have tended to have a higher tolerance for risk in their investment strategies. The authors of the report suggest,

> These new funds have tended to take a more active investment approach. They have sought high risk-adjusted returns, investing across a range of asset classes and prospecting actively around the world for attractive opportunities. Many of these funds have acted more like private equity funds, borrowing to invest in high-profile assets, rather than relying on their own capital accumulations, a strategy that emerged from an economic environment in which credit was cheap and easily available.[121]

The observations of the Monitor report are echoed in other reports on SWFs. For example, it is sometimes suggested that the QIA, established in 2006 and one of the most high profile of the recent funds, follows a less structured approach than its more

[120] Barbary, Victoria, and Edward Chin. Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis. Monitor Group, 2009.
[121] *Ibid.*

seasoned counterparts. Simeon Kerr writes in the *Financial Times* that since its creation, "the QIA also engaged in a somewhat haphazard strategy, building relationships with different partners while pursuing unfocused investments."[122] We will situate our research in the context of these current debates about Middle Eastern SWFs and their reactions to the financial crisis.

[122] Kerr, Simeon, "Sovereign wealth fund: Crisis provides breathing space to rethink strategy," *Financial Times*, 18 Nov. 2009, <\http://www.ft.com/cms/s/0/fd13d5d4-d30e-11de-af63-00144feabdc0.html>.

The Financial Crisis and Middle Eastern SWFs

Due to the lack of publicly available data and non-disclosure of assets under management by SWFs, an extensive and in-depth study on investment strategies of SWFs remains a challenge. This is especially true for the Middle Eastern SWFs. As of the end of 2007, the total amount of assets under management (AUM) by all SWFs was estimated to be US $3.2 trillion. The sum of AUM in three countries and two emirates subject to our study (Kuwait, Bahrain, Qatar, Dubai and Abu Dhabi) was estimated to be $1.165 billion.[123]

Objective of the Funds

The main objectives of the Middle Eastern SWFs are to secure long term wealth for future generations, generate funds necessary for future pension and healthcare liabilities, and minimize their countries' reliance on oil income. However, the funds also face domestic political pressures to support local economies and achieve short-term returns.[124] This pressure has become more pronounced in the wake of the global financial crisis which broke out in 2008. Middle Eastern SWFs, especially the long-established ones like KIA and ADIA, have traditionally followed a conservative and disciplined investing strategy and preferred low interest-yielding but relatively safe fixed income products in the developed markets (e.g. U.S. Treasury bonds) and public equity investments in blue chip companies (e.g. Daimler and British Petroleum). They have mostly used reputable external asset managers and rarely engaged in direct, or majority ownership, investments. The head of Kuwait Investment Authority, Bader Al-Sa'ad stated in an interview with the Wall Street Journal: "We must deploy the money in a way to keep Kuwait going when the oil is gone…We don't have the cheap labor of China or the services of Switzerland or the efficiency of Singapore."[125]

Established Players: KIA and ADIA

Several fund officers, bankers and investment managers, whom we interviewed during our trip, unanimously indicated KIA and ADIA as the "most traditional and the most sophisticated of all the funds." One investment manager in Bahrain emphasized that SWF clients required more due diligence than other institutional investors such as pension funds or national banks and the relations with these funds are "institutionalized and private-relationship based." KIA and ADIA, with their long track record and expertise, followed a very prudent strategy in achieving safe investments. They have also built their internal teams and have learned institutionally from their mistakes. No asset class was excluded over time, including real estate, private equity, hedge funds, listed equities and direct investments.

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[123] Kern, Steffen (2007), "Sovereign wealth funds – state investments on the rise," *Deutsche Bank Research*, <http://www.dbresearch.com/PROD/CIB_INTERNET_EN-PROD/PROD0000000000215270.pdf>.

[124] Bernstein, Shai, Lerner, Josh, and Schoar, Antoinette, "The Investment Strategies of Sovereign Wealth Funds," Working Paper, <http://www.hbs.edu/research/pdf/09-112.pdf>.

[125] Sender, Henry, "How a Gulf Petro-State Invests Its Oil Riches," *The Wall Street Journal Online*, 24 Aug. 2007, <http://commerce.wsj.com/auth/login?mg=inert-secaucus-wsj&url=http%3A%2F%2Fonline.wsj.com%2Fdocuments%2Fprint%2FWSJ_-A001-20070824.pdf>.

A fundamental question in investment strategies of Middle Eastern SWFs since their inception has been whether to target domestic and regional economy or international markets. As a fund officer squarely put it, “What is the purpose is of putting all this money overseas versus deploying it in local economies?” Given the total amount of assets under management in the these funds, regional economies are not large enough to absorb substantial amounts of investments which need to be undertaken to achieve enough returns to at least preserve the value of the assets. As of 2008, the combined GDP of Kuwait, Bahrain, Qatar and the UAE, $467.45 billion,[126] is almost half the amount of the total of $943.1 billion[127] of AUM of these countries’ funds.

Investment Patterns

There is no single investment pattern followed by all of these funds, as investment styles differ between older and more established funds and newer funds. In addition, some of the Gulf funds are government holding companies with structures and objectives different from those of pure revenue stabilization and investment funds with no portfolios of operating companies. Government holding companies, such as Mumtalakat in Bahrain, aim to run assets of companies in their portfolios efficiently and attain maximum efficiency before building up a surplus to use in investments.

A high-profile investment manager in the region suggested that “KIA and AIDA are 90% identical.” One of the important differences is KIA investments only in funds of hedge funds in contrast to ADIA’s investments directly in hedge funds. Both institutions have in-house and external asset managers and analysts for each asset class, and ADIA is more engaged in both active and passive management, while KIA has a preference for an active management style. A research article verifies our observations, mentioning that at ADIA each asset class is managed internally and externally, with the bulk—70-80 percent—of assets being managed by external managers. Based on the same article, the majority of KIA’s assets are managed by external managers, whereas Kuwait Investment Office, KIA’s arm in London, actively manages a smaller part, which spans a wide range of geographic areas and asset classes.[128]

The philosophy and operations of KIA and ADIA are often compared to university endowments or pension funds. In fact, shortly after taking over the helm at KIA in 2004, Bader Al-Sa’ad ordered a study of Harvard and Yale endowments to compare with KIA’s investment strategy. On the one hand, these endowments had a long-term investing horizon and a conservative approach just as KIA; on the other hand they had achieved returns higher than those of KIA by investing in real estate, private equity, hedge funds, and emerging markets.[129]

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[126] CIA Factbook

[127] Sovereign Wealth Fund Institute, “Sovereign Wealth Fund Rankings,” <http://www.swfinstitute.org/funds.php>.

[128] Fernandez, David G. and Eschweiler, Bernhard (2008), “Sovereign Wealth Funds: A Bottom-up Primer,” *JP Morgan Research*, <http://www.econ.puc-rio.br/mgarcia/Seminario/textos_preliminares/SWF22May08.pdf>.

[129] Sender, Henry, “How a Gulf Petro-State Invests Its Oil Riches,” *The Wall Street Journal Online*, 24 Aug. 2007, <http://commerce.wsj.com/auth/login?mg=inert-secaucus-wsj&url=http%3A%2F%2Fonline.wsj.com%2Fdocuments%2Fprint%2FWSJ_-A001-20070824.pdf>.

As opposed to the traditionally indirect investment approach of old funds, which involved non-controlling stakes with no board representation, newer funds, such as ADIC, Mubadala and QIA prefer to take controlling stakes in direct investments or engage in joint ventures with prominent western technology companies. Equity with unlimited upside potential seemed more attractive than bonds yielding only limited returns. Beyond achieving high returns on investments, some of these funds were specifically tasked by their governments to transfer technology, build infrastructure, establish health and transportation services and create new industries, basically to contribute to the development of the nation. One expert commented during an interview that Bahrain's Mumtalakat follows Singapore's Temasek model, diversifying into various industries such as airlines, manufacturing, communications, banking and technology. In its effort to rationalize and monetize investments of the government, Mumtalakat considers investments only from an IRR perspective and pursues an opportunistic and commercially driven investment approach.

Trophy Investments in the West

Some highly visible investments in prestigious Western companies by Middle Eastern SWFs have recently attracted considerable media attention and raised a heated dispute among policy makers, regulators and academics in the West. The motives of these investments have been placed under scrutiny, as some of these funds have been blamed for pursuing political and geopolitical agendas rather than purely economic purposes in their activities in western markets, with possible adverse implications for stability of financial markets or even national security of recipient nations. During our interviews, we observed frustration by fund managers in face of these allegations. In response, high-ranking SWF officers we interviewed repeatedly emphasized that their investments were purely "economically motivated" and pointed at the "long term, stabilizing nature of their investments, especially in these turbulent times of crisis." Fernandez and Eschweiler also spoke of the "stabilizing effect of SWF investments" due to their long term nature and diversification across a wide range of asset classes, geographies and managers.[130] Remarkably, one high-ranking banking bureaucrat in the region made a distinction between "aggressive Russian and Chinese funds" and "passive" Middle Eastern Funds. The same allegory of "aggressive Russian and Chinese funds" scaring off the West was voiced by another SWF officer during our interviews.

