The Regulation of Sovereign Wealth Funds

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Acronyms and Abbreviations

ADIA Abu Dhabi Investment Authority

AIF Alternative Investment Fund

AIFM Alternative Investment Fund Manager

AIFMD Alternative Investment Fund Management Directive

AIMA Alternative Investment Managers Association

BBA British Bankers Association

BIS Bank for International Settlements

BVCA British Venture Capital Association

CBI Confederation of British Industry

CEC Commission of the European Communities

CEC Commission of the European Communities

CEE Central and Eastern European Countries

Central Huijin Central Huijin Investment Ltd

CEPS Centre for European Policy Studies

CESR Committee of European Securities Regulators

CFETS China Foreign Exchange Trading System

CFIUS Committee on Foreign Investment in the United States

Chinese State Council

CIC China Investment Corporation

CNOOC China National Offshore Oil Corp

CONSILIUM Council of the European Union

CPC Chinese Communist Party

CRS US Congressional Research Service

CSR Corporate Social Responsibility

EC European Council

EIA US Energy Information Administration

ESMA European Securities and Markets Authority

EU European Union

EVCA European Private Equity and Venture Capital Association

FBOC Foreign Business Oriented Corporations

FDI Foreign Direct Investment

FDI Foreign Direct Investment

FDIC Federal Deposit Insurance Corporation

FPI Foreign Portfolio Investment

FRS Federal Reserve System

FSA UK Financial Services Authority

FTC Foreign Trade Corporations

GIC – Government of Singapore Investment Corporation

GIC Singapore Investment Authority

GPFG Norwegian Global Fund

GPFG Government Pension Fund of Norway

GRI Global Reporting Initiative

HE Hedge Fund

IMF International Monetary Fund

ISO International Organisation of Standardization

IWG International Working Group

LMTI Linaburg - Maduell Transparency Index (LMTI)

LSE London Stock Exchange

MiFID Markets in Financial Instruments Directive

MinFin Ministry of Finance (Russia)

MOF Ministry of Finance (China)

NWF National Wealth Fund

OECD Organisation for Economic Cooperation and Development

OPEC Organisation of Petroleum Exporting Countries

PBoC People's Bank of China

PE Private Equity

PFR Pension Fund of the Russian Federation

PIIE Peterson Institute for International Economics

QIA Qatar Investment Authority

RAB Russian Agricultural Bank

RVI Revenue Watch Institute

S&L Savings and Loans Industry

SAAS Social Accountability Accreditation Services

SAFE State Administration of Foreign Exchange

SASAC State-owned Assets Supervision and Administration Commission of the State Council

SEC Securities and Exchange Commission

SFRF Stabilization Fund of the Russian Federation

SFW Sovereign Wealth Fund

SME Small to Medium Enterprise

SOE State Owned Enterprise

SWFI Sovereign Wealth Fund Institute

TFEU Treaty of the Functioning of the European Union

UCITS Undertakings for Collective Investment in Transferable Securities

UN United Nations

UNPRI United Nations Principles for Responsible Investment

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Abstract

This thesis analyses the motivations, behaviours and outcomes of Sovereign Wealth Funds (SWFs), and the regulations pertaining to them. The motivation for examining these issues includes the growing role of SWFs as large investors in a wide range of global asset classes, their continued resistance to transparency, and the perceived lack of any unified regulatory framework to cover their activities. We consider the evolving attitudes amongst regulators, SWF officials, and independent analysts and commentators to the current and evolving regulatory environment for SWFs. Regulatory approaches include both mandatory and voluntary measures. Following a review of both the academic literature and other available materials on SWFs, we consider what type of regulation would seem both appropriate and proportionate for SWFs, and we evaluate the significance of the fact that although SWFs operate within frameworks similar to other alternative investment funds, their culture is inherently different.

We conducted fourty-three in-depth interviews, and compared and contrasted the various opinions regarding the current and evolving operation and regulation of SWFs. We followed these up with two country case studies, for Russia and China respectively. For these, we set out the background to their respective SWFs, and discuss the current and evolving state of their investment strategies and of the regulatory environments in which they operate. We consider in particular the extent to which SWFs may be pursuing geopolitical agendas, and on the other hand the degree to which they may be potential contributors to the public good, for example as a stabilising factor during global financial crises. We thus consider the impact on global markets of their investments – and the implications of the degree of transparency and accountability within which they tend to operate; and we explore the case for additional regulation of these entities.

We conclude, firstly, that greater visibility and control of SWFs would be desirable; and secondly, that a range of regulatory approaches and policies might prove appropriate in dealing with what are often rather different SWFs, often reflecting the outlook of their parent state. Thus, the Norwegian SWFs (Government Pension Fund Norway, and the Oil Fund) reflect the transparency favoured by that state; the Russian National Wealth Fund reflects the preference for secrecy inherent in the Russian state; while the activities of the China Investment Corporation match the breadth and high profile favoured by the Chinese state, albeit restricted by the controlling tendencies of the Chinese government.

Chapter 1: Introduction

The impact of SWFs, already considerable and growing fast, emphasises the need for a full and wide assessment of the effect of their activities, not only on the investment world but on a wide range of commercial activity. Of fundamental importance to any such assessment is an understanding of the regulation of Sovereign Wealth Funds (SWFs), and equally necessary, of the identification of areas for improvement.

We set out to understand and learn more about SWFs' ever growing role as investors across a wide range of asset classes, their traditional resistance to regulation, and the relative lack of attention they have to date received from regulators when compared with other alternative investment funds (AIFs).

Throughout this study it is our intention to analyse how SWFs are regulated and to determine, both through forty-three in-depth interviews with various actors across the SWF sector and two detailed country case studies, whether there is a need for further voluntary or mandatory regulation of SWFs globally is really needed.

For the purposes of this thesis it is important to define the following terms used in the above questions. The term 'appropriate' is used to define a relevant regulatory methodology in the context of the overall regulation that exists within the industry today. 'Proportionate' is intended to highlight similarities and differences in the scope of any regulation when compared with corresponding regulation adhered to by other AIFs which might invest in the same projects and jurisdictions as do SWFs.

Regulatory approaches considered in this thesis are wide ranging, including, but not limited to, self regulation by SWFs, regulation by local/national government, regulation by industry bodies, and international regulation. This research seeks to create a better understanding of the way SWFs are regulated today, and the extent to which other stakeholders in the SWFs investment environment may identify regulatory gaps. In this area, we compare SWFs with other international AIFs to consider whether AIFs as a whole are operating on a leveled playing field.

Taken as a whole, this represents a significant piece of research into the role of Sovereign Wealth Funds (SWFs) and their regulation, focusing on the funds established and run by China and Russia. Whereas the main aim of this thesis is to investigate the evolution of the regulation of SWFs, we also provide an overview of the wider AIF regulation universe, with an overview of recent laws that have a bearing on how SWFs are regulated, as well as considering possible regulation in the future. We examine academic and policy responses to SWF regulation, in particular to the issues of transparency and CSR, with specific reference to financial regulation of the Russian and Chinese SWFs. This thesis tackles in the following order the questions raised above, leading to a discussion of SWF regulation globally.

Chapter One provides context and background to the role of SWFs within the global investment community, and sets out the overarching research question, namely whether or not SWFs are regulated in an appropriate and proportionate manner, and whether their behavior gives rise for concern such as might suggest the need for further or different regulation.

Chapter Two describes the current regulatory environment, and reviews the evolving attitudes to the existing regulation of SWFs, both mandatory and voluntary.

Chapter Three reviews the academic literature, as well as relevant practitioner and other such materials, on SWFs.

Chapter Four discusses the research methods used, and describes the process for interviews and data collection.

Chapter Five reports on the interview results, focusing in particular on SWFs as possible contributors to the public good, and on interviewees' opinions as to the regulation of SWFs; this leads in to chapters six and seven, which report country case studies on the Russian and Chinese SWFs respectively. These case studies report the current state of the SWFs' investment strategies and regulation, and considers their impact on global markets.

Chapter Eight reviews the main issues arising from our interviews and case studies, and considers areas for further research and implications for policy. We argue that a balance is required between achieving a degree of transparency and control of SWFs, and recognizing that their diverse contexts, control structures and objectives make a 'one size fits all' approach difficult to achieve and possibly inappropriate.

1.1 SWFs in context

SWFs are institutional investors mandated by a nation state to invest that state's surplus financial capital, for the stated purpose of achieving returns that can be used for objectives such as supporting a pension system, diversifying a state's revenue sources and meeting budget shortfalls. SWFs have existed in various forms as far back as the 19th century, but it has only been in the 21st century that their global financial significance has become important. From 2008 to 2012, the value of global SWFs increased by 59.1 per cent. The SWFs Institute recorded a 16 per cent annual rise in 2013, and values have continued to grow.

