

# ***Resource wealth and the ethics of global investment: The legitimacy and governance of Norway's sovereign wealth fund***

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**Abstract.** The Norwegian Government Pension Fund-Global is one of the world's largest sovereign wealth funds and is one of the most transparent institutions of its type. It also has an explicit mission aimed at integrating long-term investment return objectives with a two-sided ethical commitment: to corporate engagement according to accepted principles of best-practice corporate governance and to ensuring that the fund is not associated with companies that pose a risk to social and environmental justice. As such, the Norwegian fund has an ethical mandate—a remarkable fact when compared to other sovereign wealth funds. In this paper, we argue that this mission is best understood in terms of procedural rather than substantive justice. The contrast drawn is between a function-based conception of the design and implementation of the investment process and an outcomes-based or substantive conception of the proper purpose of investment. This argument is developed with reference to recent work on the nature of state authority and legitimacy in democratic societies, the logic of best-practice investment management, and the functional integration of decision-making. To illustrate, the paper focuses on the nature and significance of the recommendations from the advisory Council of Ethics and the exercise of powers related to corporate governance. Implications are drawn for understanding the limits of sovereign wealth funds seeking to give global effect to national sentiments.

**Keywords.** Resources, Norway, democracy, ethics, investment, sovereign wealth fund

**JEL Codes.** G23, G24, L12

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## **Introduction**

A recurrent theme in public commentary about sovereign wealth funds (SWFs) is the fear that they will exercise the power associated with vast financial assets on behalf of their national sponsors—SWFs are, or can be, strategic instruments of sponsors' geopolitical interests (Aizenman and Glick 2008; Monk 2008). So, when a SWF announces the acquisition or intended acquisition of countries' infrastructure assets, one response is to suppose that behind the assessment of risk and return is an interest in acquiring a strategic foothold that will pay dividends for the national sponsor in the future. A second, related theme is about the effective independence of SWFs from national political interests. There is a fear that SWFs may be subject to the latest fad or fancy of their political masters. Best-practice investment management would have it that clarity of mandate and the formal division of authority and responsibility are essential in driving fund performance over the long-term (Clark and Urwin 2008).

The Norwegian Government Pension Fund-Global (GPF-G) is hardly a 'pension fund' in the sense that pension funds are normally separate institutions with their own governance structures ruled by the principle of fiduciary duty (Clark 2004). In fact, the GPF-G is a deposit account in the Norwegian Central Bank: its assets are managed by Norges Bank Investment Management (NBIM) which is, in the first instance, responsible to the Bank's Governor and Board and ultimately to the Minister of Finance. It has neither an independent board of trustees nor does it hire its own CEO and CIO; those employed in the NBIM are employees of the Bank and are subject to the Bank's employment policies and practices. Further, NBIM investment is subject to Ministry policies including quantitative rules regarding the allocation of assets as well as mission-led policies regarding ethical investment that derive from the national Parliament. Since the fund is required to invest its assets outside of Norway, its ethical investment policies seek to give global effect to national values and commitments.

Given the huge size of the fund and the unique ethics policy whereby the Fund may be required to exclude certain companies from the investment portfolio, the process of 'naming and shaming' can make headlines around the world. For some commentators, notably Barker (2009), the GPF-G challenges conventional boundaries between 'private' investment and 'public' responsibility for global social and environmental standards. As such, it is both an instrument of long-term national welfare and an expression of Norway's commitment to global justice. In contrast to Australia's Future Fund, the Norwegian GPF-G is also enmeshed in the machinery of government and is subject to the play of democratic debate over its investment in companies around the world that may be deemed to violate well-defined and widely-held national standards. Again, in contrast, the Australian Future Fund is 'protected' from parliament and is at arms-length from public opinion through the statutory powers invested in its trustees (Clark 2009). There is little doubt that the design of the Future Fund sought to isolate it from partisan political debate.

We accept that governments may have a legitimate interest in affecting the nature and scope of the investment of public assets. We also accept that governments may wish to give affect to the values of their citizens through the investment policies of responsible agencies and instrumentalities. These propositions form the background to the paper: its focus is on the governance of the GPF-G through the system of agencies and institutions that in sum amount to the 'pension fund'. In doing so, we

are most concerned with the process of decision-making rather than the fund's financial performance. This is because we believe that the apparent bipartisan political support for the GPF-G and its ethical policies relies upon the representation of public interests in fund decision-making and the accountability of the fund to the responsible minister. In this sense, its legitimacy is bound-up with the political process rather than its functionality as an institutional investor. To better understand the significance of this point, in the next section we suggest that the governance of the fund reflects a public commitment to procedural democracy and, in particular, what Estlund (2008, 6-7) refers to as "epistemic proceduralism": the notion that legitimacy is a product of the procedure whereby decisions are arrived at and the "correctness" of those decisions.

As Norwegian society came to grips with the discovery of North Sea oil and gas reserves in the late 1960s, the government recognised that this wealth would profoundly distort the Norwegian economy and society. The capitalisation of resource earnings in the Government Petroleum Fund, which was later renamed GPF-G, sought to impose discipline on budget planning in a manner consistent with intergenerational equity. If a 'rational' solution to the costs of temptation, it is apparent that the application of ethical criteria to investment management transgresses conventional boundaries between professional management and political interests in deliberately affecting global social and environmental standards. We seek to show, however, that there is an unresolved tension embedded in this policy. Indeed, there are two separate policies under the banner of ethical or socially responsible investment: one focused on corporate governance that seeks to affect the market performance of companies which are managed in ways inconsistent with long-term value, and the other focused on companies deemed to act in ways inconsistent with widely shared Norwegian expectations of proper behaviour. The Ministry of Finance oversees these policies through an unusual model of investment management.

In the penultimate section of the paper, we compare the Norwegian 'model' against Clark and Urwin's (2008) model of best-practice investment management. In doing so, it is observed that the Norwegian model is likely 'sub-optimal' on a number of the 'core' governance criteria identified as vital for best-practice performance. By implication, it is arguable that the governance system is quite inflexible in the face of changing global financial circumstances and the increasing premium on distinguishing the types of decisions according to their timeliness, resource-intensiveness, and reliance upon expertise. If there appear to be costs associated with the Norwegian governance model, we suggest that the functionality of the investment management process is more likely associated with political legitimacy rather than financial decision-making. Presumably, any 'costs' associated with this governance system are costs willingly borne by the public given the significance associated with accountability and the pursuit of shared values in the global arena.

In conclusion, this paper suggests that the opportunity costs of the Norwegian model may be growing as the structure and performance of global financial markets change in ways unanticipated by those that rely upon an historical approach to the issues. Here, we refer to recent research noting the increasing frequency and global propagation of financial crises (Barro 2006), as well as the changing significance of financial markets in domestic macroeconomic management (Borio 2006).