High-profile investments in Western companies and assets, such as Mubadala's purchase of a five-percent stake in Ferrari or a Qatari real estate firm's purchase of Chelsea Barracks, created a public image of a "big boys' club" investing in "trophy assets" in Europe and the U.S. A banker in the region pointed out that some in the West discounted these as "flashy investments," typical of Gulf-Arab mentality with an intention of a power show-off against the world. Nonetheless, the real intention of the funds, according the same banker, was to gain credibility by making headlines and to relay the message that "We are serious investors." This would invariably help put the funds' and the countries' names on the map. Therefore, brand building, along with

[130] Fernandez, David G. and Eschweiler, Bernhard (2008), "Sovereign Wealth Funds: A Bottom-up Primer," *JP Morgan Research*, <http://www.econ.puc-rio.br/mgarcia/Seminario/textos_preliminares/SWF22May08.pdf>.

achieving returns on money, emerged as another investment strategy pursued by at least some of the Middle Eastern funds.

Portfolio Diversification

In the years leading to the global financial crisis, Middle Eastern SWFs had started to diversify their investments across multiple dimensions such as geography (developed vs. emerging markets), investment horizons (short vs. long term), and asset classes (bonds, public equities, sovereign and corporate debt, asset based securities, real estate, hedge funds and private equity), in pursuit of returns higher than the moderate yields of fixed-income products.[131]

The realignment of KIA portfolio is representative of the strategic asset reallocation conducted by the Middle Eastern SWFs before the outbreak of the crisis. The study on Yale and Harvard endowments, which had been commissioned by Bader Al-Sa'ad, head of KIA, had revealed that KIA was significantly underweight in real estate with 2.5 percent, and private equity with1.5 percent, in stark contrast to Yale's allocation of 20 percent in real estate and 17 percent in private equity.[132] Fernandez and Eschweiler's study indicates that KIA currently has 50 percent of its assets in public equity, one third in fixed income and the rest in alternatives.[133]

Background on the Financial Crisis

The current economic crisis began as a subprime lending crisis in the U.S. real estate markets in 2007. A low interest rate policy followed by the U.S. Federal Reserve after the September 11 attacks led to an abundance of credit for home purchasers. Combined with lax lending standards of banks and financial institutions, readily available credit enabled many consumers with poor credit scores to obtain mortgages, classified as "subprime" because they were considered to be in the riskiest category of loans. In addition, adjustable rate mortgages were equally prevalent because their lower mortgage payments for the first few years rendered home purchases more affordable.

Residential and commercial mortgages were bundled by investment banks and financial institutions into complex securities—mortgage-backed securities or collateralized debt obligations—and sold to domestic and international investors, including central banks of countries with budget surpluses. These complex securities promised high and safe returns as residential property prices had never declined in the U.S. Continued surge in demand for real estate led to a steady increase in property prices in all segments: a real estate bubble was in full swing from 2001 through mid 2006.

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[131] *Ibid.*
[132] Sender, Henry, "How a Gulf Petro-State Invests Its Oil Riches," *The Wall Street Journal Online*, 24 Aug. 2007, <http://commerce.wsj.com/auth/login?mg=inert-secaucus-wsj&url=http%3A%2F%2Fonline.wsj.com%2Fdocuments%2Fprint%2FWSJ_-A001-20070824.pdf>.
[133] Fernandez, David G. and Eschweiler, Bernhard (2008), "Sovereign Wealth Funds: A Bottom-up Primer," *JP Morgan Research*, <http://www.econ.puc-rio.br/mgarcia/Seminario/textos_preliminares/SWF22May08.pdf>.

Around 2006, the increase in home prices first slowed down, then came to a halt and was followed by a downward turn of home values. As adjustable-rate mortgages started to reset to higher interest rates, subprime borrowers defaulted on their loans in greater numbers as they were unable to afford resulting higher mortgage payments and to sell their homes for profit due to sinking real estate prices.

The subprime crisis severely impacted the global financial system because of CDO's and MBS's which had been purchased by many institutional investors throughout the world and took their value from mortgage payments of home owners. As housing demand collapsed and property prices started to decline, New Century Financial Corporation, the then-largest subprime lender in the U.S., filed for bankruptcy in April 2007. This was followed by the collapse of many other providers of subprime loans. In 2008, Bear Sterns is sold to JP Morgan at a fire-sale price after facing a liquidity crisis. U.S. government intervened to take control of Freddie Mac and Fannie Mae to help contain further damage to the economy.

In the meantime, asset prices in all classes, including equities and real estate, started to decline globally. Lehman bankruptcy, the sale of Merrill Lynch to Bank of America, and the bailout of AIG by the government occurred in sequence and sent shock waves through the global markets. Although U.S. Treasury under the direction of Henry Paulson devised a bailout plan (TARP) to assist the financial sector and help the credit system function properly, financial tremors continued. Washington Mutual declared bankruptcy and Wachovia under distress was purchased by Wells Fargo. The main tool of the Fed was to control the damage to the economy and prevent the financial system from collapse was to keep interest rates as low as possible and make liquidity available through various lending facilities. Central banks globally took similar measures.

As the crisis was unfolding, unemployment steadily rose, GDP growth first stalled and then became negative, and equities continued to plunge in developed markets. The decoupling theory, which postulated that emerging markets in Europe and Asia have become independent of the U.S. economy and thus would continue growing in spite of a recession, was considered confounded by many experts since tremendous amounts of value was wiped off both in developed and emerging stock markets in tandem.[134]

NBRE declared December of 2007 as the official start of the recession in the U.S. Based on an IMF study, advanced economies experienced a 7.5% decline in real GDP in the fourth quarter of 2008, whereas the GDP contraction averaged 4% for emerging economies.[135] Many domestic and international economic indicators painted a bleak picture during this period: U.S. Bureau of Labor Statistics announced that unemployment stood at 10.2 in October 2009, the highest since April 1983. Dow Jones Industrial Average declined 53.78 percent from its recent peak in October 2007 though the bottom in March 2009.

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[134] De Aenlle, Conrad, "Decoupling: Theory vs. Reality," *The New York Times*, 7 Feb. 2008, <http://www.nytimes.com/2008/01/27/business/worldbusiness/27iht-26delink.9520541.html>.
[135] International Monetary Fund, "Executive Summary," <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/exesum.pdf>.

During the same period, S&P 500 Index lost 57 percent and FTSE 100 lost 48 percent. MSCI Emerging Markets Index dropped 67 percent during the same time period.[136] S&P/Case-Shiller Home Price 20-City Composite Index dropped 32.6 percent from its peak in July 2006 through April 2009. Commercial real estate also continued to slide in the U.S. and developed markets in general. Losses of loans held by financial institutions based on these assets continued to grow. Commercial real estate index for all property types declined 41 percent from its peak in October 2007 through August 2009.[137] The write-downs of U.S. assets by all financial institutions are estimated to be $2.7 trillion since the start of the crisis based on another IMF report issued in April 2009.[138]

Effect of the Global Crisis on Funds

One of the first and most visible effects of the recession on the Gulf economies was the 60 percent decline of oil prices, which eliminated oil exporters' current account surpluses and necessitated net capital inflows to replenish reserves. The Gulf SWFs were expected to support domestic fiscal expansion to rescue financial institutions and real estate companies in distress.[139]

Wealth destruction in all areas of economy reached enormous scales throughout the recession both in the developed and the developing markets. This phenomenon had an immediate adverse effect on the recent investments undertaken by the Middle Eastern SWFs, which had started to expand their investments to new asset classes and emerging markets, beyond traditional fixed-income securities and public equities in developed economies.

Funds with greatest exposure to alternatives such as real estate, private equity, and hedge funds, and those with high leverage ratios received the biggest hit. Experts whom we interviewed emphasized a lack of institutional sophistication of newer funds as a contributing factor to the heavy losses incurred. As a fund manager put it, "they did not understand what they were getting into" when they performed direct investments.

On the other hand, older and more sophisticated funds were not entirely spared either: ADIA incurred losses because of its exposure to equities and emerging markets. Based on anecdotal information, Saudi Arabian Monetary Agency, SAMA, lost the least due to its heavy investment in fixed income securities.

Response of Funds

SWF have become more vigilant in selecting external managers to invest their assets. They perform in-depth due diligence and bring in advisors to scrutinize investment proposals. In addition to external pressures from western governments for more

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[136] Yahoo Finance.
[137] Moodys/REAL Commercial Property Price Index (CPPI), October 21, 2009.
[138] International Monetary Fund (2007). Global Financial Stability Report, October 2007. <http://www.imf.org/external/pubs/ft/GFSR/2007/02/pdf/text.pdf>. xi.
[139] Fidora, Michael (2009), "Sovereign Wealth Funds – Before and Since the Crisis," European Central Bank, Conference *Law and Economics of Money and Finance in Times of Financial Crisis Goethe-Universität, Frankfurt am Main, May 15-16, 2009,* <http://www.lemf.uni-frankfurt.de/SWF_HoF_20090515.pdf>.

transparency, internal pressures about operations and investments, such as the pressure on KIA from Kuwaiti parliament to disclose its investments during the crisis, built up.