1.2 SWFs' attitudes, behaviors, and goals

The financial structure and goals of SWFs vary according to type. For instance, the SWFs of both China and Russia were formed to diversify their home nation's foreign exchange reserves, but each relies on a different source of funding. The Chinese SWF is non-commodity based and financed by surplus structural savings. The Russian SWF, by contrast, receives commodity-based funding from its export of natural resources.

The investment strategies of SWFs also vary, depending upon their objectives. Analysts indicate two major strategic SWF approaches to investment:

The first is based on portfolio management. Here, SWFs try to outperform various global investment indices and do not focus on a specific sector or asset class. SWFs using portfolio management strategies do not usually participate directly in the different companies in which they have invested. The Abu Dhabi Investment Authority and the Government Pension Fund of Norway both operate on a portfolio management model and are good examples of this type of investor.

The second approach is the investment fund model. The Singapore Investment Authority and the Qatar Investment Authority each adopt this model. They take hands-on roles in devising ambitious investment approaches and concentrate closely on categories of investment seen as key to the interests of their fund and home government. SWFs that use this model have a close relationship with the companies they invest in, directly monitoring their decisions.

In recent years, SWFs have significantly expanded their participation in international markets. They have made clear their concerns about perceived limitations to their capacity to invest in a diverse range of entities when compared with domestic private enterprises (Bu, 2010; Hsu, 2015). The focus of the Committee on Foreign Investment in the United States (CFIUS) on state-owned investment vehicles resulted in the head of the China Investment Corporation (CIC) stating that "if an economy will use national security as a criterion for entry of SWFs, we will be reluctant to tap the market because we are not sure what will happen" (Arnold, 2007).

1.3 Evolving attitudes to SWF inward investment

Previously dominant perceptions of SWFs as hostile market participants have been substantially eroded in the aftermath of the 2008 financial crisis. Today, two dichotomous perceptions of SWF investment predominate. Among some commentators, SWF investment is seen as an issue of national security, posing potential danger to recipient nations (Slawotsky, 2009). The converse view characterises SWFs as a valuable source of investment, for which issues of economic governance predominate (Truman, 2010; Xu & Baghat, 2010).

1.3.1 Concerns about motivation and objectives

This thesis considers the evolution of attitudes towards SWFs. Concerns regarding the motivation of SWFs are considered in the academic literature, but appear most frequently in both political and popular commentaries. As the majority of SWFs, with the notable exception of Norway's, reside in non-democratic states, the general concern relating to the wider activities of these regions is mirrored in responses to their investment vehicles. Politicised management of a significant portion of SWFs has the potential to inflict harm not only upon the targeted nations but also upon the world economy as a whole. The wealth embodied by SWFs is relatively concentrated, with the ten best-endowed SWFs managing 85 per cent of all sovereign assets.

With the growth of investment in established economies by SWFs, recipient nations have sought to modify their policy frameworks so as to gain greater control over the industries in which SWF are allowed to participate. In general, governments consider a number of sectors to be of national strategic importance and have, therefore, sought to protect them from SWF influence. In the US, for example, CFIUS has the role of reviewing investments in US firms by entities, including SWFs, owned by foreign nations, while EU states also implement a variety of similar checks on foreign investment in strategically important sectors.

1.3.2 SWFs and the 'resource curse'

The so-called 'resource curse' – also known as the 'paradox of plenty' – is the phenomenon in which oil-rich countries tend to find themselves in economic and/or political crises (Karl, 1999). This is a paradox as theoretically natural resources should be a blessing because the surpluses generated from natural resource extraction can be used to invest in infrastructure or education, both of which generate substantial multipliers for the economy. This has been done to some extent in countries such as the United Arab Emirates, which appears to be an outlier in this respect; evidence for the ‘resource course’ has been described as one of the most enduring relationships in the empirical data (Sachs & Warner, 1995; Sala-i-Martin, Doppelhofer & Miller, 2004).

There is little consensus on the reasons for this phenomenon (Ross, 1999). One possibility is that resource abundance creates a ‘crowding out’ effect; the presence of economic rents that can be obtained from natural resources encourages investment in natural resource extraction, crowding out investment in other economic activities that might otherwise have driven economic growth in the domestic market (Sachs & Warner, 2010). Thus, natural resource rents can harm economic growth. An additional danger for natural resource-rich economies is that these resources may create a false sense of security in policy-makers and citizens, leading ultimately to underinvestment in other areas of economic activity that might promote economic growth.

Empirical evidence has shown that countries that have significant stocks of natural resources generally derive fewer benefits from the technology spillovers that accrue from manufacturing. The presence of significant natural resources can lead to increased aggregate demand and cause an appreciation of the local currency, ultimately reducing export competitiveness (Papyrakis & Gerlagh, 2004). The evidence also suggests that countries that have significant natural resources tend to attract resource-seeking investments which are aimed at exploiting those natural resources, rather than efficiency-seeking investments that bring with them the advanced technology and improved skill sets that lead to a sustained increase in economic growth (Kinoshita & Campos, 2003).

There is some evidence that shows an inverse relationship between the abundance of natural resources and the proportion of the labour force engaged in primary education for example, as education is a sector that often suffers in such cases. In 1997, OPEC countries sent on average 57 per cent of their young to primary education compared with 64 per cent for the world as a whole (Gylfason, 2011). At the same time, four per cent of GNP in OPEC countries was spent on education compared to an average of five per cent of GNP for the countries in the rest of the world (Gylfason, Herbertsson & Zoega, 1999).

In Russia, this resource curse may be due to natural resources promoting a ‘voracity effect’. Where there is the potential for windfalls from natural resources, claimants to economic rents from the natural resources aim to obtain more than their fair share of the proceeds (Tornell &

Lane, 1998). This creates incentives for predatory behavior on the part of governments who tend to dispense more than is, in fact, available. This leads to an overall reduction in economic welfare. It has also been shown that competition between rent-seekers can be powerful enough to lead to civil unrest and even war (Collier & Hoeffler, 1998).

A key aspect that causes mistrust in the Russian investment system is corruption. There is evidence suggesting that natural resources from point sources – such as crude oil, minerals, or crops – are the most likely to be related to increased political corruption when compared with more diffuse types of natural resources (Isham, Woolcock, Pritchett & Busby, 2005). Oil, in particular, tends to negate democracy, increasing the level of corruption in a country (Aslaksen, 2010).

To combat corruption, transparency is required, closing off opportunities for kleptocrats to enrich political allies (Acemoglu, Verdier, Robinson, 2004). The quality and independence of institutions is thus an important factor in determining whether the presence of natural resources becomes a blessing or a curse for a country (Mehlum, Moene & Torvik, 2006). Institutions that promote accountability can dampen negative political incentives created by natural resource booms (Robinson, Torvik & Verdier, 2006).

1.3.3 Permissive approaches to SWF investment

Former US deputy secretary Robert Kimmitt has been a vocal advocate for SWF investment, pointing both to the value of their long-term investment strategies and to the lack of evidence to support accusations of investment strategies based on anything other than financial return (Kimmitt, 2008). Kimmitt's analysis is supported by research demonstrating that SWFs are primarily long-term investors, rarely taking controlling stakes in target companies (Bortolotti, Fotak, Megginson & Miracky, 2009). SWFs can therefore be considered to confer the same advantages as FDI generally, i.e. (i) bringing liquidity to markets and thereby lowering the cost of capital; (ii) enhancing efficiency through investment in projects which promise the greatest returns on investment and (iii) promising a stabilizing influence over an economy through the pursuit of long-term investment horizons.

In the wake of the 2008 financial crisis, SWFs have been developed by their home nations as a cushion against reduced financial liquidity and the danger of overall economic contraction (Kunzel, Lu, Petrova & Pihlman, 2011; Lebedinskaia, 2013).

From 2008, SWFs began to invest heavily in US and EU financial sectors, attracted by low share prices and the perceived strategic opportunity offered in those sectors. The capital provided by investments in entities suffering from the fallout of the financial crisis eased both the problems of the financial sector and the related issues faced by Western governments. Simultaneously, this activity contributed to the growing perception of SWFs as responsible market participants.

Proponents of sovereign wealth investment point to the relatively small size of SWF investments compared to the size of international financial markets as a whole and their principal non–AIF participants. Furthermore, SWFs are composed of a diverse group of entities, varying markedly in terms of size, purpose and governance.

