



The Indian Journal for Research in Law and Management

Open Access Law Journal – Copyright © 2024

Editor-in-Chief – Dr. Muktai Deb Chavan; Publisher – Alden Vas; ISSN: 2583-9896

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ASSESSING THE ROLE OF SOVEREIGN WEALTH FUNDS IN SUSTAINABLE AND RESPONSIBLE INVESTING: REGULATORY PERSPECTIVES

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In the past decade Sovereign Wealth Funds (SWFs) have grown multifold, drawing the attention of many government officials because of their non-transparent nature and expansionary investment policies. With economic and financial globalisation and replacing traditional capitalism, nations share their sovereignty with supranational states and non-governmental organisations. Sovereign Wealth Funds are funds that are state owned investment funds that provide the government with the funds that can help navigate and aid the global economic landscape¹.

The understanding and classification of SWFs has evolved over time with different typologies being used as original sources of funding and their primary objective. For clarity and standardisation, the International Monetary Fund (IMF) provides a distinction on the basis of their primary objectives. Stabilisation Funds are known for their insulatory characteristic which helps the economy against commodity, historically oil, price swings. Contingent Pension Reserve Funds are for the unspecified and contingent liabilities on a government's balance sheet from various sources exempting pension contributions. Development funds are prevalent for bolstering socio-economic projects or to promote policies aimed at enhancing a nation's potential growth.

Major SWFs include the China Investment Corporation, Qatar Investment Authority, Abu Dhabi Investment Authority, Temasek (Singapore), and Norway's Government Pension Fund Global.

¹ Phelps N A 2007 Gaining from globalisation? State extraterritoriality and domestic economic impacts – the case of Singapore Economic Geography 83 371–93

Predominantly based in Asia, SWFs collectively manage assets exceeding \$6 trillion with growth anticipated in Latin America and Africa.

The main reason behind the reaction of SWFs arises from the need to convert short term wealth into long term income following sustainable standards, this helps navigate the pertinent issue of finite natural resources. Despite these goals² SWFs are often criticised for their lack of transparency as unlike commercial banks and mutual funds³, they do not disclose public records on their holdings and their long-term investment plans. This serves the allegations of SWFs aiding a nation's political agenda while causing fluctuations in the economy that might favour the goals of the nation's political agendas.

The past decade poses examples of political friction towards SWFs, for example, in 2005, China National Offshore Oil Corporation's bid to purchase the US oil company Unocal faced intense political resistance in the US leading to the bid's withdrawal. Likewise, Dubai Ports World's attempt to acquire operating rights to several US ports was blocked due to national security concerns.

SWFs are known for investing in low-risk securities like government bonds while using minimum leverage and following a 'trend chasing' strategy where investments are done domestically when local prices are high and internationally when prices abroad are high. Stabilisation funds, particularly prefer low risk investments and bonds that safeguard against economic ruin. Outsourcing is prevalent in SWFs⁴ as they generally avoid active management, which is ensured by voting⁵ by proxy, helping prevent political friction. Considering its move towards sustainability, SWFs usually maintain long term investments ensuring that assets are rarely sold. The very pervasive concerns about SWFs lack of transparency hurting national safety may be overstated considering the ever-needed liquidity SWFs provide to financial institutions in times of financial crisis. Time and again they have shown they prioritise commercial gain over political say. While

² Monk A H B 2009 Recasting the sovereign wealth fund debate: trust, legitimacy, and governance *New Political Economy* 14 451–68

³ Andrew Rozanov, 'Who Holds the Wealth of Nations' (2005) XV(3) *C Bank J* 52 <www.centralbanking.com/central-banking-journal/feature/2072255/holds-wealth-nations

⁴ KPMG–Invest in Spain, 'Sovereign Wealth Funds' (2012)

⁵ Blackstone Group, 'China's State Investment Company to Acquire Non-Voting Minority Stake in Blackstone' Press Release, 20 May 2007

their role in global finance urges for better regulation, the scrutiny they receive is exaggerated more than what other financial institutions face.

While transparency in the acts of financial institutions can uphold accountability, it is imperative to highlight the competitive disadvantage that SWFs will have to face as it will make it hard for SWFs to compete against investment vehicles like hedge funds. SWFs should be encouraged to have more transparency in order to facilitate good governance but should not be subjected to stricter standards than its competitors. By ensuring all financial institutions are subject to similar transparency standards, SWFs cannot claim unfair treatment if asked to be more transparent⁶.