At the onset of the global financial crisis, Middle Eastern SWFs poured money to purchase stakes in western financial institutions in what they saw as a good investment opportunity. However, as the economy continued to plummet, they saw the value of their investments dwindle and hence decided to take on a more restrained stance, preferring to stay put rather than making new investments. In holding companies and investment arms of the government, managements started to revise and restructure projects by cancelling some in infancy level or allocating more funds to those closer to completion. During our interviews we heard the same message from officers of different companies: “All assets and projects are being looked at; debt is being restructured and maturities extended.” In some instances, CEOs and CFOs of operating companies were being changed to help reverse the downward spiral of losses.

As for the effects of SWFs investment actions on the markets, Roland Beck and Michael Fidora argue that in spite of heavy losses of SWFs, they will remain powerful players in the world’s financial markets from a quantitative and a qualitative perspective. They say that SWFs investments in Western financial institutions during 2007 and 2008 are now considered by many experts to have had a stabilizing effect on global financial markets.[140]

Some SWF commentators have also suggested that the losses suffered by SWF during the financial crisis may spur them towards a more active stance in investments in the future. As the Monitor report suggests, “SWFs might move beyond passive investing towards a focus on adding value by helping to build the companies in which they invest.”[141]

In a similar way as the analysis of local investment trends, it is also important in this section to draw a distinction between the different types of Middle Eastern state investment vehicles. Our research suggests that funds such the KIA and QIA, who are charged with making foreign investments to diversify and hedge against commodity exposure, may have very different approaches to active investment compared to funds whose mission is to invest in the local economy and may have more of a tendency towards active investment.

In the case of the first group of SWF, (e.g. ADIA, KIA, etc) it is not clear from our research that financial crisis had an effect on the attitude towards passive versus active investment. In our conversations with fund representatives and SWF experts, we consistently heard the message that SWFs in the Middle East will remain largely passive investors going forward. As one industry expert stated, “GCC [Gulf Cooperation Council][142] based SWFs will always be passive investors. They have no

[140] Beck, Roland and Fidora, Michael (2009), “Sovereign Wealth Funds-Before and Since the Crisis,” *European Business Organization Law Review* 10:353-367.
[141] Barbary, Victoria, and Edward Chin. Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis. Monitor Group, 2009.
[142] The GCC is a political and economic union between the UAE, Bahrain, Saudi Arabia, Oman, Qatar, and Kuwait.

political agenda and want to ensure investments generate income for future generations."

Middle Eastern SWFs' Strategic Response to the Financial Crisis

In this section we will continue to analyze in depth various elements of Gulf SWFs' response to the financial crisis. To further develop the observations from section three that focus on investment strategies we will look at how the crisis has affected SWF strategic partnerships and home bias in investments. We will compare observations from our primary research with trends suggested by other SWF observers. For each trend we will ask whether the financial crisis has created a permanent change in Gulf SWFs' strategy or if it is expected that funds will return to pre-crisis strategies.

SWF Partnerships

Recent announcements in the press suggest that Middle Eastern SWFs are increasingly moving towards partnerships in the wake of the financial crisis. These investment partnerships are taking two primary forms: joint ventures with private sector companies and alliances with other sovereign funds.

The most high profile SWF-private sector alliance to date is the $8 billion venture between GE and Mubadala announced in July 2008. This venture is focused on diverse initiatives including commercial finance, clean energy research and development, aviation, and corporate learning.[143] The alliance between GE and Mubadala has clear benefits for both parties. As part of the venture Abu Dhabi has agreed to become a top ten shareholder in GE. At the same time, Mubadala's influence in the MENA region will give GE access to a new market for its financial services. GE also brings multiple areas of expertise to the emirate that will bolster Mubadala's mandate to foster local development and investment. For example, GE will share its financial and management knowledge through GE- type training at the Mubadala & GE Management Program.[144] In addition, GE has become a key partner in the Masdar Initiative, a local project aimed at creating solutions in clean energy. (General Electric 2008) In June 2009 GE and Mubadala announced that they had signed an agreement to expand GE's network of airplane engine maintenance, repair and overhaul (MRO) providers in the Middle East thus advancing Mubadala's plans to build a global MRO network centered in Abu Dhabi.[145]

In its scale and reach, the GE-Mubadala joint venture is remains unique in the region. However, in interviews with our team, industry insiders hypothesized that Middle Eastern SWFs may be moving towards a "larger trend of creating joint ventures

[143] General Electric, "GE and Mubadala Launch Multi-Billion Dollar Global Business Partnership," Press Release, <http://www.genewscenter.com/content/detail.aspx?releaseid=3873&newsareaid=2&menusearchcategoryid=>.
[144] *Ibid.*
[145] *Ibid.*

between private companies and sovereign wealth funds."[146] Alastair Maxwell, a Managing Director in Morgan Stanley's Global Energy and Utilities Group, has suggested that SWFs "will also look increasingly to work with partners such as private equity firms and in joint ventures."[147]

In addition to SWF-private sector joint ventures such as the GE-Mubadala project, industry experts have noted a growing trend towards partnerships between SWFs, or among other government related investment vehicles, such as state-owned enterprises and state pension funds. Examples of recently announced partnerships of this type include:

- In August 2009, Qatar Holding, the investment arm of Qatar Investment Authority, purchased a $448 million issue of preference shares in UK-based property firm Songbird Estates with China's China Investment Corporation (CIC).
- In June 2009, the Kuwait Investment Company signed cooperation agreements with Malaysia's Khazanah Nasional Berhad (the investment holding arm of the Malaysian government) and Australia's QIC, the pension fund manager for the Queensland government.
- In June 2009, China's CIC, Singapore's GIC, and the KIA independently supported Blackrock's acquisition of Barclays Global Investors.[148]
- In May 2009, Mubadala signed a memorandum of understanding with France's Fonds Strategique d'Investissement (FSI) to create a framework for investing in areas of mutual interest to the two companies including listed or private French companies in the following sectors: technology, health sciences, bio-technology and renewable energy.[149]

The timing of these partnerships coincides with the financial crisis, however, some SWF experts have suggested that this recent trend towards clubbing between SWFs and state-related investment vehicles represents an economically logical decision to diversify risks and facilitate a better understanding of local markets as opposed to a direct reaction to the financial crisis. As Ashby Monk, a research fellow at Oxford University specializing in the governance and geopolitics of SWFs, has suggested:

> SWFs can fruitfully work together to facilitate local understanding in foreign markets. This in turn can lead to higher returns over the long term thanks to information asymmetries obtained by local investors. In short, by bringing together two or three funds with diverse

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[146] Anonymous interview with authors, August 2009

[147] Smith, Pamela Ann, "Sovereign wealth funds reassess their strategies," *The Middle East*, 1 Jan. 2009, <http://www.thefreelibrary.com/Sovereign+wealth+funds+reassess+their+strategies.-a0192051817>.

[148] "CIC Said to Participate in BlackRock' Purchase of BGI ," *Trading Markets*, 15 Jun. 2009, <http://www.tradingmarkets.com/.site/news/Stock%20News/2374543/>.

[149] Basit, Abdul, "Mubadala Eyes Investment in French Firms," *Khaleej Times*, 27 May 2009, <http://www.khaleejtimes.com/biz/inside.asp?xfile=/data/business/2009/May/business_May1091.xml&section=business>.

> backgrounds into a cooperative arrangement, the effectiveness of the investment function in a specific economic geography is maximized.[150]

In other words, partnerships between SWFs represent a logical next step for any regionally based investment fund.

Partnerships are a growing feature of the SWF landscape in the Middle East. However, as the SWF experts suggest, it is not clear whether these partnerships occurred coincidently with the global financial crisis or whether their growth was precipitated by the instability wrought by the financial crisis. For example, although the Mubadala-GE joint venture was announced in July 2008, it had been development for a while prior to this time. The logic of SWF partnerships is clear even in a world unaffected by the destabilizing financial crisis. In the long run, SWFs will continue to be able to benefit from the diminished risk and increased local knowledge that cross-geography partnerships offer.

<u>Home bias – Increasing Investment in the Middle East</u>

In recent months, many journalists covering MENA SWFs have focused on an increase in local region investment. In examining this trend it is important to distinguish between the SWFs designed for local investment (e.g. Mubadala and Mumtalakat) and those intended to invest abroad to diversify the local economy (e.g. the KIA, ADIA). Local development funds in the first category naturally have a high proportion of funds dedicated to local region investment. In our research we focused on the second group of funds and asked whether predominantly internationally focused funds have moved to local investment. And, if this is the case, is this a trend a response to the effects of the financial crisis? Industry experts and insiders diverge in terms of their answer to this question. Without clear data tracking SWF investment our analysis relies on publicly disclosed deals and the qualitative observations of industry experts.