Different attitudes characterise the response of different nations to the increase in SWF investment. For example, under UK law, SWFs are not treated any differently from privately owned firms. A report by a senior banker, Sir David Walker, recommended that SWFs should be subject to the same code of conduct for corporate governance as private equity (PE) firms (Walker, 2009). However, the principal focus on the governance of SWFs in the UK has been through voluntary international agreements, such as the Santiago Principles. The general attitude of the UK authorities to SWFs has proved permissive and even welcoming. For example, the Qatar Investment Authority purchased a seven per cent share in Barclays Bank, as well as taking a major stake in the London Stock Exchange. Both CIC and Abu Dhabi Investment Authority have been allowed to take large stakes in one of Britain's largest water suppliers, Thames Water (Thatcher, 2012). Such a permissive approach is not reflected throughout Europe: for example, German regulators tend to impose more stringent codified determinations on SWF investment.

In general, the EU Commission has proved to be a vocal ally of SWF activities, emphasising the EU's commitment to the free movement of capital. However, the EU Commission has asked that SWFs work to "assuage public concerns" through their commitment to minimum standards of transparency and good governance (2008, p.8).

EU law has a long history of considering the implication of states' direct engagement in markets, although principally in relation to the activities of member states' market activities. A central theme in EU law is neutrality *vis-à-vis* questions of ownership, and consequently, by its Article 345 of the Treaty of the Functioning of the European Union (TFEU), it refrains from subjecting member states to a duty to privatise. Both public and private market participants have been subject to equal legislative requirements, including rules relating to competition. The existence of a system of European state aid control exists to ensure that market competition is not distorted by the granting of subsidies by member states and that such states will not engage in subsidy wars among themselves. The extent to which these principles can be extended to govern the activities of non-EU states operating via SWFs in European markets is unclear.

In view of the dense European legal framework regulating member state interventions when they engage in economic activities, it is perhaps surprising that there is no framework for regulating the activities of foreign states engaged in economic activities within the EU. However, the protection of Article 56(1) EC and Article 63(1) TFEU has been extended to third-country investors, including those owned by third-country states. Besides protection from anti-competitive limitation on the activities of SWFs, the European Commission's publication of 'A Common European Approach to SWFs' in 2008 advised, rather than demanded, that SWFs base their decisions strictly on economic objectives and ensure that they compete on equal grounds with private-sector investors. The principles of good governance required by the Commission for SWFs include: (i) a clear allocation and separation of responsibilities in the fund's internal structure, (ii) an investment policy clearly defining the overall objectives pursued by the SWF, (iii) operational autonomy for the fund in its pursuit of its objectives, (iv) public disclosure of the general principles governing the relationship between the SWF and its government, (v) public disclosure of the general principles of internal governance providing assurance of integrity, and (vi) a fully developed risk management policy. Through codifying these principles, the European Commission both discourages protectionist responses from member states and adopts an accommodating approach to encourage voluntary compliance on the part of SWFs with a set of principles considered to be appropriate and sufficient for effective engagement in international markets.

1.4 Increasing transparency of SWF activities

The suspicion surrounding the motivation of SWF investment is sometimes attributed to the air of secrecy and minimal transparency surrounding many of these bodies (Griffith-Jones & Ocampo, 2008; Lyons, 2007). However, there is some indication that such funds may be moving towards a more open stance in recognition of the strategic advantages that they could deliver.

A number of authors have produced analyses highlighting significant positive abnormal short-term returns following SWF investment in publicly traded equities, alongside significant negative returns following announcements of disinvestment (Dewenter, Han & Malatesta, 2010). Kotter & Lel in their examination of the stock market response to 168 SWF investments found that transparency of the acquiring SWF correlated with the magnitude of the abnormal positive return for a given investment (Kotter & Lel, 2008).

Norway's Government Pension Fund is typically cited as the prime example of an independently and transparently managed SWF following widely accepted principles of good corporate governance and operating in the same manner as would a private investor (Beck & Fidora, 2008). CIC does not have such a positive reputation, remaining as it does under the overall control and auspices of the Chinese Communist Party and Chinese state policy. However, the potential financial benefits of transparent investment activity have not gone unnoticed by nations seeking to maximise the potential of their sovereign wealth investments. Interviews with CIC officials suggest a desire on their part to increase the transparency with which CIC details its objectives and the decision making-process behind the selection of investment targets. It is argued that the internal political pressure on CIC to deliver ever higher returns on invested capital are demands that it reach the highest possible standards as an international investment fund. If this proves to be the case, we ought to anticipate increasingly detailed disclosures from CIC regarding further major investment decisions and a reciprocal decline in the mistrust associated with such activity from Western nations.

In the past, SWFs have acted as passive investors, acquiring small- to medium-sized stakes in target firms. With these stakes, SWFs have sought neither influence over strategies nor control over their day-to-day operations. However, the recent spate of SWF investments in the financial industry is following a marginally more aggressive pattern, with SWFs acquiring substantial minority stakes, typically just below ten per cent. For example, CIC acquired a 9.9 per cent stake in the Blackstone Group and a similar stake in Morgan Stanley. Such significant investments often make SWFs the largest single shareholders in target entities, providing the funds with important influence in the financial sector. The size of the purchased stakes probably reflects a desire to avoid triggering special regulatory control, which in many jurisdictions occurs at the ten per cent threshold. For example, in the US, the acquisition of a ten per cent stake or more allows the foreign investment control regime to be instigated. Further, the acquisition of over ten per cent of shares in a bank demands approval by the

Securities and Exchange Commission (SEC), and the purchaser will acquire the status of a Bank Holding Company and become subject to specific supervision.

There are growing indications that SWFs in general, and CIC in particular, are keen to be viewed as responsible participants in international financial markets. However, we argue that there is a requirement for more regulation of such funds, as well as a need to address the issues of reputation with which they are currently confronted; these two developments would help to generate confidence in the objectives of SWFs, and in their financial activities.

Chapter 2: Regulation Impacting Sovereign Wealth Funds

2.1 Introduction

This chapter reports on the evolution of the regulation of SWFs, as well as of the wider Alternative Investment Fund (AIF) universe. We provide an overview of recent laws that have a bearing on how SWFs are regulated as well as considering future regulation. We consider academic and policy responses to SWF regulation, in particular to the issues of transparency and CSR, with particular reference to the financial regulation of the Russian and Chinese SWFs.

2.2 Political attitudes as a driver of AIF regulation

The financial crisis of 2008 forced politicians, economists, and analysts to focus on SWFs. As international capital markets faced unprecedented constraints, SWFs invested in international assets on a significant scale. Whereas politicians raised concerns about the possible agenda driving these investments, regulators increasingly realised that the role of SWFs in injecting much-needed funds was becoming vital for recovering economies.

Whilst the United States government was comfortable with having CIC invest in Lehman Brothers to rescue it from collapse, throughout the duration of the 2008 financial crisis the United States Senate opposed China's takeover bids for some of its prominent national assets. This opposition has gradually lessened. Mr. Xuedong, Chairman of CIC, stated that the fund is interested in contributing, through investment, to the recovery of the world's largest economy (Wei, 2015). The fact that such foreign investment would not include infrastructure has made American commentators feel more comfortable, as geopolitical investment was the most critical issue in 2008 when foreign SWFs bid for control of United States ports.

It is possible that the US government has realised that the best way to achieve a balance between conflicting arguments around FDI is to strengthen domestic laws to protect strategic assets while encouraging investment elsewhere to help achieve economic prosperity.

Countries have been encouraged to clearly specify the legal owners of SWFs. For example, the two most notable SWFs in Singapore, Temasek, and GIC, are accountable to the President of Singapore. Key questions remain: should all the responsibility for the investment decisions made by these SFW lie with the President of Singapore, and if the answer is no, who should be in charge of and responsible for the investment decisions of such entities?

The CIC has a clearer management profile; however, it is known that the CIC's decisions are monitored closely by the State Council of The People's Republic of China, which issues final approval of major investment decisions.

The activities of the Norwegian Pension Fund are put before the Norwegian legislature for approval before its management can commit to investments (Clark & Monk, 2010).

In 2008, the Russian authorities passed a law, which restricted interference from sovereign entities trying to invest in projects of national significance. This new Federal Law did not inhibit foreign investments, which the Russian authorities were quick to realise. It allowed foreign entities to go through a strategic process whereby permission and approval were applied for if the foreign investor wanted to make an investment in one or more of the forty-two industries identified as Russia's national assets. Appropriately, specific thresholds were introduced to make the approval process easier. This allowed for discussion, and if foreign investors were able to meet the minimum requirements, they were allowed to make takeover bids, as they were considered to be 'safe investors'.

