



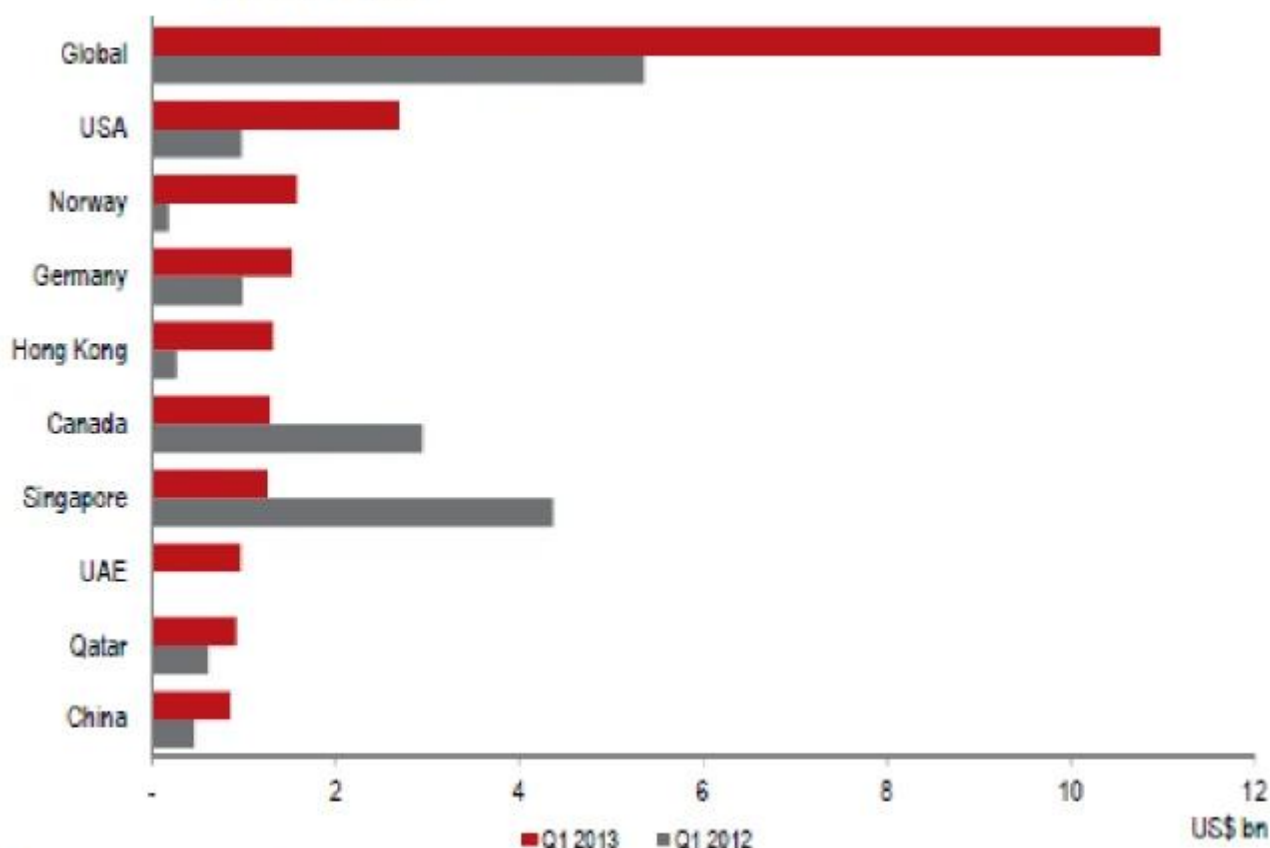
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Capital, Property, and Politics: The Governance of Sovereign Wealth Funds in Global Real Estate Markets

By Omar Khattaly · 1 January 2015

Should governments in the U.S. and Europe be concerned with the presence and growth of these government-owned investment funds? In recent years, many in the U.S. capital and within EU countries have expressed concern and have started to pay close attention to the activities of Sovereign Wealth Funds (SWFs) within their borders.

Figure 8: Top 10 Cross Border Purchasers by Source of Capital Q1 2012 & 2013



Source: Jones Lang LaSalle

Critics of SWFs worry that as this asset pool continues to grow in size and importance, it could have an impact on national security and affect internal markets. A primary concern is that the purpose of these investments may not be solely for financial profits, but instead to secure control of strategic industries for political gain. This concern is heavily driven by the fact that many SWFs lack transparency regarding their size, source of funds, investment goals, internal checks and balances, and—perhaps most importantly—the disclosure of their relationships with holdings in private equity funds.

A prime example of these governance challenges can be seen in the Libyan Investment Authority, which has had four changes in its chairman and CEO positions since 2012. Over this same period, the Libyan Prime Minister's office has been occupied by four different ministers amidst broader government turnarounds. This profound lack of continuity in leadership and executive management has raised major flags within the financial world and among concerned governments, particularly regarding the ownership, transparency in reporting, and internal governance of the \$67-billion-dollar fund.



Despite these concerns, research shows no cases of major disputes between host governments and SWFs over investment issues. Instead, recent history offers many examples of capital-rich countries coming to the rescue of large economies. A notable instance was the injection of billions of dollars into struggling U.S. companies during the financial crisis of 2007, where foreign investors were hailed as saviors of major financial institutions such as Citigroup, UBS, and Morgan Stanley. Ultimately, such mutually beneficial financial interventions can result in stronger, more resilient political relations.