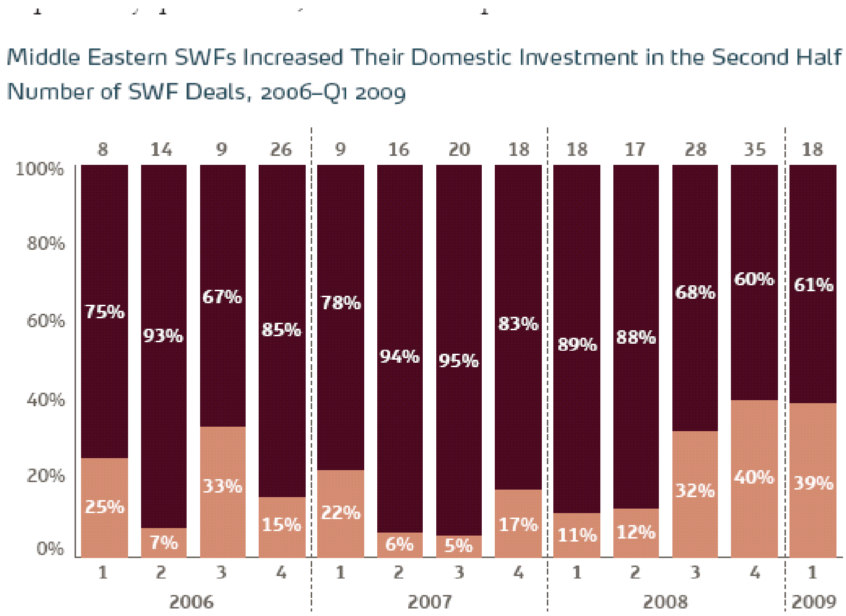
Some industry observers suggest that, as home bias theories would suggest, local region investment has long been a feature of MENA SWF investment strategy. As one of our interviewees explained, "Gulf mindset is to understand government and politics of investments." [151] The idea is "you don't buy what you don't understand." [152] However, at the same time, industry observers suggest that the financial crisis has served to increase the intensity of local investments. As one expert suggested, SWFs and private equity funds in the region have "pulled back" in response to the crisis and "all major money is focusing back into MENA."[153]

Research from the Monitor Group supports the theory that global economic insecurity has increased the rate of local investment by SWFs. According to the report, "in the last three months of the year [2008], 40 percent of MENA SWF transactions…were in

[150] Monk, Ashby, "SWFs Working in Concert," *Oxford SWF Project.* 22 Jun. 2009, <http://oxfordswfproject.com/2009/06/22/swfs-working-in-concert/>.
[151] Anonymous interview with authors, August 2009
[152] *Ibid.*
[153] *Ibid.*

domestic markets."[154] The investment figures in Exhibit 4.1, that show investment trends in 2006-2009, provides further evidence to show that MENA SWFs have increasingly favored local investment during the crisis.[155]

Exhibit 4.2: Investments by the Middle Eastern Sovereign Wealth Funds



Source: "Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis." *Monitor Group*

High profile examples of local investment during the crisis include:

- On the request of the Qatari government, in November 2008, the QIA invested $5.3 billion into the local financial sector to buy a 20% stake in all the banks listed on the Qatar stock exchange.[156]
- In December 2008, the KIA launched a fund on behalf of the Kuwaiti government to stabilize the local stock market, which had fallen 38% in 2008.[157]
- In December 2008, Sama injected SR 14.4 billion into Saudi banks.[158] Finally, although not an example of direct local investment, ADIA has a

[154] Barbary, Victoria and Chin, Edward, "Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis." *Monitor Group*, May 2009.
[155] *Ibid.*
[156] Unlike governments in Western Europe and U.S., the Qatari government could not prop up the country's banks without undermining the riyal. Source: Barbary, Victoria and Chin, Edward, "Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis." *Monitor Group*, May 2009.
[157] Goma, Eman and El Gamal, Rania, "UPDATE 2-Kuwait wealth fund not to cut foreign investments," *Reuters UK*, 17 Jan. 2009, <http://uk.reuters.com/article/idUKLH67070120090117>.
[158] Evans, Sophie, "Sovereign funds narrow their focus," *Middle East Economic Digest*, 1 May 2009.

> stake in the more locally focused fund, ADIC, which has stakes in two large Emirati banks, Abu Dhabi Commercial Bank and National Bank of Abu Dhabi.[159]

As shown by the types of investments SWFs have made in the regional economy, in the current environment this investment is probably driven more by the need for local investment than fund managers' familiarity and comfort with the region. Indeed even those funds traditionally focused on international investment have been subject to pressure from local stakeholders and governments to make direct investments to support the local economy. As the *Middle East Economic Digest* explains,

> While these funds have invested much of their wealth overseas in the past, a combination of falling international asset values and a need to boost their own economies means that they are now directing more of their cash to domestic investments… government-owned sovereign wealth funds in the Middle East have a key role to play in reviving local economies affected by lower oil prices."[160]

Investment data suggests that MENA SWFs have increased their investment in the local region during the crisis. However, industry insiders are not unanimous in their interpretation of this trend. The comments made by some of our interviewees suggest that the current levels of local investment are a temporary trend that will reverse as local and international economies stabilize. While discussing funds that focus on foreign investment, one industry insider suggested that there are "no general trends" but Gulf SWFs seem currently to be "more interested in emerging markets." She went on to say that perhaps this is because they are "more comfortable" and generally SWFs "use money to invest outside of the region" to act as a "natural hedge" against assets that are directly tied to commodity prices.[161]

An increased trend towards local investment has been a frequently discussed feature of Middle Eastern SWF investment strategies during the financial crisis. However, as local markets stabilize in the future, it is expected that funds will return to pre-crisis investment distribution focusing on internationally balanced investment portfolios.

<u>Long-term vs. short-term change</u>

It is clear that Middle Eastern funds have undertaken strategic changes during the financial crisis. However, it is important to ask whether the financial crisis has effected a long or short-term strategic change in Middle Eastern SWFs. Industry insiders differ in their opinions on the question. At one end of the spectrum, the Monitor Group report has suggested that the financial crisis may not have a long-lasting effect on MENA SWF strategy.

SWFs have not been forced to rethink their strategies by the losses they have sustained or a lack of attractive opportunities. Rather they have been constrained by economic and political factors, which have forced many funds to look to investing at home to help develop and diversify, or to bail out and support flagging local financial

[159] *Ibid.*
[160] *Ibid.*
[161] Anonymous interview with authors, August 2009

sectors and stock markets, particularly where the SWF is the state's main holder of liquidity.[162]

Monitor's position that the financial crisis will not have a lasting effect on the strategies of MENA SWFs is echoed by Pamela Ann Smith in *The Middle East.* Writing in January 2009, she has suggested that, "many SWFs are now suffering losses at a time when their own economies at home need closer attention. But, analysts say, once financial stability returns, this increasingly important pool of money will again be deployed in the West as well as in the East, helping both to recover."[163] To further counter the suggestion that current SWF investment in local economies may signal a long-lasting change in strategy, Smith explains that:

> While there has been much speculation that the Gulf funds may concentrate increasingly on investments in their own domestic and regional markets, international analysts point out that, unlike the Gulf's central banks, finance ministries or governments, these funds have been set up specifically to obtain the best returns possible for future generations… SWFs will want to ensure that their investments, whether at home or abroad, are independently taken, competitive and profitable over the medium-to-long-term.[164]

However, Smith also suggests that in the near future the financial crisis may have an effect on SWF strategy. She writes that, "In the medium-term, analysts point out that the future growth of the Gulf's SWFs will depend on relations between them and their governments as well as on the price of their oil and gas exports."[165] In addition, going forward, a larger portion of GCC future revenue flow may be directed towards central banks to be held as reserves for domestic investment in infrastructure, the financial sector and real estate.