Their diverse objectives, as well as a long history of communism, have ensured that Western states remain cautious as to how to do business with SWFs from Russia and China. Europe and the United States like to maintain control over key national assets and remain concerned about an economic takeover by Russian and Chinese SWFs. Much of the recent attention paid to SWFs is due to the development of SWFs in Russia and China and to their active investment strategies. Experts raised concerns about how state actors may determine the future of global financial markets and as a response called for a creation of multilateral standards by International Monetary Fund (IMF) and Organization for Economic Cooperation and Development (OECD).

When analysing Russian and Chinese SWFs, it is possible to gain insight as to the challenges that the West and East face regarding investment reciprocity. There is a debate over fair treatment of SWFs from the West when investing in Russia. Several prominent leaders such as Jean-Claude Juncker, President of the European Commission, have stated that Russia must consider allowing European firms to make investments in Russian markets without draconian restrictions or discrimination. Strategic action has been mentioned should Russia continue to block high-profile EU investments despite its own SWFs having enjoyed a relatively free reign over investments in the West to date (Sauvant, Sachs, & Schmit Jongbloed, 2012).

There is a dearth of research in the literature focusing on investment reciprocity, but political pressure seems to be the most effective method in opening former communist countries to investment, rather than long-awaited internal reforms that may take several years or even decades to complete and test.

Political issues are important for regulators to consider when working on international regulations and legal frameworks that allow for allocating investment. It would make sense to create a domestic framework in which governments are able to hold a single individual or a board responsible and liable for investment decisions of SWFs. Apart from the legal framework, it would be appropriate for the development of regulations pertaining to domestic supervision of SWFs in order to eliminate conflicts of interest between SWFs and connected government bodies. For example, some SWFs are in a position to access central banks to finance their financial assets, creating a potentially trade-distorting allocation of financial resources.

The complexity increases when one looks at some of the structural frameworks of the largest SWFs. For example, CIC was created in 2007, a relatively newly formed SWF which has grown rapidly to become a leading player in the international SWF market. Its largest holdings are invested domestically through one of its wholly-owned subsidiaries, Central Huijin Investment. Without a clear legal framework, it is difficult to ascertain who would receive priority for funding during a financial crisis. Would it be CIC or the domestic corporation, Central Huijun Investment, which holds large stakes in the local economy? This highlights the need for domestic rules setting out legal and structural issues when resolving conflicts of interest between the SWFs, related financial authorities, and subsidiaries.

International regulation of SWFs is far more complex than internal regulation. Perhaps this is because of the conflicts of interest between home and host countries. Academics are engaged in a debate on how international standards can harmonise interests of both state actors. The main reason for host countries to objecting to SWFs investment remains concern over national security, particularly where some SWFs refuse to disclose relevant information required by stakeholders. One suggestion would be to create separate multilateral guidelines for SWFs wanting to invest in other states. Such guidelines would ensure that foreign SWFs have an obligation to disclose their investment objectives, and are held accountable for their governance structure, and also for ensuring transparent reporting and administration of the fund. There are, of course, specific international rules for the activities of SWFs, but the introduction of multilateral guidelines would add transparency and ease to the process. Guidelines must address paramount issues such as the role of administrators and their responsibilities towards the affairs of the host country.

Some industry professionals believe that multilateral constraints would be welcome. To them, it is discriminatory to ask the investing SWF to abide by all the laws of host nations, suggesting instead that host nations should lift constraints, thereby allowing international SWFs to bid for lucrative contracts even if of national importance.

2.3 Historic SWF regulation

In the last decade, the significance of SWFs has soared. From 2008 to 2012, the value of global SWFs increased by 59.1 per cent. The SWFs Institute recorded a 16 per cent annual rise in 2013, and values have continued to grow. The significance of SWFs became apparent during the financial crisis of 2008. SWFs were able to contribute billions of US dollars into struggling economies.

Developing country investments are not the only ones that are attracting interest: a number of SWFs from emerging market states are taking the lead in investing large sums of capital to ensure their financial future. For instance, Carlyle Group analysts have suggested that alongside the decline in oil prices, some Middle Eastern governments have been investing significant amounts of capital in their SWFs. In fact, according to analysts, these are the most significant investments that have been deployed for decades (Primack, 2015). It might have been anticipated that the Gulf States would withdraw cash from SWFs as the oil prices dropped, but in fact, the opposite appears to have happened. Arab governments have deposited large sums in SWFs in the hope of investing profitably for the long term, so as to compensate for the decline in oil revenues.

Asian states that have been facing internal domestic crises have also increased their investments in SWFs.

SWF investments have raised concerns among Western states about national security and the financial volatility that might result from insufficiently considered decisions by SWFs, as to what are or what are not profitable investments.

For example, the United States government called for a review of the 2004 offer by China National Offshore Oil Corp (CNOOC) to buy the oil company Unocal Corp (Pottinger, Gold, Phillips & Linebaugh, 2005). The Chinese company was unwilling to take the time to go through the detailed review process at the end of which there might be only a small chance the sale would be approved, and withdrew its bid, stating that if it was not for being accused of undermining national and economic security, the management of CNOOC were happy to increase the offer and proceed with the deal. The Dubai-owned DP World was also prevented from purchasing six seaports in Long Beach and New York. Despite the fact that both firms were public companies, regulators in the United States concluded that bids of that nature would endanger national security, and following high-level objections from the US Senate, DP World cancelled its bid (Hufbauer, Wong & Sheth, 2006).

Universally understood international laws allowing state governments to forbid takeovers by SWFs would be beneficial; such an idea was strongly supported by the German Chancellor, Angela Merkel when she spoke of the potential manipulation of SWFs by foreign governments to protect national security.

The creation of universal standards, which would force governments such as Russia or China to open their economies to the flow of capital from European countries, was recommended by the former French President Nicholas Sarkozy, who voiced concern about the lack of reciprocity from emerging markets in terms of market access.

2.4 Key issues in SWF regulation

Regulation of SWF activities presents a complex landscape, and one that is constantly changing. Its importance, because of its relation to the vulnerability of global financial systems, was exposed during the 2008 financial crisis. SWFs lack tailor-made regulation which takes into consideration their global reach and the sheer size of their investment capabilities. In most cases, they act like hedge funds, but because of the size of funds at their disposal, the impact of their activities has far-reaching consequences.

Experts have argued that SWFs are very much in the development stage, and their respective governments have the responsibility to respond to critics. The issues at the heart of the sovereign investment have been highlighted by the Santiago Principles which were formed in 2007 as a response to the concern of Western powers worried about national, political, and economic security. The principles are voluntary and encourage SWFs to promote greater disclosure and transparency surrounding their investments.

It is hard to say if a unified code of conduct for SWFs is required or if it would complicate issues further. SWFs are unlike corporates in the standards that they adopt in some areas, such as human rights, aspects of which, such as inhumane working conditions, are not a direct issue with SWFs, because their extra-national investments do not bring extra physical locations.

However, these problems are a source of controversy because SWFs invest in corporations which may have human rights issues. Further, SWFs may be blamed for being associated with human rights violations by making investments in states where such corporations are operating.

For example, a key issue arises specifically in relation to the oil-rich nations of the Gulf or to former communist powerhouses like China or Russia: are their investments based solely on generating good long-term returns or are they geopolitically motivated? The previously mentioned examples of China National Offshore Oil Corp and DP World being involved in large scale takeover bids in politically sensitive strategic sectors were scrutinised. Strategic sectors include, but are not limited to, energy, transportation, banking, telecommunications, defense and port infrastructure.

The complexity of the debate about SWF regulation is manifest in a number of other areas. We have examined it thorough case studies, in subsequent chapters, of the current legal and strategic frameworks of Chinese and Russian SWFs, relating them to an understanding of the key issues facing SWFs today.

There are two main reasons why Russian and Chinese SWFs were chosen as case studies for examining the global phenomena of SWF in more detail. First, international interest and debates around SWFs are a direct result of economic changes in Russia and China following the financial crisis of 2008. The enormous volumes of the capital and foreign exchange reserves of both those economies led to the creation of some of the largest non-commodity based SWFs in the world.

Recent economic sanctions against Russia present a rich opportunity for analysts and scholars to study the performance of the SWFs owned by Russia and their roles in sustaining one of the largest economies in difficult times.

Russia has called on the two SWFs to transfer finances to support the local economy after the introduction of economic sanctions and has injected a significant amount of cash to resuscitate state-owned enterprises (SOEs). The SWFs in Russia played a lifesaving role before, as well as during, the 2008 financial crisis, but they bounced back, refilling their coffers with three times their original assets.