### **Political Legitimacy**

The idea that sovereign wealth funds may be the geopolitical instruments of their national sponsors, and the idea that SWFs may be subject to the arbitrary influence of organised domestic interests, are ideas often-times supplemented with another argument: investment management is an exacting discipline and should be protected from the public because of their lack of knowledge and expertise. In part, this is an argument about the costs of ignorance. It is also an argument familiar to many political theorists: some aspects of modern life are so complex and so significant for public welfare that it is far better if disinterested experts perform these tasks. In its broadest sense, this argument seeks to reconcile the democratic commitment to public participation with a knowing regard for those matters best left to others. Indeed, it could be argued that expert management of the economy and financial markets is a prerequisite for public participation in the daily life of culture and society.

Clearly, this type of argument does not find favour with social democrats. In fact, liberal political theorists believe that modern societies owe their legitimacy to public participation in the process of decision-making whether about economic, financial or social matters. However, it is also apparent that financial markets are especially demanding given the prevailing risk and uncertainty that characterises domestic and international markets. It would seem that periods of market stability that attach a premium to incremental decision-making are punctuated in unpredictable ways by episodes of market volatility, instability and crisis. Lessons learnt in one period about the theory and practice of investment management may not translate to subsequent periods when both the nature and probability of financial crises change and the rate of their global propagation increases (see Barro 2006 and the lessons drawn for financial governance by Clark and Urwin 2009). Whereas democratic societies may value very highly public participation in, or at least public representation on, the institutions responsible for financial management, there can be little doubt about the probable costs of policies that favour participation over expertise.

This argument has been made about financial governance in general and the governance of pension funds in particular. So, for example, when Clark et al. (2007) demonstrated that the skills of an untrained but representative UK pension fund trustee were little better than the skills of a neophyte, the implication drawn was that the balance between 'representation' and 'expertise' may have to be re-drawn if pension funds are to be effective institutions in the context of market uncertainty. This argument went against the policies of the Labour government that had placed a premium on representation over expertise, supposing that commonsense is sufficient to adjudicate between differing expert opinions. More recently, we have shown that those funds that have sought through innovation to enhance their performance have done so in part by mimicking best-practice in corporate governance where the selection, compensation, and allocation of responsibilities to board members reflects their expertise and their domain-specific skills (Clark and Urwin 2009). Here, the question of public participation and representation is 'resolved' by discriminating between those eligible to represent the public interest on these boards according to their qualifications.

In a similar vein, Estlund (2008) has argued that the accepted principle that western democracies owe their legitimacy to the willing participation of the public in collective decision-making is confounded by reality on two counts: most democracies

are actually representative rather than direct politics, and participation is hardly an unalloyed ‘good’ given the possibility of very poor decision-making in circumstances subject to partisan conflict over the purpose and prospects of public institutions. By this account, few of us have the opportunity to act directly in relation to the legitimacy of modern democracies; the conclusion to be drawn is that implied ‘consent’ rather than explicit tests of legitimacy is the most common metric of legitimacy. Therefore, states owe their legitimacy to the process of representation and the extent to which the resulting actions of governmental institutions have some validity beyond the obvious interests of those involved and the various options. For Estlund, validity hinges on the existence of an acceptable moral template that has widespread support if not universal acclaim. While he is properly concerned about the possible tyranny of a well-entrenched minority, his model of democracy has a test of the value of participation and representation.<sup>1</sup>

It is important to acknowledge, however, that tests of value need not be measured in economic or financial terms, nor need they be measured by outcomes. So, for example, in the Norwegian case it is apparent that the value attributed to ethical standards in the investment mandate of the GPF-G is, on one side of the equation, a moral value not a financial value. That is, the chosen ethical standards were conceived to flag-up areas of investment which the public would not accept as part of the GPF-G investment universe. As such, these standards are not subject to a profit and loss statement. As we note below, however, there are aspects of the policy that may well be justified by reference to long-term returns, but these are kept separate from the process of assessing ethical value. It is also apparent that there is a premium on the transparency and accountability of the process whereby ethical issues are evaluated. In fact, it might be argued that the process is more important than any outcome in these circumstances. Put slightly differently, the degree to which the public trusts the process of evaluation may determine the degree to which the public may dispute resulting ministerial decision-making. Equally, if it is decided after consultation and assessment not to exclude a company from the GPF-G mandate, the integrity of the process may be such that even those initially against the decision may be willing to accede to the decision.

In what follows, we examine in detail the governance of the GPF-G beginning with its formation in what was then known as the Government Petroleum Fund. We focus on the governance process including its institutions and the mechanisms of accountability precisely because the process is a constitutive element of the legitimacy of the whole edifice. As such, its claim to be heard in the rest-of-the-world is based, in part, on its bipartisan support at home and the process used to evaluate the ethical standing of identified companies from other jurisdictions. Perhaps paradoxically, such is the transparency and accountability of the governance process that the fund scores highly in independent tests of governance quality. Whether that translates into superior investment performance remains to be seen.

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<sup>1</sup>/. In this respect, it is arguable that democratic states carry with them an accepted moral purpose, going beyond simply the regulation of interest-group politics. This point is developed in more detail by Reus-Smit (1999) and forms the background to recent research over the importance attached by some states to inter-generational equity; see the study by Clark (2009) of the formation and political support attributed to the Australian Future Fund.

### **Establishment of the Petroleum Fund**

In 1990, an act of the national parliament established the Norwegian Government Petroleum Fund (GPF) (see Backer 2009). The reasons for its establishment are, in retrospect, widely appreciated: two different but complementary reasons for its establishment have been advanced. One reason references the potential costs of long-term resource wealth for the structural configuration of any economy that has to absorb such riches. Eriksen (2006) from the Norwegian Ministry of Finance rehearsed the argument made by many to the effect that resource wealth may distort the economy, discounting the value of agriculture and industry as well as the benefits of education for long-term individual human capital and social development. Although not mentioned directly, Eriksen effectively explained the establishment of the GPF as a policy designed to at least ameliorate the ‘curse’ of resource wealth. As Skancke (2000, 326) noted, the ‘Dutch disease’ can result in the “weakening of international exposed industries” and “substantial restructuring costs and unemployment” (see Appendix).

A second reason for establishing the fund was the potential short-term costs of fluctuating revenues for macroeconomic stability. For such a small economy, the volume and volatility of resource earnings posed a threat to domestic economic stability. This point has been made in a number of other smaller, developed countries such as Australia and Canada. So, for example, the Australian Future Fund was established, in part, to dampen the flow-on effects of booming resource prices on an already capacity-constrained economy (Clark 2009). For Norway, moreover, the question of macroeconomic stability was particularly acute because of the significant and sustained increase in public spending based on resource earnings over the late 1970s through the 1980s. The increasing reliance of the public *fisc* on resource earnings for social welfare threatened to amplify the volatility of international resource prices through the Norwegian domestic economy. Given the fixed nature of public spending when channelled through multi-year commitments, unpredictable foreign earnings could result in accumulated public indebtedness as unfunded government spending seeks to dampen the effects of price volatility.