Other Developments Amongst Middle Eastern SWFs

The creation of the Santiago Principles or Generally Accepted Principles and Practices for SWFs has been an important development for Middle Eastern SWFs. These principles reflect the regulatory and political context in which Middle Eastern SWFs are formulating their future strategies. The Santiago Principles comprise of 24 voluntary principles designed to improve SWFs' "operational independence in investment decisions, transparency, and accountability".[166] The principles were published in Santiago, Chile in October 2008 and were written by the International Working Group of Sovereign Wealth Funds (IWG). Reflecting SWFs' efforts to improve communications with recipient countries and show that SWFs investments are driven by considerations of financial risk and return as opposed to by political

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162 Barbary, Victoria and Chin, Edward, "Testing Time: Sovereign Wealth Funds in the Middle East and North Africa and the Global Financial Crisis." *Monitor Group*, May 2009.
163 Smith, Pamela Ann, "Sovereign wealth funds reassess their strategies," *The Middle East*, 1 Jan. 2009, <http://www.thefreelibrary.com/Sovereign+wealth+funds+reassess+their+strategies.-a0192051817>.
164 *Ibid.*
165 *Ibid.*
166 "International Working Group of Sovereign Wealth Funds Presents the "Santiago Principles" to the International Monetary and Financial Committee." International Working Group of Sovereign Wealth Funds. October 11, 2008. http://www.iwg-swf.org/pr/swfpr0806.htm

motivations, the IWG was formed in May 2008 in concert with the International Monetary Fund.[167]

The Santiago Principles reflect the aims of all SWFs that were involved in their creation or who have signed the agreement. The IWG was comprised of SWFs from across the world including: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, The United Arab Emirates, The United States. Amongst these funds Middle Eastern SWFs, particularly the well-established ADIA and KIA, played a leading role in the formation of the Santiago Principles. When the IWG was formed in 2008, the group was co-chaired by a senior representative from ADIA. (International Working Group of Sovereign Wealth Funds 2008) Further reflecting Middle Eastern SWFs' commitment to the IWG and the Santiago Principles, in April 2009 Kuwait hosted a meeting of the IWG where members agreed to form the International Forum of Sovereign Wealth Funds (also known as "Kuwait Declaration"). This forum would take over the work of the IWG and would be an informal body where SWF representatives could meet and "facilitate an understanding of the Santiago Principles and SWF activities." [168]

[167] "International Working Group of Sovereign Wealth Funds is Established to Facilitate Work on Voluntary Principles." International Working Group of Sovereign Wealth Funds. May 1, 2008. http://www.iwg-swf.org/pr/swfpr0801.htm

[168] "International Working Group of Sovereign Wealth Funds Presents the "Santiago Principles" to the International Monetary and Financial Committee." International Working Group of Sovereign Wealth Funds. October 11, 2008. http://www.iwg-swf.org/pr/swfpr0806.htm

Conclusion

Middle Eastern SWFs are a complex and varied group of investment companies. From ADIA and the KIA to Mubadala and Mumtalakat, the funds are located in different countries and have distinct mandates and investment philosophies. However, for all their differences, the funds were all affected by the financial crisis. Many funds suffered dramatic losses and political pressure to invest in faltering local economies. Each responded in different ways, including reevaluating their investment process and asset allocation, forming partnerships, and investing in local economies. These responses provide a view into the complex functioning of Middle Eastern SWFs who are renowned for their secretiveness. With billions of dollars under their control, Middle Eastern SWF will no doubt continue to be important global investors in years to come. Their response to the current financial crisis may provide us with a better understanding of their operations.

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Legal and Regulatory Aspects of Sovereign Wealth Funds

Introduction

The inherent duality[169] of SWFs' activities and origins raises significant questions about U.S. law and regulatory policy.[170] As investors, SWFs "must abide by the same rules as private pools of capital, such as private equity funds or hedge funds."[171] At the same time, as actors associated (or synonymous) with a foreign government, SWFs may simultaneously be regulated as private investors and occupy the peculiar position U.S. law reserves for sovereigns and their agents operating in the United States. Foreign sovereigns enjoy privileges, bear responsibilities, and are subject to restrictions over and above those applied to their garden-variety, nonsovereign counterparts. Its appeal to legal academics aside,[172] the problem of SWF status under U.S. law implicates a range of issues, including when and under what conditions SWFs can invest in the United States, the extent of SWFs' exposure to U.S. taxes, and whether SWFs should fear lawsuits brought in U.S. courts. An understanding of the legal and regulatory issues attendant to SWF activities in the United States is thus critical for both SWFs themselves and those who do business with them.

This chapter will briefly address each of the three major considerations described above: (1) restrictions on SWF investment in the United States, (2) U.S. tax policy as it relates to SWFs, and (3) SWF exposure to legal action in U.S. courts. As demonstrated below, informed strategic decision making demands analysis of relevant U.S. legal and regulatory systems in each of these crucial areas.

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[169] *See, e.g.*, Ibrahim Warde, *Sovereign Wealth Funds to the Rescue: Are They Saviors, Predators, or Dupes?*, LE MONDE DIPLOMATIQUE, May 15, 2008, *available at* http://fletcher.tufts.edu/news/2008/02/Warde_May16.shtml (noting the "dual nature" of sovereign wealth funds as financial and political actors).

[170] This chapter adopts the definition of sovereign wealth funds described in Chapter 1.

[171] Richard A. Epstein & Amanda M. Rose, *The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow*, 76 U. CHI. L. REV. 111, 117 (2009).

[172] *See, e.g.*, Joel Slawotsky, *Sovereign Wealth Funds and Jurisdiction under the FSIA*, 11 U. PA. J. BUS. L. 967, 967 & 967n.6 (2009) (observing that a "flourishing legal scholarship" has blossomed around SWFs) (additional citations omitted).

Sovereign Wealth Fund Investments Under U.S. Law: Legal Requirements, Political Realities

SWFs are generally considered "foreign government entities" whose investments in the United States are subject to review by the Committee on Foreign Investment in the United States (CFIUS).[173] CFIUS acts as a gatekeeper, created by and tasked with enforcing U.S. laws that restrict foreign investments that may impair national security interests.[174] Foreign control of U.S. nuclear assets or airlines, for example, is prohibited.[175] CFIUS review is mandatory across a wide variety of deal structures, including joint ventures.[176]

While transactions such as these are clearly forbidden, it can be difficult for SWFs and their potential U.S. partners to predict how CFIUS will apply its regulations. Significantly, "national security" is not clearly defined in this regulatory scheme,[177] leaving proposed deals at the mercy of "a broad, vague generality subject to numerous inconsistent interpretations" made by White House officials on a case-by-case basis.[178]

Recent legislation has not made CFIUS approval easier to predict or obtain. The Foreign Investment and National Security Act of 2007 (FINSA) added new requirements to the range of CFIUS regulations, including compliance with U.S. and multilateral counterterrorism, proliferation, and export control regimes.[179] FINSA also expands the scope of transactions subject to CFIUS review to include "critical infrastructure," from power generators to gas storage tanks.[180] While the act has erected new barriers, it has not clarified how SWFs might clear existing hurdles. "Control," for example, remains poorly defined under the statute: There must "be evidence that the acquisition's purpose is solely for investment"[181] for the transaction to be approved; even if an SWF does not have a majority ownership in a U.S.

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[173] *See* 31 C.F.R. Sections 800.213–214.

[174] Although the White House has the authority to suspend, prohibit, or reverse any such transaction under U.S. law, it should be acknowledged that a foreign sovereign might successfully challenge U.S. restrictions on foreign investment in an international tribunal. Indeed, the United States itself mounted a successful challenge to Canada's now-defunct "Foreign Investment Review Act," arguing that its application to U.S. investment in Canada violated Article III(4)'s guarantees of national treatment. Brendan J. Reed, Note, *Sovereign Wealth Funds: The New Barbarians at the Gate? An Analysis of the Legal and Business Implications of Their Ascendancy*, 4 VA. L. & BUS. REV. 97, 123 (2009) (citing M. SORNARAJAH, THE INTERNATIONAL LAW ON FOREIGN INVESTMENT 298 (2004)). Such considerations are beyond the scope of this analysis, however, which assumes the application of current U.S. law.

[175] Epstein & Rose, *supra* note 3, at 118 (citing Michael Hagan & Heidi Johanns, *Sovereign Wealth Funds: Risks, Rewards, Regulation and the Emerging Cross-border Paradigm*, 8 M&A J. 1, 5 (2008)) (additional citations omitted).

[176] See 31 C.F.R. Section 800.301(d).

[177] Zhao Feng, Note, *How Should Sovereign Wealth Funds Be Regulated?*, 3 BROOK. J. CORP. FIN. & COM. L. 483 (2009) (citing Christopher F. Corr, *A Survey of the United States Controls on Foreign Investment and Operations: How Much is Enough?*, 9 AM. U. J. INT'L L. & POL'Y 417, 421 (1994)).

[178] *Id.* (quoting Robert Shearer, *The Exon-Florio Amendment: Protectionist Legislation Susceptible to Abuse*, 30 HOUS. L. REV. 1729, 1741–42 (1993)) (internal quotation marks omitted).

[179] David Alan Richards, *Sovereign Wealth Funds and U.S. Real Estate Investment*, 23 PROB. & PROP. 38, 39 (2009).

[180] Feng, *supra* note 168, at 505-06.