2.5 Development and objectives of the AIFMD

(Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directive 2003/41/EC and 2009/65/EC and regulations (EC) No. 1095/2010 EU)

The AIFMD is an EU Regulation which places various AIFs, although importantly excluding SWFs, under the supervision of EU regulatory bodies. This regulation is discussed here to contextualise the thesis question (ii) which asks whether the application of this regulation to other AIFs puts SWFs at an unfair competitive advantage as they make investments in the EU. The funds to which this applies are defined as all those not covered by the UCITS (Undertakings for Collective Investment in Transferable Securities) Directive, a set of EU Directives intended to allow collective investment schemes to operate freely throughout the EU on the basis of authorisation from a single member state.

2.5.1 Development

The need for the extension of financial regulation to AIFs was identified by the High-Level Group on Financial Supervision, chaired by Jacques de Larosiere (De Larosiere 2009). Although the original motivation and main emphasis came from concerns about hedge funds (HFs) and private equity funds (PE), funds not covered under UCITS include SWFs, real estate funds, commodity funds, infrastructure funds, listed and non-listed investment companies and long-only funds structured as anything other than UCITS (Financial Services Authority 2012). A final version of the text of the directive was passed by the European Parliament on 11th November 2010 and published in the Official Journal of the European Union on 1st July 2011; the proposals were required to be placed on national statute books by 22nd July 2013, and will be effective from that date. By 2017, the European Commission is required to review the Directive's application and direction and assess whether it is functioning effectively. Thus, the AIFMD is nearing full implementation throughout the EU.

The text of the Directive (Commission of the European Communities 2009), outlines the principal aims of the legislation to be (i) the establishment of a secure and harmonised EU framework for monitoring and supervising the risks that AIFM pose to their investors, counterparties and other financial market participants and to financial stability and (ii) to permit, subject to compliance with strict requirements, AIFM to provide services and to market their funds across the internal EU market.

In the version of the Directive that was passed in 2011, AIFMs were to be permitted to market AIFs located in non-EU countries subject to certain controls, as long as the AIF country had entered into an agreement based on Article 26 of the OECD Model Tax Convention with the Member State on whose territory the AIF would be marketed, thereby allowing the collection of all information necessary to tax investors in offshore funds.

In December 2010, the European Commission requested technical guidelines from the Committee of European Securities Regulators (CESR) for implementing the measures of the Directive. Following consultations and deliberations, which concluded on the 13th September 2011, the European Securities and Markets Authority (ESMA), which took on the responsibilities of the CESR on January 1st 2011, provided its final guidelines on the 16th November 2011. The guidance covered issues such as the calculation of leverage used by AIFMs, depositaries, asset valuation, and operating conditions for AIFMs. The European Commission was then expected to propose its own final implementation procedures for adoption by the Directive in the first quarter of 2012 (Financial Services Authority 2012). However, the release of the final implementation procedures was delayed. In April 2012, a European Commission draft text of ‘supplementary rules’ became available.

Immediately, several industry representatives complained that this draft diverged from the advice of the ESMA, taking a tougher line on several areas and reneging on some of the political compromises which preceded the 2011 passage of the Directive. The Commission has been accused of using the implementation procedures to take a political stance against the industry. The Alternative Investment Managers Association (AIMA), the global hedge fund industry representative, has outlined a number of issues on which the draft text diverges from the ESMA advance, including rules for custodian banks, curbs on fund borrowing and standards for allowing non-EU fund managers to access EU investors. The draft text also dismissed the ESMA methods calculating fund leverage as unworkable, with the result that more AIFs will be brought under a more stringent set of leverage restrictions (Alternative Investment Managers Association 2012).

In mid-2012, draft domestic legislation was issued by Germany and Luxembourg, with these countries aiming to gain a first-mover advantage by being ‘AIFMD ready’ as early as possible. The final implementations and applications of the AIFMD will only become apparent in coming years, as the legislation is tested against potential breaches of its requirements. However, the structure of the directive is currently sufficiently clear to enable organised anticipatory responses on the part of AIFs currently or intending to operate in the AIFMD's sphere of influence.

2.5.2 Objectives

The legislation seeks to achieve its objectives by placing the managers of AIF operating within the EU under restrictions affecting several different aspects of their operations, although the Directive will not apply to AIFMs managing portfolios with less than 100 million euros in assets. However, all AIFMs will be required to obtain authorisation from the designated regulatory authority of their home member state. In order to maintain this authorisation, they will be required to provide proof that they are maintaining certain standards on a regular basis. For example, AIFs must retain a minimum level of capital; they will also be required periodically to satisfy the home authority of the soundness of their arrangements with respect to risk management (i.e. liquidity risks, operational and counterparty risks, conflicts of interest, fair valuation of assets and the security of their arrangements with depository institutions). In the interests of consumer protection and financial stability, fund managers will also need to achieve satisfactory levels of information provision to investors and to report, on a regular basis to the competent home authority on the principal markets and instruments in which it trades, its main exposures and concentrations of risk. Additionally, specific requirements will be in place for AIFMs managing leveraged AIFs or acquiring controlling stakes in companies (Consilium, 10791/11).

The dangers of weak balance sheets and high leverage in the bank system have evidently been present in the development of the AIFMD. However, the Directive approaches this issue by trying to restrict the use of credit in all AIFs of a certain size. Network approaches, on the other hand, suggest that it would be advantageous to identify individual institutions that may have a disproportionate effect on the system, owing to the number and magnitude of the credit links they have with other companies, and to target these for intervention.

2.6 The Santiago Principles

Among the first major regulations adopted by the international community were the Santiago Principles, which underlined the need for SWFs to take note of international investment standards. The twenty-four guidelines of the Santiago Principles acted as a benchmark, forcing the international community to think about a unified set of rules for SWFs. The guidelines were created with the purpose of providing the SWFs with a custom-made list to guide them on the best business practices when investing.

The Santiago Principles were designed with three core issues at heart based around SWF management:

- Legal frameworks to abide by international law.
- Institutional frameworks to manage internal management structure.
- Risk management to protect SWFs from making unnecessarily risky investment decisions.

The principles took into consideration the evolving nature of global capital investments and suggested that the implementation of rules for SWFs should be on a voluntary basis. SWFs of member states were given flexibility to learn and adapt the principles according to the changing international environment; as long as the idea behind the core of the regulation agreed with the established way of running the business and usual accounting practices, the SWFs were left to interpret the principles to suit their investment plans. Notably, enforcement may take time as member states themselves take time out to reassess and realign their mandate with the Santiago Principles. To make the transition easier, the Santiago Principles are subject to the intergovernmental agreements where each SWF is governed by the laws of its home state.

Over the last fifteen years, efforts have continually been made to establish regulation that can blend well with the principles that have already been created by various global authorities and the IMF. The Santiago Principles were the first joint effort with the SWF community to tailor laws to a unified code of conduct. SWFs were given time to adhere to the rules, and the International Working Group (IWG) monitors their progress and advises when and where appropriate. The main expectations are fairly straightforward:

- SWFs must maintain a strict code of financial risk mitigation strategies aligned with their investment goals.
- When doing business abroad, SWFs should follow all the laws of host states in which they become investors.

- Improvement of transparency structures to reassure stakeholders and foreign governments by providing public notification.

The Santiago Principles are the most important unified guideline for SWFs. It is clear that SWFs can utilize flexible policies and standards to address a wide range of issues. Many standards exist, such as international standards for best management practice, transparency, risk management and social issues, and SWFs can rely on their ability to interpret these guidelines to assist them with their investment decisions.

Prior to the introduction of the Santiago Principles, the majority of SWFs relied upon a ruling by the IMF on fiscal policies and reserve management. This ruling allowed SWFs effectively to manage transparency, operations, corporate social responsibility, and management issues. The IMF issued a manual of good practice regarding fiscal transparency and produced a code of conduct for financial policies. On a regular basis, the IMF updates the standards on how information is to be distributed to the public or which risk management practices need to be in place.

Before the introduction of the Santiago Principles, each SWF could decide which guidelines it wished to adhere to and how it wanted to function. Lack of appropriate standards and regulations that could be applied universally led to the creation of the IWG of SWFs and the IMF; together they produced the guidelines on best practice that states should embrace when creating the operating mandate for their SWF. One of the most significant goals of the Forum of SWFs established by the IWG in 2009 is to sustain financial stability worldwide while balancing the constantly evolving changes of the global financial framework. It monitors the behavior of SWFs to ensure that the way they invest does not threaten the equilibrium of the global economy.