At the time of the establishment of the GPF, two political aims (called *handlingsregel*) were applied to manage the public budget process and the flow of earnings to the fund. In the first instance, so as to constrain the future reliance of government spending on oil and gas revenues, a notional long-term ‘share’ of resource wealth was set. In the second instance, so as to impose discipline on the year-to-year budget process, the flow of earnings to the fund was made dependent upon year-to-year budget surplus. That is, the aim was that only in budget surplus would an allocation be made to the fund. For Skancke (2000, 320), these two rules and the fund itself could be “seen as a fiscal management tool to ensure transparency in the use of petroleum revenues.” Further, he contended that policy makers believed that the Fund should be closely aligned with the budget process and noted that “a budget surplus is the only way a government can accumulate financial assets on a net basis.” In the Norwegian case, fiscal discipline in the face of resource wealth was to be sustained through a comprehensive financial management process rather than sequestering ‘windfall’ assets into a self-governing independent fund (as in Australia; see Clark 2009).

Because of the global recession in late 1989 through the early years of the 1990s, the Norwegian government budget did not return to surplus until 1995 when the first allocation was made to the GPF. Thereafter, reserves have grown dramatically. In Figure 1, the combination of earnings inflows and returns on investment are depicted showing that the fund grew from NOK48 billion in 1996 to just over NOK1000 billion in 2004 and then doubled in value through the on-set of the global financial bubble through to 2008 only to loose asset value in the consequent downturn. In the first instance, assets were invested in Central Bank currency reserves. In 1998, the government allowed investment in foreign equities with an initial allocation of between 30-50 per cent (and the equity portion of the benchmark portfolio was 40 per cent) of assets. It is notable that the fund is required to invest in traded foreign securities subject to the interplay between strategic asset allocation and actual market performance. We return to this issue in later sections, especially as regards the implications of such holdings for meeting ethical commitments.

[INSERT FIGURE 1 ABOUT HERE]

In 2006, the GPF was renamed the Government Pension Fund-Global (GPF-G). The renaming of the fund reflected strategic issues as regards the long-term economic and financial prospects of the country. Eriksen (2006) observed that by 2005 the petroleum sector accounted for 25 per cent of the Norwegian GDP and that the net cash flow of oil and gas revenue accounted for 33 per cent of the government's revenue. At the same time, Eriksen noted that both crude oil and gas production were close to achieving their likely peaks in production and that there were some uncertainties over the future scope and size of reserves (depending on the rate of exploration and exploitation). Forecasts of future production by the Ministry of Petroleum and Energy cited by Eriksen suggested that the volume of oil production would likely decrease by as much as 66 per cent through to 2030 and the volume of gas production would likely decrease through to 2030 by about 25 per cent. Inevitably, net earnings would follow production and the global prices for these resources. By this account, the rate of growth in Norway's accumulation of wealth would likely decline as well.

As noted in many studies of the spending patterns of western governments, the ageing of the baby boom generation and the increasing longevity of each cohort as they age through retirement implies a growing liability against a likely absolute decline in most European countries' total population. Estimates from the OECD suggest that Norway will also be affected by these trends, leading to a twofold growing liability: making good on the costs associated with the retirement of the expanding public sector employment and making good on the costs of increasing longevity for those that stand to benefit from these promised benefits. In the context of declining (in relative terms) expected resource revenues and increasing commitments to the retired population, the Norwegian government, like a number of governments, has sought to invest for the future. While the GPF-G is not a traditional pension fund, as it has no direct liabilities, Skancke (2000) argued that an important purpose of the GPF is to insure the long-term payment of those obligations and hence protect the welfare of future generations of Norwegian citizens. When the Australian government came to consider the management of resource income, the experience of the Norwegian government was as a powerful reference point for the argument in favour of

sequestering assets. In this case, though, the GPF-G has remained within the direct responsibility of the Ministry of Finance.

### **Structure, Control, and Accountability**

The Parliament (*Storting*) established the status and powers of the Norwegian Government Pension Fund. Therein, a distinction is made between the GPF-Global, which holds the flow of net receipts from Norway's petroleum reserves and the GPF-Norway which holds the assets and liabilities of the government's National Insurance Scheme (NIS). Together, the purpose of the fund is "to support government savings to finance the pension expenditure of the NIS and long-term considerations in the spending of government petroleum revenues" (Ministry of Finance 2009, 11). Further, the Ministry is charged with the responsibility for the management of the fund including its investment strategy, the regulation of investment, and its ethical guidelines. Operationally, the GPF-G is managed by the Norges Bank through Norges Bank Investment Management (NBIM) and is accountable to the Minister through the Bank's Governor and Board. Figure 2 maps the various institutions involved in the governance of the fund including the hierarchical status attributed to the NBIM (manager), the Ministry (principal), and Parliament (legislator).

[INSERT FIGURE 2 ABOUT HERE]

The Ministry has a secretariat dedicated to the management and regulation of the fund staffed by permanent civil servants. There are advisors to the Ministry on matters pertaining to the management of the fund including the Council on Ethics (and until this past August the Council of Investment Strategy). Both Councils have 'members' appointed by the Minister for fixed terms with mandates to advise the government on important policy issues (see below). So, for example, the Ethics council is comprised of 5 appointed members, a staff of 8 government employees, and an annual budget of NOK9 million. Appointees to the Ethics council are expected to be independent experts, with appropriate knowledge of ethics in theory and practice and Norway's international commitments as evident in treaties and conventions as well as OECD and UN agreements and guidelines. The current Council has three professors, two of which have significant expertise in international law. In summary, "the Council on Ethics provides evaluation (to the Ministry) of whether potential investments in financial instruments issued by specific issuers are inconsistent with the ethical guidelines" (Ministry of Finance 2009, 12).

Unlike some SWFs where government delegates the framing and execution of investment strategy to the designated responsible board, in Norway the Ministry has a detailed set of 'Provisions' that effectively regulate the management and operation of the Fund. To illustrate, Section 1 of 'Regulations' (found in Provisions) states that the "Norges Bank manages the Government Pension Fund-Global ... on behalf of the Ministry of Finance. The Bank may use other managers." Regulation requires investment in instruments denominated in foreign currencies subject to an asset allocation formula with various elements: first, assets are to be allocated to fixed income instruments between 30-70 per cent and equity instruments 30-70 per cent. The Ministry also sets the geographical spread of assets such that fixed income and equity assets are to "be invested in accordance with the following currency and regional distribution": respectively Europe 50-70 per cent and 40-60 per cent, the

Americas and Africa 25-45 per cent, and Asia and Oceania 0-15 per cent and 5-25 per cent. In short, the Ministry determines the asset classes that are permissible.

The Ministry regulates the benchmarking of investment portfolios, the rebalancing of the fund, the limitation of tracking errors, and the valuation, measurement and control of investment risk. The Ministry also sets expectations as regards proper investment behaviour: on tracking errors, its Guidelines state that the Bank shall “employ conservative estimates and methods making it more likely that expected tracking error will be overestimated than underestimated” and “an important objective for the risk system is that risk attending financial instruments should be calculated in such a way as to ensure that, over time, estimated risk in the Fund deviates as little as possible from actual risk.” On investment in countries not previously included in the Bank’s portfolio, the guidelines require “a thorough process” of review and risk assessment; on valuation and performance measurement, the guidelines require compliance with “international recognised standards and methods”. On the valuation and measurement of returns, the guidelines require monthly valuation reports; and on risk management, there are detailed and extensive requirements on assessment, measurement, and reporting (see Sections 4.2 and 4.3 of the ‘Guidelines’).