[181] Richards, *supra* note 170, at 40.

enterprise, it may nevertheless be prohibited from completing the deal under the "control" standard.[182]

On a related note, as witnessed by the aborted 2006 Dubai Ports World acquisition of Britain's Peninsular and Oriental Steam Navigation Company (P&O), which, in turn, owned six U.S. ports, political considerations can often play a powerful role in determining whether SWFs can go forward with acquisitions or investments, regardless of CFIUS approval.[183] CFIUS review and disclosure requirements, coupled with a history of embarrassing leaks, make this process politically dangerous for SWFs. Transactions subject to CFIUS review are examined for 30 days and then reviewed for an additional 45 days, unless an official with the rank of Deputy Secretary or above signs off on them first.[184] During these review periods, the parties must submit sensitive personal and proprietary information to CFIUS, including "their businesses' structures, commercial relationships and affiliations, transactional documents, market share and business plans."[185] This information is officially exempt from Freedom of Information Act requests and should not be disclosed except through administrative or judicial proceedings. Nevertheless, the U.S. Department of the Treasury itself has admitted to "several instances" in which embarrassing leaks occurred.[186]

Although CFIUS review applies in principle to real estate transactions involving SWFs,[187] certain real estate investments may be relatively safe bets, as they do not require CFIUS approval. Acquisition of unimproved land, for example, is generally exempt,[188] as is the purchase of unused buildings if that purchase does not "include customer lists, intellectual property, or other proprietary information, or other intangible assets or the transfer of personnel."[189] CFIUS's recent decision not to intervene in SWF investments in the Chrysler and GM buildings in New York further suggests that even relatively high-profile real estate investments may pass regulatory muster.[190]

[182] Feng, *supra* note 168, at 503–04.
[183] *See, e.g.*, Jonathan Weisman, *Port Deal to Have Broader Review: Dubai Firm Sought U.S. Security Probe*, WASH. POST, Feb. 27, 2006, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/02/26/AR2006022600737.html (describing negotiations surrounding and opposition to Dubai Ports World transaction).
[184] Epstein & Rose, *supra* note 162, at 118–19.
[185] *See, e.g.*, Letter from Henry M. Paulson, Secretary of the Treasury, to Max Baucus, Chairman of the Senate Finance Committee (Apr. 15, 2008), *available at* blog.nam.org/treasury-ms-ltr041508.pdf.
[186] *Id*.
[187] Experts characterize the impact of the new CFIUS regulations quite broadly. *See* Richards, *supra* note 10, at 41 (noting that these regulations "have the potential to reach any American real estate transaction in which an SWF is involved.").
[188] *Id*. at 43 (citing 31 C.F.R. Section 800.302(c), ex. 1, subsection (b)).
[189] *Id*.
[190] *Id*. at 44.

Sovereign Wealth Funds and U.S. Tax Policy

The United States currently treats SWFs as sovereigns for tax purposes.[191] Sovereign status in this context can be a significant benefit. As long as the SWF does not engage in commercial activity other than "portfolio investments," which are defined as the acquisition of noncontrolling stakes, the funds can avoid both U.S. income and withholding taxes on their U.S. investments.[192] Curiously, U.S. law arguably treats SWFs more favorably than private foreign investors, taxing the latter (albeit relatively "lightly") and declining to tax the former.[193] Scholars note that such generosity is not required under international law, as "the international doctrine of sovereign immunity as such imposes no restrictions" on the United States' right to tax SWFs.[194]

However, when SWFs do engage in taxable activities, they are taxed at corporate rates heavier than those applicable to private investors.[195] Taken together, the benefits and disadvantages of U.S. tax laws, as applied to SWFs, thus may cancel each other out, leading scholars to conclude that there is "no single and simple answer to the question of whether taxation provides SWFs with a competitive advantage when they invest in the United States."[196]

Taking a Sovereign Wealth Fund to Court

U.S. law grants foreign sovereigns and certain entities associated with foreign sovereigns immunity from suit in U.S. courts under the Foreign Sovereign Immunities Act (FSIA). Despite FSIA's presumption of immunity for these actors, the statute includes a number of exceptions that may subject SWFs to jurisdiction in U.S. courts. This act also regulates a litigant's ability to enforce a judgment against a foreign sovereign, an important related consideration that will be addressed below.

FSIA Immunity and Sovereign Wealth Funds

Two key considerations determine whether SWFs can claim immunity under FSIA: the SWF would have to satisfy the act's definition of a foreign sovereign and fend off arguments that jurisdiction in a U.S. court might be appropriate under one of the act's exceptions.

It appears likely that practically any SWF worthy of the name would be considered a foreign sovereign under FSIA. The act includes both "organs" and

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[191] Michael S. Knoll, *Taxation and the Competitiveness of Sovereign Wealth Funds: Do Taxes Encourage Sovereign Wealth Funds to Invest in the United States?*, 82 S. CAL. L. REV. 703, 712 (2009) (noting that, under Section 892 of the U.S. Tax Code, SWFs are exempt from taxation of noncontrolling investments. *See also* Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. 440 (2009).

[192] Fleischer, *supra* note 182, at 461.

[193] *Id*. at 464–65.

[194] *Id*. at 459 (citing Qantas Airways, Ltd. v. United States, 62 F.3d 385, 388–90 (Fed. Cir. 1995)).

[195] Knoll, *supra* note 182, at 712.

[196] *Id*. at 763–64 (concluding that "U.S. investors have an advantage over SWFs in making portfolio investments in both U.S. equities and real estate.")

"political subdivisions" of a foreign state, as well as "agencies and instrumentalities" of a foreign state, in its definition of foreign sovereigns.[197] Any of these may qualify as a foreign sovereign if it has a "national purpose," even if it operates relatively independently of its home country's government.[198] Although engaged in commercial activity, the ultimate purpose of most (if not all) SWFs involves some sort of governmental function that would qualify it as a sovereign under this test.[199] In addition, SWFs' tax immunity would work in their favor as evidence of foreign sovereign status.[200]

The question of an SWF falling into one of FSIA's exceptions to its general grant of immunity to foreign sovereigns is somewhat more complicated. The act allows U.S. courts to exercise jurisdiction over foreign sovereigns under certain circumstances, including the following: (1) the foreign sovereign waives its immunity; (2) the suit against the foreign sovereign arises out of a "commercial activity" in the United States or impacts the United States; or (3) the suit arises out of violations of international law or involves money damages sought against a foreign state for torture, various acts of terrorism, or extrajudicial killings.[201]

Of these exceptions, waiver and "commercial activity" tend to surface most often in suits under FSIA involving business transactions. Many potential business partners require a waiver of FSIA immunity before entering into a relationship with a sovereign. Even without such a waiver, however, it may be possible to obtain jurisdiction over an SWF by invoking the "commercial activity" exception.[202] Essentially, this exception applies when the sovereign actor is engaging in business that could be carried out by a nonsovereign entity and this activity has a direct effect in the United States. Recent cases on sovereign bond defaults suggest that most SWF investments, assuming they were made with the intention of making money for the sovereign, would probably qualify as "commercial activity." In a case involving an Argentine bond default, for example, the U.S. Supreme Court held that a government's sale of "garden-variety debt instruments" on the international market triggered jurisdiction under FSIA,[203] as the bonds were freely traded on the international market and promised a "future stream of cash income."[204] Unless the SWF could argue that its investments were not intended to produce cash income, this exception would likely apply.

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[197] Slawotsky, *supra* note 163, at 993-94 (citations omitted).
[198] *Id*. at 995.
[199] *Id*. at 997.
[200] *Id*.
[201] *See* 28 U.S.C. Section 1605(a). *See also* Slawotsky, *supra* note 4, at 997–98.
[202] *See, e.g.*, Autotech Technologies L.P. v. Integral Research & Dev. Corp., 499 F.3d 737, 743-44 (7th Cir. 2007) (applying waiver and commercial activities exceptions under § 1605 to find company owned by Belarusian government was subject to federal court jurisdiction).
[203] *See generally* Republic of Argentina v. Weltover, Inc., 504 U.S. 607 (1992) (applying 28 U.S.C. § 1605(a)(2)).
[204] *Id*. at 615.

Enforcing a Judgment Against a Sovereign Wealth Fund

Establishing jurisdiction over an SWF, however, would be only half the battle for a litigant in a U.S. court. FSIA permits U.S. courts to execute judgments only against sovereign property used for a commercial activity in the United States.[205] Even where "a foreign state completely waives its immunity from execution, courts in the U.S. may execute only against property that meets these two statutory criteria."[206] 28 U.S.C. § 1609 provides that, generally, "the property in the United States of a foreign state shall be immune from attachment arrest and execution except as provided in sections 1610 and 1611" of the statute.[207] 28 U.S.C. § 1611 exempts the property

> of a foreign central bank or monetary authority held for its own account, unless such bank or authority, or its parent foreign government, has explicitly waived its immunity from attachment in aid of execution, or from execution, notwithstanding any withdrawal of the waiver which the bank, authority or government may purport to effect except in accordance with the terms of the waiver; or the property is, or is intended to be, used in connection with a military activity and the property is that of a foreign central bank or monetary authority held for its own account, unless such bank or authority, or its parent foreign government, has explicitly waived its immunity from attachment in aid of execution, or from execution, notwithstanding any withdrawal of the waiver which the bank, authority or government may purport to effect except in accordance with the terms of the waiver; or the property is, or is intended to be, used in connection with a military activity and is of a military character, or is under the control of a military authority or defense agency.[208]