There is not yet a regulatory body formulated to impose the Santiago Principles. SWFs are not bound to comply with the guidelines, which are not legally enforceable. Yet the general consensus remains that over the years the Santiago Principles have had a beneficial influence on SWF behavior. Some SWFs have undergone a management reorganisation within their structure in order to be able to improve their reporting mechanisms, and as a direct result of the Santiago Principles have adapted risk control practices. A significant win for the Santiago Principles was the release of the first annual public reports by some of the SWFs; these reports provided the business and political world with the first detailed insight into the operational structure of a SWF and its inward and outward investments. The academic literature on SWFs pays much attention to inward investments, in particular, those made in the West by Arab states or Communist countries.

2.6.1 G30 Report

The main goal of the Santiago Principles remains encouraging transparency and investing in socially responsible projects. Even before the 2008 financial crisis, a number of organisations were engaged in pursuing the development of financial regulations that would suit managing the evolving market place. About a year before the development of the Santiago Principles, the IMF working group on financial supervision produced the first-ever comprehensive report on the financial regulatory systems and architecture of seventeen prominent national jurisdictions. The goal of the G30 report was to focus on the current benefits and issues of supervisory tasks around the world by offering insight into different types of financial structures. Analysts responsible for putting the report together hoped that government leaders and fund managers would refer to it as helping to match the variety of financial systems to a single global standard.

The report identified four main approaches to supervision, as prominent decision makers in the industry were interviewed, and regulatory systems of the participating states were analysed; the four supervisory models were grouped as (Financial Regulatory Systems Working Group, 2008):

- Institutional approach.
- Functional approach.
- Integrated approach.
- Twin-peak approach.

For the institutional approach, the legal status of the firm determines which regulatory authority oversees the supervisory framework of that particular company. Mexico, China, and Hong Kong are examples of countries that use this approach. The functional approach emphasises supervisory regulation by the type of business instead of the legal status of the parent organisation. Under this supervisory framework, there can be two different regulatory bodies concurrently overseeing the company. Spain, Italy, France, and Brazil are examples of countries that work with this approach. The integrated approach uses the simplest form of supervision, requiring a single regulator to oversee the financial operations of companies. Countries that use this approach are the UK, Singapore, and Switzerland. Finally, the twin-peak approach resembles the integrated approach but supervises financial services based on their objectives. Systemic risk posed by a firm is regulated by one authority whereas another oversees tasks related to transparency and consumer protection. The USA, France, and Italy are some of the countries currently contemplating implementation of the twin peak approach to supervision.

2.7 EU Directive

After the 2008 financial crisis, as international economies began to recover, EU members finalised the terms of the Solvency II Directive (2009). This EU directive encourages financial companies to hold sufficient capital to avoid the risk of being unable to pay creditors, and thereby reduce the risk of illiquidity. The inadequacy of financial firms' own reforms highlighted the need for the Solvency II Directive. It is a significant milestone because it allows different types of financial companies and other related businesses to operate within the EU if they can fulfill its minimum requirements. Solvency II is part of the continuous attempt to create a single market in financial services in the EU.

This directive was implemented in January 2016 and aims to curb risky practices of companies and reduce the risk of bankruptcy, with the associated loss suffered by stakeholders when investing insurance companies go bankrupt. The financial regulators and authorities are concerned with risk-management practices in the EU. The Solvency II Directive is important to SWFs as it proposes solutions that will have a significant impact on investing in businesses with long-term objectives. It aims to discourage pension funds and insurance companies from holding infrastructural assets, so prohibiting the matching of long-term liabilities and assets on their balance sheets. There will be significant ramifications for all types of investment firms wishing to operate in the EU, as financial companies would force investors to comply with a strict code of conduct, which may be an obstacle for SWFs wanting to invest in the EU, including the UK.

Arguably, the Solvency II Directive could also be beneficial for SWFs because new regulatory changes are forcing hedge funds actively to transfer their assets from insurers and banks to SWFs that currently still have less stringent regulatory demands. This could be one of the reasons behind the continuous flow of capital entering SWFs which are owned by emerging market economies, despite oil prices being low and other economic issues plaguing the emerging markets. A situation may be beginning to appear whereby selling takes place when regulations become more expensive to comply with and because of this there may emerge a restriction on investment opportunities, leading to buying in states where regulations are more relaxed and costs lower.

2.8 CSR and transparency

The questions that become relevant to inward investment in strategic sectors lead to the need for analysis of how regulation towards inward investment has evolved, and how host nations view them. The last decade has been pivotal in the emergence of regulatory tools such as significant landmark directives and new rules of conduct for SWFs. The directives can be separated into two groups: those associated with corporate social responsibility (CSR) initiatives and non-CSR rulings; both are relevant to the way SWFs operate today.

Paramount among the issues surrounding investments by SWFs is the question of transparency. Because SWFs are not required to follow a standard global code of conduct, the measurement of their transparency and impact on social environment remains uncertain.

It is important to be aware of the significant landmarks in the development of CSR principles in relation to the activity of SWFs. The development of rules regarding social compliance, transparency, and sustainability can be traced back to the initial efforts of regulatory bodies such as the Social Accountability Accreditation Services (SAAS). Modelled on ISO (International Organisation of Standardization) standards, regulators created a basic structure for companies to apply socially responsible practices in the workplace. One such document is SA8000, a certification standard for workplaces across all industrial sectors. The certification can be acquired by any organisation or company that seeks to adhere to the rules created to maintain strict enforcement of corporate social responsibility in the workplace. Like other ISO standards, the certification is audited, and firms must maintain a minimum standard if they wish to remain compliant. Managers of certified companies undergo regular training where they are given feedback on evolving trends in the global workplace. In 2013, for instance, there were more than 3000 facilities employing approximately 1.8 million workers, which adhere to SA8000 standards. There are 23 accrediting bodies around the world that oversee these regulations in their respective areas.

This standard brings to light the issues that must be monitored to ensure a decent workplace and has set out eight performance criteria that companies must address, including:

- Child labour.
- Forced Labour.

- Safety of Works.
- Collective Bargaining.
- Laws on Discrimination.
- Disciplinary Practices.
- Working Hours.
- Remuneration.

Although SWFs are not financial entities, their managers are encouraged to adhere to the SA8000 rules, as they are a good guiding force when it comes to assisting with the analysis of investment opportunities in socially responsible companies. SA8000 also offer SWFs important information on corporate responsibility issues in emerging and third-world markets. SWFs have a responsibility to see that their investments are in line with regulatory authorities on a national level in order to ensure a safe and transparent working environment for the workers that they employ.

One notable comprehensive effort by the international community has been the G4 Global Reporting Initiative. This has been devised to introduce fair practice with respect to reporting of sustainability relating to people, the environment, and the economy. It provides guidelines on the reporting structure of social responsibility and represents an attempt to streamline reporting across all forms of organisations, from private corporations to investment funds and stock exchanges. SWF managers and analysts can rely on using this initiative when making decisions about the impact of their investments on the environment and communities. The G4 Global Reporting Initiative accords with other related significant frameworks in the transparency and CSR arena, such as the UN Global Compact Principles, UN Guiding Principles on Business and Human Rights, and the broader OECD guidelines for multinational firms. It is a practical approach to reporting, which suits institutional investors such as SWFs, as reporting organisations are encouraged to report only the most critical aspects relating to their business.

Under the G4 Guidelines issued by Global Reporting Initiative, there are two kinds of disclosure that companies must make: a description of their organisation, and its reporting structure (GRI, 2015). The outline guides stakeholders on how the company manages its sustainability and interacts with the stakeholders to address matters of importance. The guidelines on G4 can be amended with the purpose of making reporting easier for a wide range of businesses. Rather than enforcing rules on how companies must report, the guidelines allow organisations to choose from two kinds of reporting structures, and the core indicators selected by companies depend on the type chosen.

One of the most significant landmarks establishing regulation for risk management practices in social and environmental projects is the Equator Principles. Before 2013, there were several smaller initiatives on risk management, where most standards depended on internal risk management practices of companies. With the introduction of the Equator Principles, companies, including SWFs and investment bodies, acquired the ability to assess and manage the impact that their investment makes. These principles apply worldwide to four types of products:

- Project advisery services.
- Project finance services.
- Corporate loans.
- Bridge loans.

The Equator Principles have had a positive impact on communities and the environment as well as labour standards in remote areas and in socially inactive markets. In relation to the world's SWFs, it is notable that states such as China are keen to adopt the Equator Principles for SWFs and corporations. China has outsourced to European companies several environmental assessments that will assist Chinese entities to comply with the principles in developing and boosting the sustainability and transparency record of the country. The Equator Principles may be more specifically intended for banks; the SWFs are free to learn from and adapt to an institutional perspective. Abiding by the principles provides greater opportunities for SWFs to address important issues regarding risk management with reference to social and environmental initiatives. Some critics have expressed concerns as to the adaptation rate of the Equator Principles by SWFs, stating that SWFs in emerging markets are well known for poor transparency records and that the public in those countries does not see social responsibility as a major concern. It might, therefore, be unlikely that SWFs will implement the extensive guidelines voluntarily unless their reputations are at stake and there is international pressure for greater accountability. When comparing the adoption rate of the Equator Principles by banks, it can be noted that institutions in the United States and Western Europe are willing to embrace such initiatives much faster because of the fear of a backlash from brand conscious consumers.