There have been various procedures that have been formatted in order to help the regulation of SWFs. The Limiting SWF Acquisitions and Protecting Strategic Industries Model aims to limit the number of shares of domestic companies that SWFs can buy while also considering banning certain industries if they are strategically irreplaceable. These include Golden Shares⁷, held by a government that provide certain control rights over a company while limiting foreign ownership.

Using penalties or limitations in order to coerce SWFs to change their behaviour is propagated by the Incentive-Type Regulations Model. It aims at SWF ensuring that it reduces any negative impacts that it may have had on a host country and transfers ownership of acquired shares to private entities. These restrictions include limiting the voting power attached to shares held by SWFs and imposing additional taxes on SWF investments to prevent potential drawbacks. The Reporting Requirements Model's primary focus is on increasing transparency by ensuring that SWFs disclose information regarding their share holdings, hence, improving market efficiency. The Self Regulation Model requires SWFs to establish its own guidelines for regulation while keeping its activities in check, the model is not efficient in its objective and execution due to the lack of accountability.

⁶ Indicatively see, Lawrence Summers, 'Funds That Shake Capitalist Logic' Financial Times (London, 29 July 2007) accessed 1 November 2014; Steven Weisman, 'Concern about "Sovereign Wealth Funds" Spreads to Washington' The New York Times (New York, 20 August 2007) accessed 26 December 2013; Joshua Aizenman and Reuven Glick, '[SWFs]: Stumbling Blocks or Stepping Stones to Financial Globalization?' Federal Reserve Bank of San Francisco Economic Letter Number 2007-38, 2-3

⁷ Franke A, Gawrich A and Alakbarov G 2009 Kazakhstan and Azerbaijan as post-soviet rentier states: resource incomes and autocracy as a double 'curse' in post-soviet regimes Europe-Asia Studies 61 109-40

The Command-and-Control Model⁸ puts forth a level playing field by aligning SWFs with pre-established reporting mandates for other financial institutions like commercial banks and insurance firms. The transparency established by this approach ensures reduced concerns attached to SWFs and better market analysis followed by tailored decisions made by well informed investors. The reporting requirements⁹ under this model requires SWFs to disclose their shareholder voting records if its ownership stake in accompany exceeds a pre decided threshold, in order to ascertain the SWF's influence in the company's decision-making activities. They are required to report their relationship with foreign countries who have a history of a lack of transparency. The model mandates a two layered approach of self regulation with a government established legal framework. While SWFs will have some flexibility, minimum reporting requirements will be standard for the disclosing of information, a similar pattern of attaining transparency is followed for stock exchange regulation in Europe¹⁰. The model also suggests a global reporting system, mainly an international body for the SWF to report to, like, the World Trade Organisation (WTO). It is imperative to understand the need for transparency coupled with regulation while also ensuring a level playing field to maintain competition between financial institutions. Protectionist regulatory frameworks must be done away with as SWFs cannot be aligned with them without losing its standing in the industry. The balance of transparency and competition can only be brought about by the perfect amalgamation of principles like that of Generally Accepted Principles and Practices (GAPP)¹¹ which are not overly restrictive but also ensure a healthy and investor friendly economic and global environment.

⁸ Friedman, Stigler and Posner argue government intervention creates more problems than it seeks to solve, Howard Davies, 'Financial Regulation: Why Bother?' Society of Business Economists Lecture, Financial Services Authority, January 1999; Milton Friedman, *Capitalism and Freedom: Fortieth Anniversary Edition* (Chicago University Press 2002); J Stigler, *Production and Distribution Theories* (New York: Macmillan, 1940); Richard A. Posner, 'Theories of Economic Regulation' (1974) 5, *The Bell Journal of Economics and Management Science* 335; Ludwig von Mises, *The Historical Setting of the Austrian School of Economics* (Ludwig von Mises Institute 2007).

⁹ Bryan Balin, 'Sovereign Wealth Funds: A Critical Analysis' (2008) Johns Hopkins University School of Advanced International Studies

¹⁰ An OECD paper published during the crisis warned that 'countries will be tempted to adopt 'beggar thy neighbor' policies, including investment protectionism in various guises'; OECD, 'Building Trust and Confidence in International Investment: Report by Countries Participating in the "Freedom of Investment" Process' OECD (March 2009) 12, available at

¹¹ Principle No 21 of GAPP states that 'SWFs View Shareholder Ownership Rights as a Fundamental Element of Their Equity Investments' Value', see International Working Group on Sovereign Wealth Funds, 'Sovereign Wealth Funds - Generally Accepted Principles and Practices' (October 2008)