In addition, courts have interpreted FSIA to require identification of specific property for attachment.[209] Thus, while a wide range of tangible and intangible property could theoretically be attached to satisfy a judgment,[210] absent waiver by the sovereign, only property used for commercial activity would be subject to attachment under the act. Thus, for example, an embassy or consulate building, diplomatic

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[205] *See, e.g.*, Connecticut Bank of Commerce v. Republic of Congo, 309 F.3d 240, 247 (5th Cir. 2002) (quoting 28 U.S.C. § 1610(a)(1)).
[206] *Id*.
[207] 28 U.S.C. § 1609. FSIA also notes that this immunity is "[s]ubject to existing international agreements to which the United States is a party at the time of enactment" of the FSIA. Research into this caveat's impact on the FSIA analysis in this case is ongoing.
[208] 28 U.S.C. § 1611(b). 28 U.S.C. § 1611(a) and (c) concern categories of property that do not appear applicable in this case: the property of those organizations designated by the President as being entitled to enjoy the privileges, exemptions, and immunities provided by the International Organizations Immunities Act, and property sought to be attached or executed in an action brought under section 302 of the Cuban Liberty and Democratic Solidarity (LIBERTAD) Act of 1996 to the extent that the property is a facility or installation used by an accredited diplomatic mission for official purposes.
[209] Autotech Technologies, 499 F.3d at 750 (citing Af-Cap, Inc. v. Republic of Congo, 383 F.3d 361, 367 (5th Cir. 2004)).
[210] *See, e.g.*, Connecticut Bank of Commerce, 309 F.3d at 257 n.7 (noting that bank accounts are not precluded from FSIA attachment per se, but cannot be attached if they are being used to fund diplomatic or consular functions, for example) (citing Liberian Eastern Timber Corp. v. Republic of Liberia, 659 F. Supp. 606 (D.D.C. 1987)); *Id*. at 258-59 (noting that letter of credit obtained by state-owned company to do business with an American drilling company was used for a "commercial activity" and was thus attachable) (citing Atwood Turnkey Drilling, Inc. v. Petroleo Brasileiro, S.A., 875 F.2d 1174 (5th Cir. 1989)).

vehicles, or central bank funds could not be seized to satisfy a judgment against an SWF. Because attachability hinges on the use of the property, plaintiffs would have to discover what assets located in the United States were being used for nonstate, commercial purposes, a difficult and time-consuming task. Without assets to fund a judgment, victory against an SWF defendant would prove decidedly pyrrhic.

Conclusion: Are There International Alternatives?

Across the board, then, the legal and regulatory environment for SWF activity in the United States is characterized by uncertainty and unpredictability. From the SWF's navigation of opaque CFIUS requirements, to the relative tax advantages of SWF investment in the U.S. market to begin with, to the SWF's litigation risk in U.S. courts, U.S. law does not appear to have adapted to the realities of current SWF activity.

This conclusion naturally invites comparison between the U.S. approach and international alternatives. It is not difficult to imagine a competition for SWF investment encouraging a "race to the bottom"[211] to present more attractive investment opportunities to SWFs—a race the United States would appear to be losing. With the exception of the United Kingdom, however, it appears that the major European Union powers are pursuing policies similar to those of the United States.

Though uniform in some respects relevant to SWFs,[212] the European Union generally evinces a "fragmented national regulatory response" to SWF control.[213] Despite proposals to adopt a uniform EU approach,[214] including a largely German-backed effort to establish a European Union counterpart of CFIUS,[215] EU member states' attitudes toward and policies regulating SWFs vary widely.

Great Britain appears to be the champion of a laissez-faire approach to SWF regulation within the EU. The country has opposed SWF regulation at the EU level,[216] apparently seeking to maintain its position as a regional leader in attracting foreign investment.[217] Germany and France are at the other end of the spectrum.[218]

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[211] *Cf.* Matthew Saxon, *It's Just Business, Or Is It?: How Business and Politics Collide With Sovereign Wealth Funds*, 32 HASTINGS INT'L & COMP. L. REV. 693, 711 (2009) (noting the potential for such a "race to the bottom" within the European Union).

[212] European Union investor disclosure regulations, for example, can be compared as a comprehensive unit to their U.S. and "major Asian" equivalents. *See* Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1361 (2008)

[213] Reed, *supra* note 165, at 129.

[214] *See* Commission Proposal for a Common European Approach to Sovereign Wealth Funds, at 9, COM (2008) 115 final (Feb. 27, 2008), *available at* http:// ec.europa.eu/commission_barroso/president/pdf/COM2008_115_en.pdf.

[215] Saxon, *supra* note 202, at 706, 708. *See also* Bertrand Benoit, Tony Barber & George Parker, Germany *Plans For Own Cfius Deal Watchdog*, FIN. TIMES, Sept. 27, 2007, *available at* http:// www.ft.com/cms/s/0/48128c56-6c82-11dc-a0cf-0000779fd2ac.html.

[216] Saxon, *supra* note 202, at 709 (citing Ambrose Evans-Pritchard, *EC to Rule on Sovereign Wealth Funds*, THE TELEGRAPH, Nov. 29, 2007).

[217] *Id.* at 704–05.

[218] Justin O'Brien, *Barriers to Entry: Foreign Direct Investment and the Regulation of Sovereign Wealth Funds*, 42 INT'L LAW. 1231, 1236 (2008).

As Germany encourages the EU to adopt a CFIUS-like system, it has redrafted its own foreign investment laws to allow German officials to monitor and prohibit transactions in which a foreign entity acquires more than a 25 percent stake if the transaction could threaten "public security or order."[219] Though somewhat less strict in its regulatory approach,[220] France has also indicated that it intends to "protect its companies" from SWF acquisition as it deems necessary.[221]

These hard-line regulatory policies may reflect the limited opportunities SWFs have for investing outside the United States and the European Union. As Daniel Drezner observes,

> Part of the reason that you see sovereign wealth funds is that these countries desperately need to invest in dollar assets in order either to keep their currencies undervalued or to prevent them from appreciating. So as a result, the United States and the European Union have started promulgating regulations. My prediction is that essentially they will be able to regulate whatever they want, in large part because the countries that have sovereign wealth funds do not have a lot of other places where they can invest their money. Over 80 percent of sovereign wealth fund investment is going to either the United States or the European Union.[222]

Thus, notwithstanding Great Britain's relatively lax approach to SWF regulation, the legal and regulatory status quo in the United States and those countries that have adopted variations of the U.S. model may remain undisturbed as long as SWFs cannot find enough attractive investment opportunities to shift their resources elsewhere.

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[219] *Id*. at 1238 (citing Agence-France Presse, Germany Moves to Block Sovereign Wealth Funds, Industry Wk. (Aug. 21, 2008), available at http://www.industryweek.com/ReadArticle.aspx?ArticleID=17121.)

[220] Saxon, *supra* note 202, at 707–08 (citing Rachel Ziemba, Responses to Sovereign Wealth Funds: Are "Draconian" Measures on the Way?, Roubini Global Economics Service, Nov. 2007, at 6, *available at* http://www.rgemonitor.com/economonitor-monitor/220669/responses_to_sovereign_wealth_funds_are_draconian_measures_on_the_way).

[221] *Id*. (citing Helen Beresford, Sarkozy to Use CDC to Defend French Cos Against "Aggressive" Speculators, Forbes.com, Jan. 8, 2008, http://www.forbes.com/afxnewslimited/feeds/afx/2008/01/08/afx4505120.html)

[222] Daniel Drezner, *Remarks*, 102 AM. SOC'Y INT'L L. PROC. 259, 261 (2008).

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Appendix

Essential Readings on Sovereign Wealth Funds

1. What Are Sovereign Wealth Funds? — Definitions and Classifications

International Working Group of Sovereign Wealth Funds. Appendix I. "Sovereign Wealth Funds: Generally Accepted Principles and Practices ('Santiago Principles')," 2008. http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf, p. 27.

> This document lays out the Santiago Principles of the IWG, the working group of countries with SWFs. The Santiago Principles are a set of best practices regarding fund management and transparency. The appendix to this report has a definition that is important, given that it is that of the SWFs defining themselves. *This citation appears again under "Transparency and Best Practices."*

Mezzacapo, Simone. "The So-called 'Sovereign Wealth Funds': Regulatory Issues, Financial Stability and prudential supervision." *European Economy* Economic Papers 378, April 2009. Directorate-General for Economic and Financial Affairs. European Comission.
http://ec.europa.eu/economy_finance/publications/publication15064_en.pdf.

> This long but informative report provides in detail various institutions' definitions of SWFs as well as a more practical explanation of what they are and what they do. In addition, it discusses legal and regulatory issues within a European framework and provides a great deal of data about various funds in the appendix. This report is highly recommended.

Rozanov, Andrew. "Who Holds the Wealth of Nations?" *Central Banking Journal*, 2005. Reprint by State Street available. **(citation is incomplete)**http://www.libertyparkusafd.org/lp/Hancock/Special%20Reports/Sovereign%20Wealth%20Funds/Who%20Owns%20the%20Wealth%20of%20Nations%20-%202005.pdf.