Overall, SWFs face a difficult task in complying with set benchmarks of social responsibility; they are especially exposed via their stakes in large corporations. SWFs do show interest and willingness to be more transparent and are beginning to abide by flexible and voluntary codes of conduct as they work towards meeting guidelines set by international regulatory bodies. It must be understood that SWFs are global and that they have a diverse cultural and political history which may make them reluctant to adopt a unified benchmark.

2.9 Current state of regulation

Unified SWF regulation remains imperative, and sustained effort from regulators is necessary to ensure systematic methods of investment that will prove efficient in the long run. More relevant rules like the Santiago Principles are needed to guide SWF managers and governments. The Santiago Principles remain the only set of rules tailor-made for the governance of SWF, although managers continue to rely on other rules relevant to investment sectors by following corresponding codes implemented by working committees of the IMF, the OECD, and by ISO standards. These regulations owe their importance to the work of SWFs as they offer flexibility of implementation on a voluntary basis.

The absence of a binding set of international guidelines means that it is a difficult task for fund managers – who are responsible for constantly following the extensive literature and legislation – to find clauses that are relevant to the operation of their SWF in a particular territory and business sphere. A working committee established by regulatory authorities related to the SWFs would be beneficial, as it would prepare relevant literature and guidelines from each ruling to guide the SWF managers through issues of importance in various jurisdictions. SWF managers should be free to consult the broader ruling in a condensed form as relevant to the activities of SWF. This is a valuable and beneficial way to educate and train SWF managers on an ongoing basis internationally.

Another important step is to guide host countries by recommending institutions that rank SWFs for transparency. One such institution is Sovereign Wealth Fund Institute (SWFI), which actively participates in defining transparency ratings for large scale global SWFs. Amid the debates on voluntary regulations versus mandatory, perhaps one answer towards finding a reasonably unified solution is the creation and establishment of bodies like the SWFs Institute. It rates SWFs based on the transparency index, which offers easy to use league tables to assess the viability of cooperation between regulators and individual SWFs, as it relates to concerns about risk management, national security, and corporate social responsibility. SWFs are free to make their own decisions as to which standards they are prepared to accept, but a lack of transparency on their part is likely to lead to mistrust by the international investment and the business community. The question going forward concerns whether it is preferable to rely upon voluntary frameworks such as Santiago Principles, or whether to bring SWFs into more binding mandatory regimes.

Several host governments are currently consulting SWFI ratings to establish how they want to best deal with transparency issues originating from individual SWFs. In addition, the legal structure of SWFs at the domestic level also requires consideration. Governments must clearly define the legal status of SWFs to hold the decision-maker accountable. Within the SWF industry, there remains the concern that several prominent SWFs report to the state president directly or require permission from a political review committee before making investments abroad. Such requirements make it hard to improve transparency.

Although there are certainly consistent and ongoing attempts by the international community as a whole to regulate investment decisions made by financial institutions, inclusive of SWFs, it is also notable that the financial crisis of 2008 prompted prominent regulators to take action to regulate financial institutions so that they would keep up with adverse financial risks. Evidence of the efforts of the international community to regulate and clean up the investment world can be clearly seen in the emergence of an array of rules and guidelines. These range from the Santiago Principles to the Solvency II Directive and most recently the binding AIFMD. Regulators are working to ensure the development of a united set of regulations, which would permit governments and investors worldwide to comprehend, analyse, and address paramount issues in a fast and effective manner.

2.10 Conclusion

There is a dynamic tension in political attitudes towards SWF regulation. On the one hand, regulators with an international financial stability outlook may perceive SWFs as a potential force for global financial stability. The size, financial power and long-term outlook of SWFs mean they can ‘rise above’ the short-termism of more fickle players. Furthermore, their lack of leverage means they are less subject to volatile swings in the value of their portfolios, and can thus ride out short-term negative fluctuations in financial market sentiment. In this sense, their interests are more likely to be tied up in ensuring long-term appreciation of their portfolios by promoting authentic economic growth, rather than a focus on shallower short-term speculation. In this context, regulators might be reluctant to discourage SWFs, and may rather seek to encourage them to become a counterweight to more volatile smaller funds and leveraged players like private equity funds and hedge funds. An example of such a regulatory body might be a multilateral group such as the IMF, tasked with ensuring global financial security.

An internationally focused regulator focuses on SWFs as a class and their impact on the general global financial markets. Regulators that are more subject to local and nationalist concerns, however, are far more likely to be pressured into focusing on the dangers of particular SWFs to particular national economies. From this standpoint, SWFs are not viewed as generic international investors seeking long-term returns from the global economy, but rather as state-directed investors influenced by geopolitical motives.

The tension between these two poles is reflected in the various attempts to create frameworks for SWF regulation. The various tit-for-tat regulatory conflicts and battles for regulatory reciprocity between particular nation states mirrors the broader bilateral international relations between those states. More subtle, however, is the process by which groups of states with common interests align: in many ways the core group of SWFs represent developing or emerging economies, or nations that have deep commodity resources. This is in contrast to advanced industrial nations who often need access to such commodities in order to produce higher value manufactured goods while dominating the services industries that are built upon them. The SWF's in this context might represent nations on the second tier of the international hierarchy, using the surplus money they earn during commodity booms to make inroads into the higher value activities of the advanced industrial nations of North America and Europe.

Bodies such as the IMF – from this standpoint – become politicised because they have historically represented the interests or norms set in advanced industrial nations. Thus, while they have interests in maintaining global financial stability – something that might lead to them to potentially support the aspirations of SWFs – they are also subtly influenced to picture 'global financial stability' as the maintenance of existing lines of economic power.

Finally, the issue of regulating foreign SWFs needs to be separated from the particular dynamics of home countries regulating their own SWFs. This requires detailed forensic examination into the often opaque and complex internal politics of specific countries. A SWF does not generically represent a country. Rather, it often was conceived of and set up by particular administrations in a particular context and subsequently becomes controlled by particular departments that may be at odds with other departments or institutions of state. A domestic SWF thus may be a site of internal struggles within a country. Civil society groups – which might call for anti-corruption, transparency or environmental accountability measures – may challenge the dominant practices of the fund, while opposition parties may seek to use it to demonstrate weaknesses or shortcomings of incumbent administrations.

2.10.1 Potential classes of SWF regulation going forward

It is within the frame of these various differing motivations that we can conceive of possible configurations of future regulation. The first major parameter is the *geographic scope* of the regulation – is it national or international, or regional? The scope impacts upon which regulatory bodies are likely to be involved. The second major parameter is whether the regulation is binding (mandatory) or voluntary, or – the intermediary category – voluntary regulation that has the characteristic of binding regulation through informal sanctions aimed at those who do not comply.

At an *international* level, three configurations are possible. Firstly, an international effort can be spearheaded by SWFs themselves in the form of a self-regulatory framework. In practice this requires the mediation by a coordinating body such as the IMF or industry group like the IWG. Such voluntary frameworks are non-enforceable, but may carry informal sanctions such as 'naming and shaming' those who do not comply. Thus, failure to complying may carry reputational risks.

Secondly, efforts at mandatory international – or at least regional – regulation can be driven by multilateral institutions with enough power to coral national governments to implement ratified versions of the regulation within their national law systems. The EU is such a body, which is why the AIMFD is a potential model for how SWF regulation may look. Other international bodies are groups like the IMF, WTO or UN that have varying abilities to coordinate (quasi) mandatory forms of international regulation.

The third possibility at an international level is for a powerful nation state to implement regulation that becomes a de facto standard for other nations to follow, as a condition for maintaining relations. In this regard, the US or the EU – insofar as it can be imagined as a coherent 'mega-state' – might lead.

Against these potential international regulatory formations, regulation by national governments will continue. It seems unlikely that all nations will completely converge on unified local rules for all elements of SWFs. Thus we may see the emergence of two different classes of regulation. On the one hand, international regulation – both voluntary and mandatory – which will deal with the *generic* risks of SWFs as a class, while national regulation will deal with the *specific* impacts of particular SWFs to particular nation states.