Section 5 of the “Guidelines for the Management” of the fund provides instructions as regards the “ethics”. In Sec 5.1 the Ministry sets out two statements of principle: first, “the Fund is an instrument for ensuring that a reasonable portion of the country’s petroleum wealth benefits future generations and “financial wealth must be managed with a view to generating a sound return in the long term, which is contingent on sustainable development in the economic, environmental and social sense” and; second, “the Fund shall not make investments that entail an unacceptable risk that the Fund is contributing to unethical acts or omissions” including violations of humanitarian principles, human rights, gross corruption, and severe environmental damage. In the following Section, the Ministry identified three ways in which ethical considerations were to be given effect: through the exercise of ownership rights based on international conventions, negative screening of companies that produce weapons whose use violates fundamental humanitarian principles, and the exclusion of companies from the fund’s portfolio that are deemed to constitute a “considerable risk” of corruption, environmental degradation, and the violation of human rights. The Ministry’s Council on Ethics advises on the first two matters (negative screening and exclusion) while exercise of ownership is managed exclusively by the NBIM; though final authority for any related decision rests with the Minister.

Should a decision be made to exclude a company from the Fund’s portfolio, the decision is transmitted to the Bank and is implemented by the NBIM. As to the exercise of ownership rights, Sec 5.3 states that the “exercise of ownership rights shall be based on a long time horizon and broad diversification of assets across markets informed by the appropriate international and national guidelines on corporate governance.” Elsewhere, this policy is described in terms of the circumstances (and responsibilities) that face what Hawley and Williams (2005) term as ‘universal owners’—institutional investors that, by reason of their size, hold such significant stakes in the market for traded securities that portfolio diversification is not an adequate means of risk management (see also Gjessing and Syse 2007). The NBIM, as the entity charged with exercising ownership rights, holds the equity of nearly 8000 companies. In doing so, the Bank is required to report on an annual basis the nature

and scope of these activities including the voting of proxies, corporate engagement and the initiation and participation in campaigns designed to encourage or enhance standards of corporate governance and its regulation around the world.

### **Governing Ethics**

As one of the world's largest SWFs, the GPF-G is widely recognised as a remarkably transparent and well-governed financial institution. By Truman's (2007) assessment, based on publicly available information, the GPF-G scored 92 out of a possible 100 in terms of its adherence to best-practice. In doing so, it came second only to the Alaska Permanent Fund (which scored 94). By contrast, the average score across 34 non-pension funds was 46—the Alberta Heritage Fund scored just 77 against Truman's criteria. The GPF-G has also led the development of the Santiago Principles arguing for the importance of agreed principles and practices consistent with global best-practice. Indeed, international conventions loom large for the GPF-G: shared principles and practices are referenced time and again in official statements that justify investment decision-making with an explicit ethical component. If these statements have a rhetorical element, there is little doubt that they are underpinned by broad bipartisan political support (see Runciman 2008 on rhetoric as a substantive commitment).

By Ministry edict, the GPF-G is required to keep any individual equity holding to less than 10 per cent of outstanding shares. As such, the GPF-G is always in a minority position, and for the vast majority of holdings its claim on outstanding shares is less than 1 per cent. Nonetheless, in some cases to hold 5-10 per cent of a company may provide the GPF-G considerable power over management especially if combined with the holdings of other large institutional investors. It is not surprising that “there are concerns reflecting the view that the growing size of SWFs matters and that sovereign fund management may be motivated by non-economic considerations, deviating from conventional wealth maximization” (Aizenman and Glick 2008, 23). On the ethics issue, however, it is arguable that the principles and practices followed by the Council on Ethics and the Ministry of Finance are such that negative screening and exclusion have the virtues of deliberation and transparency. That is, it is arguable that the process of review, recommendation, and Ministry decision-making is such that the application of ethical principles to GPF-G investment can claim both virtue and integrity.

It appears that the government established the Council to deal with a controversial issue: investment in Total, the French energy company with significant investment in Myanmar (Burma), and the ensuing claims that it was complicit in the military regime's suppression of human rights (though the Graver Report was specifically responsible for the ethical guidelines; see also Chesterman 2008). At the time, there was considerable political pressure on the Minister to personally direct NBIM to exclude Total from the GPF-G portfolio. The formation of the Council, its mandate, and the appointment of members with acknowledged expertise in ethics and international law provided the Ministry with an opportunity to postpone any decision and deflect claims made on the Minister. However, it is apparent that the formation of the Council meant that the government could hardly reject out-of-hand any recommendation. This is recognised by the major political parties, and has been acknowledged as government has changed from centre right to centre left over the past 5 years.

From this issue, the Council has developed a multi-stage process of review and assessment designed to identify the crucial issues and apply a series of decision-rules that provide for robust and defensible recommendations. The Minister may ask the Council to consider a specific case, and the Council may identify an issue and company that it considers significant (given the limits of time, expertise, and institutional capacity). The Council maintains a regular ‘scanning’ process conceived to keep members abreast of the issues on a worldwide basis. Given the various issues and companies identified by the ‘scanning’ process, the Council undertakes research to better understand the significance of the identified issues drawing upon the enormous flow of information available on the web and from NGOs. As ‘targets’ for assessment and evaluation are identified, the Council limits disclosure of their interest so as to dampen speculation and political manoeuvring. Having decided there is a case to be considered given the terms of the Council’s mandate, a factual case is developed focused, in part, on the extent to which the company is directly involved in the ethical violation. The last stage in the process normally involves contacting the target company with a view to eliciting a response. Thereafter, the case is formally presented at the Council, and the members make their determination as to whether a recommendation for exclusion should go forward to the Minister.

Over the period 2005 to 2009, the Council recommended that a number of companies be excluded. In Table 1, the companies, the issue that was the basis of the Council recommendation and the date of exclusion are summarised. In almost all instances, the Minister accepted the recommendation. Note that the companies excluded come from a variety of jurisdictions although the largest single group are US corporations (perhaps reflecting the significance of US corporations in the weapons industry).

[INSERT TABLE 1 ABOUT HERE]

Here, it is useful to emphasize three aspects of the Council’s business. As noted above, the Council has limited time, expertise and institutional capacity. Inevitably, it has had to choose amongst a large number of possible cases. As noted elsewhere, large companies with recognised names are attractive targets given their public visibility (Clark et al. 2008). The Council is also concerned to distinguish between ‘association’ and ‘causality’: that is, their case is strengthened when it can be shown that the target company has a direct connection with the circumstances giving rise to the ethical assessment. Most importantly, the Council sees its recommendations as an expression of the public interest in "proper" behaviour, according to the criteria set out in the ethical guidelines. As such, the Council is not concerned to affect corporate behaviour except in the sense that ‘naming and shaming’ may prompt companies to reconsider their alliances and management performance (Braithwaite 1989).