> This relatively brief document—the first to define SWFs—provides a general definition of their size and sources of wealth. This should be coupled with other readings to gain a full understanding of the topic.

U.S. Department of the Treasury, Office of International Affairs. "Appendix III: Sovereign Wealth Funds." *Semiannual Report on International Economic and Exchange Rate Policies*, 2007.
http://ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007_Appendix-3.pdf.

This is a definition and classification system of the U.S. Department of the Treasury for SWFs. This frequently cited document is an important, though brief, overview of one set of definitions among many.

2. Overview and Significance of Sovereign Wealth Funds

Avendaño, Rolando and Santiso, Javier. "Are Sovereign Wealth Funds' Investments Politically Biased? Comparison with Mutual Funds." OECD Development Centre. Working Paper No. 283.

This work tackles the question of whether SWFs act with political interests in mind. The authors use data analyses and studies of institutional and national governance within a clear argument to find that SWFs behave like mutual funds.

International Monetary Fund (2008). "Sovereign Wealth Funds—a Work Agenda," February 29, 2008. http://www.imf.org/external/np/pp/eng/2008/022908.pdf.

This work agenda and paper of the IMF provides a thorough background about SWFs, their macroeconomic impact, and their best practices and lays out a framework for studying funds in the future. In addition, it presents selected models and fund classifications.

Navarro, Peter. "Testimony of Business Professor Peter Navarro Before the U.S.-China Economic and Security Review Commission, February 7, 2008." *U.S.-China Economic and Security Review Commission*, October 26, 2009.
http://www.uscc.gov/hearings/2008hearings/written_testimonies/08_02_07_wrts/08_02_07_navarro_statement.php.

This testimony from a University of California professor provides an excellent overview of what SWFs are and how they differ from traditional investments, a history of each of a variety of influential SWFs and their relevance to their respective countries, and a particularly useful section that debunks a number of "spurious claims" about SWFs.

O'Neill, Jim; Nielseon, Erik F.; and Bahaj, Saleem. "In Defence of Sovereign Wealth Funds." Goldman Sachs *Global Economics* Paper No. 167, 2008.
http://portal.gs.com.

This report by researchers from Goldman Sachs provides a detailed overview of the effect of SWFs to date, with an interesting section on how they have been rebalancing the large U.S. current account deficit. It provides detailed justification for SWFs' potential utility as well as some suggestions on the proper response to their rise.

Paulson, Anna L. "Raising Capital: the Role of Sovereign Wealth Funds." The Federal Reserve Bank of Chicago. Chicago Fed Letter Number 258, 2009.

http://www.chicagofed.org/publications/fedletter/cfljanuary2009_258.pdf.

> This article describes what SWFs do, where their funding comes from, and what drives their investment strategies. It also highlights some of the policy issues that their activities raise.

Shediac, Richard and Samman, Hatem. "The Vital Role of Sovereign Wealth Funds in the GCC's Future." Booz and Company, 2009. http://www.booz.com/media/uploads/Vital_Role_Sovereign_Wealth_Funds.pdf.

> This report from Booz and Company is an excellent overview of everything related to SWFs. It discusses worldwide SWFs, different styles of fund management, socioeconomic goals, the question of regulation, and more.

Teslik, Lee Hudson. "Backgrounder: Sovereign Wealth Funds." Council on Foreign Relations, January 28, 2009. http://www.cfr.org/publication/15251/.

> This page from the Council on Foreign Relations provides a brief introduction to SWFs and their relevance in a modern context.

3. Key Issues and Controversies

a. National Security

Cohen, Benjamin J. (2008). "Sovereign Wealth Funds and National Security: the Great Tradeoff." *Paper presented at the annual meeting of the ISA's 50th ANNUAL CONVENTION "EXPLORING THE PAST, ANTICIPATING THE FUTURE", New York Marriott Marquis, New York City, NY, USA*, 15 Feb. 2009. http://www.allacademic.com/meta/p312068_index.html.

> This paper tackles the ever-relevant and controversial issue that comes with government entry into public markets: the balance between open capital markets and national security. The key question discussed is to what extent should countries be allowed to affect and allow themselves to be affected by other countries' capital?

b. Transparency and Best Practices

International Working Group of Sovereign Wealth Funds. "Sovereign Wealth Funds: Generally Accepted Principles and Practices ('Santiago Principles')," 2008. http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf.

> This document lays out the Santiago Principles of the IWG, the working group of countries with SWFs. The Santiago Principles are a set of best practices regarding fund management and transparency. Familiarity with these principles is essential for those interested in fund transparency, management, or best practices.

Kotter, Jason and Lel, Ugur. "Friends or Foes? The Stock Price Impact of Sovereign Wealth Fund Investments and the Price of Keeping Secrets." Board of Governors of

the Federal Reserve System. International Finance Discussion Paper No. 940, 2008. http://www.federalreserve.gov/pubs/ifdp/2008/940/ifdp940.pdf.

> This paper from the Federal Reserve analyzes the effects of investment by SWFs on stocks and the effects of fund transparency, concluding that a fund's investment in a stock is considered a good sign and transparency is beneficial to both fund and firm.

OECD. "Sovereign Wealth Funds and Recipient Countries—Working Together to Maintain Investment and Expand Freedom of Investment." Brochure presented at the Ministerial Roundtable on the Santiago Principles, October 11, 2008. http://www.oecd.org/dataoecd/0/23/41456730.pdf.

> This document presents the Ministerial Declaration and the associated OECD guidance for recipient country policies toward SWFs, particularly policies regarding freedom of investment, accountability, and national security.

Truman, Edward M. "A Scoreboard for Sovereign Wealth Funds." Peterson Institute for International Economics. Paper presented at Conference on China's Exchange Rate Policy, Peterson Institute, Washington, D.C., 2007.
http://www.iie.com/publications/papers/truman1007swf.pdf

> This paper presents a general "scoreboard" for classifying and comparatively evaluating SWFs of all kinds, despite their wide variety and lack of definition. The scores for most funds are given at the end of the paper.

4. Investment Strategies

Balding, Christopher. "A Portfolio Analysis of Sovereign Wealth Funds." Social Sciences Research Network, June 5, 2008.
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1141531

> Despite the scarcity of data regarding SWFs and their effects on international finance, the author tries to estimate SWFs' sizes and the composition of their portfolios. This paper demonstrates the difficulty in studying SWFs due to the lack of transparency. In addition, the appendix contains a great deal of information about various SWFs and their holdings.

Bernstein, Shai; Lerner, Josh; and Schoar, Antoinette. "The Investment Strategies of Sovereign Wealth Funds." *Harvard Business School Finance Working Papers*, No. 09-112, 2009. Social Sciences Research Network.
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1370112.

> This paper, quite simply, attempts to analyze various funds' investment strategies while taking into account their organizational structures, with nearly 20 pages of statistics assembled by the authors.

5. Selected Regions

a. Chile

Ministry of Finance. "Sovereign Wealth Funds." *Government of Chile.* http://www.hacienda.cl/english/fondos_soberanos/index.php.

> Unusually transparent for SWFs, the government of Chile provides a great deal of information in English about its various funds, including management styles, a thorough set of frequently asked questions, and even quarterly reports.

b. China

Truman, Edwin M. "The Management of China's International Reserves: China and a Sovereign Wealth Fund Scoreboard." In Morris Goldstein and Nicholas R. Lardy, eds., *Debating China's Exchange Rate Policy*, pp. 169-93. Washington, D.C.: Peterson Institute for International Economics, 2008.

> This paper details the unique aspects of China's SWFs—investment funds in an officially communist country—and explains the funds' history as well as their context within China, especially in terms of the exchange rate and the U.S. trade deficit.

c. Middle East

Setser, Bard and Ziembra, Rachel (2007). "Understanding the New Financial Superpower—the Management of GCC Official Foreign Assets." RGE Monitor, 2007.
http://www.cfr.org/content/publications/attachments/SetserZiembaGCCfinal.pdf.

> This paper attempts to classify the SWFs in the Gulf Cooperation Council and estimate the size of their assets and the composition of their portfolios.

d. Norway

Norway Ministry of Finance. "The Government Pension Fund." *Government of Norway*.
http://www.regjeringen.no/en/dep/fin/Selected-topics/the-government-pension-fund.html?id=1441.

> Norway's Government Pension Fund, swelling with funds from petroleum, is famously transparent and a worldwide example for best practices. As such, its website is very thorough and provides a great deal of information in English.

6. Organizations of Interest on the Topic of Sovereign Wealth Funds

Council on Foreign Relations
http://www.cfr.org/

International Forum of Sovereign Wealth Funds
http://www.ifswf.org/

International Working Group of Sovereign Wealth Funds
http://www.iwg-swf.org/

Peterson Institute of International Economics
http://www.iie.com/
SWF link: http://www.piie.com/research/topics/hottopic.cfm?HotTopicID=11

Sovereign Wealth Fund Institute
http://www.swfinstitute.org/

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