Since 2007, SWFs and key world powers have addressed many of these concerns by adopting the Santiago Principles, while several individual governments have also enacted their own protocols:

The United States: The U.S. government passed the Foreign Investment and National Security Act of 2007, which established greater scrutiny for cases when a foreign government or government-owned entity attempts to purchase a U.S. asset. Under this framework, SWFs face more intense investigations when purchasing more than a 10% stake in a U.S.-based company. Furthermore, on March 5, 2008, a joint subcommittee of the U.S. House Financial Services Committee held a hearing to discuss the role of foreign government investment in the U.S. economy and financial sector. This hearing was attended by representatives from the U.S. Department of the Treasury, the U.S. Securities and Exchange Commission, the Federal Reserve Board, Norway's Ministry of Finance, Singapore's Temasek Holdings, and the Canada Pension Plan Investment Board.

Germany: On August 20, 2008, Germany approved a law that requires parliamentary approval for foreign investments that potentially endanger national interests. Specifically, this legislation affects acquisitions of more than 25% of a German company's voting shares by non-European investors. However, Economics Minister Michael Glos pledged at the time that actual investment reviews would be extremely rare. This legislation was loosely modeled on the U.S. Foreign Investment and National Security Act of 2007.

The International Working Group: The International Working Group of Sovereign Wealth Funds, which is comprised of the world's major SWFs, met during a September 2008 summit in Santiago, Chile. During this summit, the member funds officially agreed to a voluntary code of conduct that had been originally drafted by the International Monetary Fund (IMF), now widely known as the Santiago Principles.

This set of 24 principles, now referred to as the Santiago Principles, was made public



after being presented to the IMF Governing Council on October 11, 2008. It is worth noting that the Santiago Principles are voluntary and non-binding. Similarly, in June 2008, the OECD Ministerial Council adopted a framework between governments and SWFs; this agreement is called the Declaration. Much like the Santiago Principles, the Declaration is voluntary and non-binding.

Financial capitals around the world welcome SWFs and try to make it as easy as possible for them to do business within their borders. For this purpose, the U.S. government established a multi-agency government body. The Committee on Foreign Investment in the United States (CFIUS) was created to ease entry into the U.S. market. Companies interested in buying large shares of U.S. corporations submit a voluntary request for approval to ensure that such an entry does not violate any national security laws. This Committee is administered by the U.S. Department of the Treasury, and the U.S. President can be consulted on these applications. Historically, CFIUS has worked very effectively with companies looking to enter the U.S. market.

In 2008, the U.S. Treasury outlined four guiding principles for SWFs:

- A policy statement dictating that investment decisions should be based solely on economic grounds, rather than political or foreign policy considerations.
- World-class institutional integrity, including transparency regarding investment policies, strong risk-management systems, governance structures, and internal controls.
- Fair competition with the private sector.
- Respect for host-country rules.

On March 20, 2008, the U.S. Treasury and the governments of Singapore and Abu Dhabi issued a joint statement welcoming these policy principles as the basis for SWF best practices, with a specific focus on transparency and governance. These three countries also issued a statement of principles for nations receiving SWF investments.

At the same time, the EU was also busy setting up a working framework for SWFs. On February 28, 2008, the Commission of the European Communities issued a statement outlining its preferred standards of governance and transparency for Sovereign Wealth Funds.

The Commission agreed on the following:

- **Governance:** A clear allocation and separation of responsibilities between the government and the SWF.



- **Investment policy:** Definition of the SWF's overall objectives, along with the operational autonomy required to achieve those objectives.
- **Public disclosure:** Disclosure of the principles governing the relationship between the SWF and its governmental authorities.
- **Internal governance:** Procedures that provide assurance of integrity and appropriate risk management policies.
- **Transparency:** Annual disclosure of investment positions and asset allocations, as well as disclosure of the use of leverage, the currency composition of assets, and the size and source of the fund's resources. This includes full disclosure of the home country's regulations and oversight governing the SWF.

The Commission advocated that SWF home countries open up their markets to EU investors to secure fair and equitable treatment for them through free trade agreement negotiations.

We must keep in mind that all these statements are recommendations for the mutual benefit of both sides: SWF countries and recipient countries. Financial capitals around the world are excited about the presence of SWFs and consider them important participants in economic growth. On October 19, 2007, the Group of Seven (G-7) finance ministers and central bank governors declared:

"Sovereign wealth funds are increasingly important participants in the international financial system and our economies can benefit from openness to SWF investment flows. We see merit in identifying best practices for SWFs in such areas as institutional structure, risk management, transparency, and accountability. For recipients of government-controlled investments, we think it is important to build on principles such as nondiscrimination, transparency, and predictability."

In my research, two issues seem to come up often and represent a major concern to governments when dealing with SWFs: transparency and internal governance. As of 2015, total SWF investments are valued at over \$5 trillion. As these funds continue to invest in many different regions across the globe, there will be an important question regarding how this industry can be better regulated and monitored. I believe that during the next decade, world governments—particularly in the U.S. and Europe—will start paying close attention to the flow of this money from areas that lack political stability and are outside of the OECD group of countries. As the threat of terror increases, there will be an increased demand to look into issues such as money laundering, the financial support of terrorism, and taxation.

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