By contrast, the NBIM’s commitment to high standards of corporate governance seeks to affect the structure and performance of the companies that are targets of actions and campaigns. This can be justified on efficiency grounds, as well as ethics. It is widely accepted that well-governed firms are more likely to enhance shareholder value (Bebchuk 2005). Equally, it is widely accepted that some governance regimes are more likely to protect the interests of minority shareholders than others such that reform of the regulation of corporate governance in favour of global best-practice is consistent with the long term efficiency of global capital markets and the interests of

large institutional investors (Gordon 2004). In this context, the actions of the NBIM in exercising the GPF-G's ownership rights through proxy voting, sponsoring and supporting shareholder resolutions, and corporate engagement have the virtue of promoting the GPF-G's financial interests as well as acting consistently with respect to collective welfare. In these matters, the NBIM is an active investor—the 2008 Annual Report of the GPF-G noted that the fund voted on more than 68,000 items at more than 7500 annual meetings around the world.<sup>2</sup>

In practice, the NBIM has relied upon international standards of corporate governance to motivate its campaigns for best-practice corporate governance. In part, this is because recognised international standards allow for coalition-building amongst large institutional investors that have a global mandate. In part, these standards allow for third-party validation of campaigns, especially as events prompt shareholder response to apparent instances of malpractice. So, for example, the common expectation that the Chairman and CEO of major corporations be held by separate people with clear roles and responsibilities has been an important reference point in motivating shareholder actions. Given limited time, expertise, and institutional capacity the NBIM office tends to focus its voting activities upon the world's 500 largest companies, representing approximately 80 per cent of the market value of the total equity portfolio of the GPF-G. Moreover, the NBIM has sought to influence not only individual companies but also whole industries, especially those with distinctive characteristics (eg. seed producers). The goal is to safeguard the GPF-G's financial assets, and add value over the long term recognising that  $\beta$  (beta) investment strategies that rely upon the performance of whole markets often depend upon regulation and investor vigilance.

Recently, the NBIM strategy for active ownership has been revised (by the Executive Board) and through that deepened and broadened. Most specifically, the NBIM focuses upon 6 areas: the first set of 3 relate to capital market performance and the second set of 3 relate to three substantive issues, which represent for the fund areas of significant risk as regards safeguarding the long term value of the portfolio. The first three are: equal treatment of shareholders, shareholder influence and Board accountability, and well-functioning, legitimate and efficient markets. The second three issues are: children's rights, climate change, and water management. So, for example, protecting children's rights could involve major corporations that have extensive supply networks through to the developing world. Based upon ILO conventions, the NBIM has sought information on sectors' child labour practices, the extent of company monitoring of this issue, and disclosure on existing practices and intended policies. As noted elsewhere, these issues can have significant implications for sectors of the economy where 'value' is a product of corporate reputation and consumer tastes. In this respect, reputation can be a significant albeit intangible asset (Clark and Hebb 2005).

In many respects, the NBIM agenda is about protecting and creating long term value. If relevant in this respect, ethical commitment has more to do with the long term

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<sup>2</sup>. This role is shared by a number of other, very large institutional investors from the UK, USA, Canada and Australia. The most active institutional investors tend to be pension funds rather than sovereign wealth funds and are motivated, in part, by the fact that their investment performance is dependent upon the efficient functioning of home and global financial markets. See Clark and Hebb (2004) and Hawley and Williams (2000) for historical accounts of this development.

consequences of corporate engagement than the virtues of acting in a manner consistent with social values. This difference can be starkly if crudely put as follows: the NBIM is consequential in intention whereas the Council is deontological in intention. This distinction goes to the heart of differences in intended effects between the two arms of Ministry policy. Nonetheless, efforts have been made to encourage cooperation between these two units of government. In the external assessment of Articles 3 and 4 of the Ethical Guidelines, the Review Panel (Ministry of Finance 2008) noted the apparent overlapping interests of the Council and the NBIM and recommended greater coordination as well as the allocation of more resources to better manage these issues. Even so, basic differences in philosophy are likely to persist, making coordination more problematic than some believe.

### **Best-Practice Fund Governance**

As noted above, the Norwegian GPF-G scores highly on the governance framework made popular by Truman (2007). It also has an enviable reputation as an innovative and progressive investment fund—witness the success of the Santiago Principles and the world-wide interest in its ethics policy. And yet, it has a number of characteristics that Anglo-American commentators on SWFs find problematic. Most importantly, it is, in fact, integrated with the elected political process being accountable to the Minister of Finance and ultimately Parliament. The institution that oversees and regulates the investment process is, in fact, the Ministry not the Norges Bank or its investment management arm the NBIM. This is apparent, for example, in the degree to which the Ministry sets the asset allocation, receiving advice from an advisory council that answers to the Minister and the NBIM. This includes quantitative rules on asset allocation by class and geography, and the behavioural imperatives associated with caution and risk management. If this governance process has the virtue of transparency it is, nonetheless, a process that has as its fundamental goal the political legitimacy of the fund and its commitment to intergenerational equity.

Indeed, it is arguable that the GPF-G governance process is essentially a political process rather than an investment management process whose objective it is to sustain the functional efficiency of investment decision-making. In what follows, we seek to justify this view with reference to the framework on best-practice investment management developed by Clark and Urwin (2008, 2009). Before doing so, we should acknowledge that this distinction between the political interests embedded in established institutions and their functional efficacy with respect to achieving certain goals and objectives is highly contested. Roe (2006), for instance, argues that institutions by their very nature carry with them the political compromises that were instrumental in their conception and design and that any institution necessarily carries-forward those interests even if functional efficiency is less than perfect. Merton and Bodie (2005) would likely acknowledge this fact-of-life but also contend that the imperfections of human nature as evident in the findings of the behavioural revolution suggest that institutions have an important role in making good on social welfare given the limits of human reasoning.

Two implications follow from this debate over institutional design. Most obviously, it seems inevitable that investment managers operate in institutions that were conceived at a certain time and in a certain place framed by the interests reflected in accepted governance procedures. Also important, though, is the functional efficacy of these institutions in relation to their purpose—it also seems inevitable that functional

efficacy is a vital reference point in assessing institutional governance and performance. In this sense, the criteria used to score governance must also be sensitive to the environmental imperatives such as the nature and performance of financial markets and the ways in which governance procedures and practices are consistent with high standards of performance in this type of environment (Clark 2008). The 12-point governance framework discussed in this section and applied to the GPF-G emphasises functionality over political legitimacy (see Truman 2008).

Clark and Urwin (2008) began by distinguishing between 6 ‘core’ attributes of best-practice and 6 ‘exceptional’ attributes of best-practice investment management. If framed with reference to recent global developments in pension fund governance, it is apparent that the logic is applicable to a range of investment institutions including endowments and sovereign wealth funds. Notice, in this case the Norwegian fund is labelled a ‘pension fund’ by government, indicating a commitment to underwriting long-term commitments associated with public sector employment. And yet, it is not strictly a pension fund if what is meant by such a label is an institution with identifiable beneficiaries, expected liabilities by individual participants or cohorts of participants, and/or specific roles and responsibilities for participants’ future welfare. So, for example, those responsible for the governance and management of the fund are not fiduciaries in a legal sense but employees or elected politicians with responsibility for social welfare. Therefore, care must be used in applying these best-practice attributes.

We suggest that ‘mission clarity’ is the first, core attribute of a well-governed institution. While we recognise that the GPF-G has certain responsibilities including the “sound, long-term management of Norway’s petroleum wealth” in such a way that “this wealth can benefit all generations” in a manner consistent with macroeconomic “stability” (Ministry of Finance 2009, 11), this mandate combines a set of objectives that are more or less consistent with one-another rather than a well-defined risk and return mandate that is increasingly common amongst newly established institutions. In effect, the mission statement is a set of ‘golden-rules’ rather than operational targets with well-defined time horizons. The second core attribute features an ‘investment executive’ involving “an explicit ‘map’ of institutional authority, distinguishing the responsibilities of trust boards, executives, and service providers.” In this case, there is a hierarchical ‘map’ of authority in which the Minister of Finance and NBIM hold the power, but there remains some confusion as to the role of certain advisors.

As for the third core attribute of best practice, we argue that institutional performance is best sustained by “resourcing each element in the investment process and governance chain with an appropriate time and resources budget.” It is difficult to come to a conclusion on this issue with regard to GPF-G. It is notable that the Ministry has allocated significant resources to both advisory councils just as the NBIM has allocated resources for the corporate governance initiative. Nonetheless, there remain resource constraints (see above). With respect to item 4, investment beliefs, it is apparent that the investment advisory council has set the agenda emphasizing the long-term patterns of return of different asset classes in relation to the relevant academic studies (see Dimson et al. 2002). Belief in the existence of a long-term equity premium underpins the fund’s investment strategy. Because of the lack of measured liabilities, it is more difficult to hold the fund to account on its risk

budget. Notwithstanding the quantitative risk parameters set for specific asset classes, the risk parameters for the entire portfolio are difficult to determine. Finally, we are not able to comment on the sixth issue—the effective use of external managers.

The second set of best-practice characteristics emphasizes the management of the investment function. Here, the leadership, staffing, and coordination of investment management with respect to the timeliness of decision-making are crucial issues. With respect to the GPF-G, it is apparent that the fact that the fund is not a stand-alone entity and is bound-up in a hierarchical structure of political accountability suggests that on many of these issues the GPF-G is not close to global best-practice. Given the reporting structure, the layers of boards and advisory councils, and the multiplicity of ‘golden rules’ it is not surprising that decision-making is more often formal rather than informal, and is based on the reporting process rather than the imperatives flowing from global financial markets. This is justified, of course, by the edict that GPF-G is a long-term investor. Even so, it is arguable that even if the fund is  $\beta$ -focused, the process of decision-making should be designed to enhance the timeliness of market plays.

Gieve (2009, 11), a previous Deputy Governor of the Bank of England, in commenting on the re-regulation of banks in the aftermath of the global financial crisis noted that inertia and risk-amplification is a possibility in circumstances where there are close links between the regulators and financial institutions. In these circumstances “banks and regulators are in constant discussion and negotiation and tend to develop shared views and shared misjudgements”. The issue for the GPF-G is whether the political process of governance, designed as it is for political legitimacy, is fit-for-purpose for a global investment institution sensitive to the nature and rate of innovation in financial markets (Merton 1995).

### **Implications and Conclusions**

One way of justifying public institutions is to ‘test’ their legitimacy against independent norms, including functionality. When coupled with unambiguous goals and objectives, the test of functionality allows observers (even voters) to discriminate between competing institutional forms and attribute to those that are found ‘superior’ appropriate support. If this logic depends upon the existence and routine application of a public ethic of perfectionism, it has broad support across the social sciences including financial theorists (Merton and Bodie 2005). Few public institutions begin life in such a manner, and it is arguable that over time public institutions become increasingly encumbered with various amendments to their mandates such that their functional effectiveness is increasingly compromised. At one level, this is a *realist* observation about the life of institutions in western democracies. At another level, it draws on theories of institutional formation and interest-group representation that are arguably essential in understanding the nature of public regulation (Roe 2006).

In this paper, we have sought to analyse the legitimacy of the Norwegian GPF-G from a rather different standpoint arguing that public support for its existence depends upon the process whereby the public interest in its decision-making is governed. It is shown that there is a premium on public accountability, represented by the Minister of Finance and the accountability of the Minister to government and ultimately Parliament. This process-based claim for institutional legitimacy has been very successful; witness the bipartisan support for the institution, its commitment to

intergenerational equity, and global justice. Indeed, it is shown that the Ministry of Finance is at the centre of a web of governmental entities all of which have a role in either implementing or overseeing the GPF-G mandate. It is also argued that this institutional framework is representative of what Estlund (2008) has termed *epistemic proceduralism*: a means of legitimating institutions by virtue of the processes used to represent the public interest rather than the functionality of those institutions against certain expected outcomes.

There is a paradox deeply embedded in the governance of the GPF-G. On one side of the equation, it is clear that the procedures developed to give effect to the public interest in ethics and global justice have been very important in representing shared commitments to Norway's international obligations. The recommendations of the Council on Ethics on GPF-G investment are taken very seriously by the Ministry and serve as a vital element in screening and excluding companies from the GPF-G investment portfolio. But it should be obvious that naming and shaming hardly ever moves markets, and the instant Norway disinvests another investor takes its place. There is little evidence that naming and shaming increases the long-term cost-of-capital for the affected companies. Nonetheless, naming and shaming is an essential ingredient in their process-model of institutional legitimacy: the Council and its recommendations are meant to *represent* public values. Whether or not these recommendations exact a penalty on the targeted companies is less important.

In this respect, the transparent nature of this type of decision-making and its apparent accountability to the democratic process are widely cited and score highly in comparative studies of SWF governance (witness the Truman 2007 scores). But it is apparent that scoring the governance of the investment decision-making and management process is far more problematic. When we sought to apply the global best-practice governance criteria and scoring regime developed by Clark and Urwin (2008, 2009) for pension funds and other institutional investors it became apparent that the premium on epistemic proceduralism may compromise the functionality of investment management. Of the most important core elements of best-practice fund governance, it is apparent that there is considerable ambiguity over the mandate of the fund, the decision-making process is so complicated that it is difficult to determine whether the fund has appropriate resource-budget just as it is difficult to determine whether the effective decision-makers up and down the chain of accountability have the requisite skills and expertise. There are, no doubt, clear and well-articulated investment beliefs flowing from the investment advisory council. But, again, it is difficult to trace through the effect of those beliefs on investment managers.

The paradox can be stated in the following terms: at one level, the GPF-G is a transparent and accountable institution which scores highly on recognised governance criteria reinforced by its support of the Santiago Principles. At another level, however, there are reasons to doubt the functionality of the process of accountability and transparency for timely and resource-efficient long-term investment. So, whereas the GPF-G may score highly on accountability, it is not as clear that it would score as highly on functionality. Of course, given the premium attributed to epistemic proceduralism this may be entirely appropriate. But, we doubt that in a resource-constrained environment that functionality can be ignored (see also Das et al. 2009).

A distinction might be drawn between the high premium on timeliness and decision-making effectiveness in short-term investment management and the ethos of long-term investment which is meant to take a strategic perspective on short-term volatility. We note, for example, that the asset allocation formula is based on the finding made popular by Dimson et al. (2002) that over the past 100 years equities have out-performed bonds and that trading for short-term advantage incurs both high direct costs and high opportunity costs relative to holding stocks over the long-term. In setting the fund's investment strategy based on this argument may effectively buy enough time to allow those involved in decision-making to negotiate their way through the political process. But, there is considerable debate over the degree to which the past 100 years are an adequate recipe for the next 100 years (witness Borio 2006). Dimson et al.'s findings hinge on the moment in which we may find our ourselves in the past 100 years, and the degree to which globalisation has accelerated the integration of global capital markets such that financial crises will be more rapidly propagated through all markets (see Barro 2006).

By this logic, the underlying structure of financial markets may be changing so profoundly (see Borio 2006) such that the costs of epistemic proceduralism are far higher than expected. If so, the claimed basis of GPF-G legitimacy may be self-defeating. As such, the political legitimacy of the GPF-G may threaten the fund's functional legitimacy. If so, another way may have to be found for Norwegians to give affect to their ethical commitment to international justice.

#### **Appendix: The 'Dutch disease'**

The discovery of large fields of oil and gas in the North Sea during the late 1960s provided Norway an 'unearned' windfall that came on-stream during the early 1970s and is likely to last through to at least 2030. Karl (1997, 247-9 Tables A-2 and A-3) reported that, for Norway, from 1971 to 1972 the annual real rate of growth in government revenue jumped from 12 per cent to 72 percent followed in 1973 by an increase in real expenditure of 61 per cent. Unlike many other resource-rich countries, then and now, this windfall was absorbed into an already established nation-state characterised by entrenched democratic traditions and a relatively conservative administrative system. As Karl suggested, burgeoning resource wealth is often coincident with nation-state formation thereby affecting the structure and shape of the emerging relationships between government, (often multinational) corporations, and civil society. Resource riches have subverted nation-state formation by privileging elites closest to the flow of inward investment and export revenue while impoverishing the majority otherwise isolated from the flow of benefits.

As North Sea revenue came on-stream it became apparent that even the most advanced countries could be adversely affected by the 'bonanza'. Corden (1982) and Corden and Neary (1986) are credited with identifying the adverse consequences of unearned windfalls summarised in the phrase "the Dutch disease". With reference to the experience of the Netherlands, it refers to "an overvalued currency that impedes non-primary exports and perhaps total exports as well, and a heavy dependence on natural resources which, in times of resource booms, is viewed as the root cause of the real overvaluation of the (national) currency" (Gylfason 2001, 302). The negative effects of resource-dependence can affect the structure of the whole economy: the lack of local backward and forward linkages, the limited employment effects of resource development, and low returns on education can effectively bifurcate the host

economy and isolate inherited non-resource assets from the global economy (Auty and Kiiski 2001).

Resource earnings began to flow to Norway, the UK and the Netherlands in the early 1970s at a time of global financial crisis and stagflation in most developed economies. Two oil price shocks and the unravelling of the European social consensus forged in the aftermath of the Second World War, undercut economic policy management in many European states during the 1970s and early years of the 1980s (Nothermans 2000; Ch. 5). For instance, the UK registered an average yearly government budget deficit of approximately 3 per cent of GDP (nominal) over the period 1973 to 1987 following a similar path to Germany and somewhat better than the Netherlands over the same period of time. In terms of unemployment, the UK registered annual rates higher than most other western European economies with peaks of 3 per cent (1972), 5.5 per cent (1977), and over 10 per cent through the years 1981 to 1986. By contrast, Norway maintained much lower rates of unemployment averaging approximately 3 per cent over the period 1973 to 1990 (but with a dramatic increase in the early 1990s), with government budget surpluses averaging approximately 4.5 per cent GDP over the period 1973 to 1990. North Sea revenue underwrote Norwegian economic prosperity over this period (Karl 1997, 217), transforming an otherwise relatively poor country into one of the most prosperous in the world.

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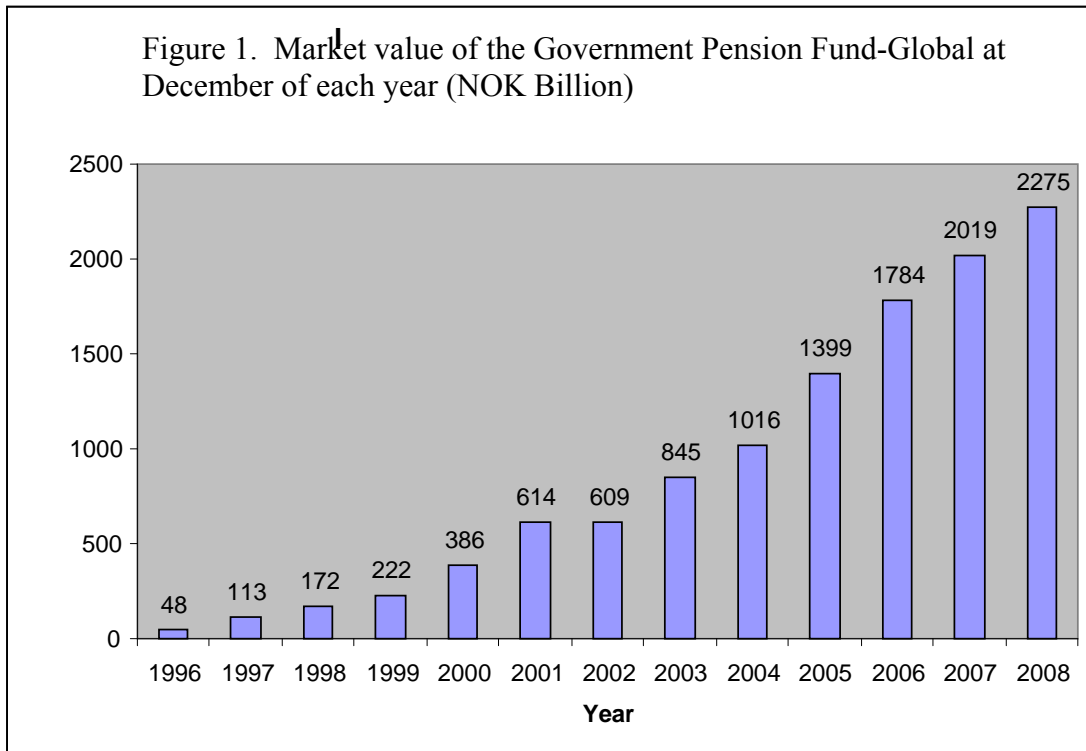
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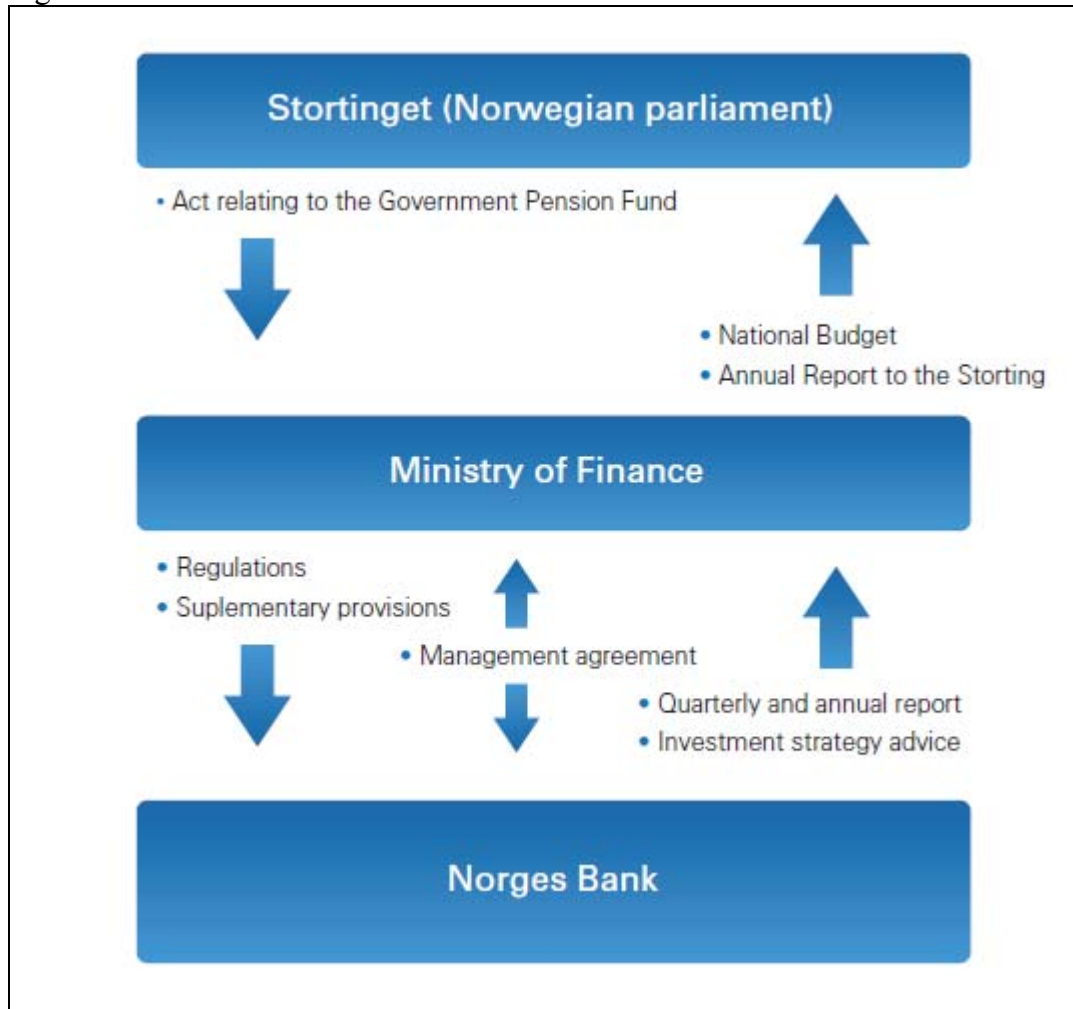
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Figure 1. Market value of the Government Pension Fund-Global at December of each year (NOK Billion)



Source: [http://www.norges-bank.no/templates/article\\_\\_\\_\\_42086.aspx](http://www.norges-bank.no/templates/article____42086.aspx)

Figure 2:



Source: [http://www.norges-bank.no/upload/73979/nbim\\_annualreport08\\_rev.pdf](http://www.norges-bank.no/upload/73979/nbim_annualreport08_rev.pdf)

**Table 1.** Companies excluded from the investment universe by the Ministry of Finance upon recommendation by the Council of Ethics \*

Reason	Date	Company
Anti-personnel landmines	26 April 2002**	Singapore Technologies Engineering Ltd, Singapore
Companies supplying arms or military equipment to Burma	28 February 2009	Dongfeng Motor Group Co. Ltd, China
Cluster munitions	31 August 2005	Alliant Techsystems Inc, USA General Dynamics Corporation, US L-3 Communications Holdings Inc, US Lockheed Martin Corporation, US Raytheon Company, US Thales SA, France
	30 November 2006	Poongsan Corporation, South Korea
	31 December 2007	Hanwha Corporation, South Korea
	31 December 2008	Textron Inc, US
Nuclear weapons	31 December 2005	BAE Systems plc, UK Boeing Company, US Finmeccanica SpA, Italy Honeywell International Inc, US Northrop Grumman Corp, US Safran SA, France United Technologies Corp, US
	10 May 2006	EADS Co, Netherlands***
	31 December 2007	GenCorp Inc, US Serco Group plc, UK
Breaches of human rights	31 May 2006	Wal-Mart Stores Inc, US Wal-Mart de Mexico SA, Mexico
Environmental damage	31 May 2006	Freeport McMoRan Copper and Gold Inc, US
	31 March 2007	DRDGOLD Ltd, South Africa
	30 June 2008	Rio Tinto plc, UK / Rio Tinto Ltd, Australia
	30 November 2008	Barrick Gold Corporation, Canada
Environmental damage and breaches of human rights	31 October 2007	Vedanta Resources plc, UK Sterlite Industries Ltd, India Madras Aluminium Company, India

**Notes:** \* The company Kerr-McGee Corporation was excluded on 31 May 2005 because the company was active in Western Sahara. These activities ceased in spring 2006, and the company (subsequently merged with Anadarko Petroleum) was included again from 30 June 2006. \*\* Exclusion of Singapore Technologies Engineering Ltd was recommended by the Advisory Commission on International Law. On 30 November 2001 the Government appointed a special advisory Commission on International Law for the Petroleum Fund. The Commission should, at the request of the Ministry of Finance provide an evaluation of whether specific investments are in conflict with Norway's commitments under international law. When the Ministry of Finance issued ethical guidelines for the Government Petroleum Fund in autumn 2004, the exclusionary mechanism was extended and the Advisory Commission on International Law was replaced by the new advisory Council on Ethics. \*\*\* EADS was originally excluded on 31 August 2005 because the company was involved in the

production of cluster munitions. EADS no longer produces cluster munitions. However, EADS is involved in the production of nuclear weapons, and the Ministry of Finance therefore renewed its exclusion on 10 May 2006.

Sources: Norges Bank Investment Management, Government Pension Fund - Global, Annual Report 2008; Council on Ethics for the Government Pension Fund - Global, Annual Report 2008, p. 12; Website Ministry of Finance, Norway:

<http://www.regjeringen.no/en/dep/fin/Selected-topics/The-Government-Pension-Fund/Ethical-Guidelines-for-the-Government-Pension-Fund---Global-/History.html?id=434896>

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