Chapter 3: Literature Review

This thesis seeks to address the following questions:

i. Is the *manner* in which Sovereign Wealth Funds (SWFs) are currently regulated appropriate and proportionate?
ii. Could SWFs' exemption from the EU (European Union) AIFMD (Alternative Investment Fund Management Directive) give them an unfair competitive advantage in their investment activity?
iii. Does the *behavior* of SWFs suggest the need for any particular form of further regulation?

The questions above were chosen in order to address issues that have been identified in relation to the application and monitoring both of voluntary standards and mandatory regulations within the international private and public investment sectors, areas in which SWFs operate as a direct, significant investors.

In particular these questions were selected in order to help the thesis to define a number of apparent anomalies and gaps in the treatment and understanding of SWF regulation. Too little of the available data seemed to stem from professional research or academic analysis, and too much, by contrast, from less dispassionate sources, such as media, politicians and fund managers themselves.

That imbalance seemed to be aggravated by insufficient communication between the various entities whose contribution to the shaping of SWF regulation would be beneficial. The paucity of thorough information on SWF regulation led to the review of literature on the subject, set out in the thesis, and inspired the framing of questions one and two. They in turn led on to question three because the lack of literature on SWF regulation, especially comparative information, highlighted the need for proposals and solutions, with which this thesis deals.

3.1 The systemic importance and objectives of alternative investment firms

In the wake of the 2008 financial crisis, one of the substantive aims of regulating AIFs more closely was to address the concern that these institutions may be systemically important to financial markets, whereas previous regulatory frameworks had focused mainly on the banking industry.

Turner (2009) recognises the mechanics of these risks when he documents the increasing role of AIFs in financial markets and argues that if a particular investment activity is regularly performed by a bank and poses a significant risk to consumer or financial stability, it should be subject to banking style regulation, since activity in alternative financial services may feed through to the financial system and even into the real economy. It is in response to such fears that Buiter (2009) proposes that any corporate entity above a certain size and with more than a certain amount of capital should be subject to the same capital and liquidity requirements, reporting demands, and governance. He also suggests that a single EU-wide regulator be established not just for cross-border banks, but for other systemically important cross-border institutions.

These comments are broadly in line with the aims of the AIFMD; moreover, they provide some explanation for the uniform treatment of AIFs discussed earlier, in the sense that any institution conducting transactions of a particular size could be a source of systemic risk. In this context, it is of particular note that many commentators adopt the position, consistent with the ‘one size fits all’ criticism, that among AIFs, only hedge funds pose a real systemic risk by virtue of their activities.

The analysis is complicated by the fact that, despite the potential risks associated with AIF activities, it is difficult to demonstrate convincingly that they played an important role in bringing about the 2008 financial crisis, independent of the well-documented troubles in the banking industry. Van den Burg & Rasmussen (2007, p. 132) refer to a 2006 Wall Street Journal survey, in which 50 economists were asked if HFs posed a risk to the stability of financial markets. In the survey, 23 of the 41 respondents claimed that they did. Van den Burg & Rasmussen (2007) identify six factors that might lead to HFs contributing to systemic risk: (i) risk taking as a response to growing contribution and high performance fees; (ii) growth of assets under management; (iii) the practice of short selling; (iv) increased correlations between hedge fund strategies; (v) the tendency to concentrate investments in less liquid markets, and (vi) high leverage. In combination, these factors are seen to create credit and liquidity risks in the investment strategies of HFs, which could make such funds weak when the financial system comes under stress. The authors argue that a boom in leverage could go unmonitored if HFs invest in illiquid classes of financial contracts on which information is relatively sparse. They conclude that improved reporting procedures are a possible solution to the systemic risks posed by hedge funds. This discussion provides the detail behind the perception of HFs as risk takers who complicate financial markets, disclosed in interviews conducted by the UK House of Lords EU Committee.

In terms of the attempt to protect against these risks, Malcolm, Tilden, Wilsdon, Resch, & Xie (2009) state three conditions that must be fulfilled for any component of the AIFMD to have a positive impact on systemic risk: (i) HFs create systemic risk; (ii) the relevant component of the AIFMD would mitigate such risk and (iii) the impact of the proposal does not have unintended consequences which themselves cause systemic risk.

These authors support Van den Burg & Rasmussen (2007) in concluding that HFs create systemic risk, as declines in asset values during a market downturn cause leveraged hedge funds to sell assets as a result of margin calls and investor redemptions, which in turn cause asset values to fall further. However, they are pessimistic about the overall effectiveness of regulation in this area; the basis of their conclusion is that the second and third conditions do not generally hold. Specifically, the proposed limits on leverage might add to volatility by forcing funds to sell assets during crises to stay within these limits; they also speculate that these requirements could lead to the creation of new financial instruments to circumvent leverage limits; a further example of a possible countervailing change in the behavior of AIFs that might undermine the objectives of the regulators.

Payne (2011) considers systemic risk as one of two board arguments for regulating PE companies more closely. In this vein, he highlights a common feature of funding models of private equity transactions, namely the high level of debt included in the purchases of, and subsequently maintained in, the capital structure of acquired firms. Although historically the majority of debt finance was provided by the major commercial and investment banks, in the first years of the 21st century funding became available from a greater variety of sources, including a wider range of banks, investment funds, and HFs. However, in terms of the associated risks, there is a crucial distinction between the activities of HFs and private equity (PE). HFs can be seen as engaging in maturity transformation; funds are typically ongoing, with investors able to cash in their investments with some notice, often approximately ninety days, while the fund itself typically invests for the longer-term. PE firms, on the other hand, operate with a closer match between their liabilities and the maturity of their assets. This measured view of the systemic importance of PE is not consistent with the arguments of Rizzi (2009), who documents the fall of the PE industry during the crisis due to 'self-inflicted' wounds from over-aggressive investments and a reliance on inexpensive credit and financial engineering. The conclusion highlights the cyclical nature of such behavior and predicts that the industry will recover, but in the absence of government intervention, only to expose itself to the same risks.

The objective of regulating SWFs can be framed from three distinct angles. Firstly, regulation can be framed in terms of geopolitical concerns. This involves, for example, the development of standards of regulation for cases in which SWFs are engaging in direct or large scale investment into strategic sectors in a national economy. Secondly, regulation can attempt to address their potential collective role in creating financial instability or stability. Thirdly, regulation might be placed on them for the purposes of keeping a "level playing field" between SWFs and other institutions that are subject to regulation, such as private equity funds and hedge funds. In this latter context, regulation exists to remove unfair advantages, rather than to combat a specific negative element of SWF behavior.

Overall, on the issue of the necessity of regulation to protect against the systemic risks carried by AIFs, academic commentators are largely united in identifying the problem as far as HFs are concerned, but they take a more nuanced view with respect to other types of investment fund. Recalling, for example, the IMF observation that SWFs have the ability to hold on to depressed assets during a market downturn, it is apparent that the need for such measures is not completely clear. Considered in this light, the commentary is rightly interpreted as proposing that the AIFMD may have a very limited impact on the resilience of the financial system, as the principal systemic risks are generated in the traditional banking industry (Allen & Caruana, 2008).

3.1.1 Objectives of SWF investment

Truman (2008) points to the growth of SWFs as a reflection of a 'dramatic redistribution' of international wealth from traditional industrial countries to those nations which have not previously been important participants in international finance. The location of this new wealth in public rather than private hands has resulted in the suggestion that SWFs are instruments for competition with the West for political and economic power, representing a 'new mercantilism'. M. Weber (1978) has argued that capital interests and the political system have become inextricably intertwined in modern industrial states, a situation he terms 'imperialist capitalism'. Expanding opportunities for financial gain are generated as new territories are opened up by political and economic reform. Schweitzer (2011, p. 80) has interpreted SWF activity in Weber's context of imperialist capitalism to suggest that "SWFs may be seen as the instruments of commodity-rich states who use their growing economic power to exploit the capitalist system to their political and economic benefit", and that consequently there is an impetus for Western nations to defend the economic system to which they are committed by precluding the substitution of foreign state control for home state control in the context of the broad efforts towards privatization that have characterised the past three decades worldwide (Schweitzer, 2011). It is this concept of SWF activity that naturally accounts for the prevalent desire of states to protect what could be considered strategically important sectors from investment.

From 2008, SWFs began to invest heavily in US and EU financial sectors, attracted by low share prices and the perceived financial strategic opportunity offered by taking such positions. The capital provided through such transactions to entities suffering from the fallout of the financial crisis of 2008 eased both the problems of the financial sector and the related issues faced by the governments of Western nations. This has contributed to the growing perception of SWFs as responsible market participants.

Emerging from the existing academic literature are five issues of principal importance in any determination of the likely effectiveness of the proposed regulation if it were to include the moderation of SWF's under their AIF umbrella. The first four relate to the context in which the AIFMD has been formulated: (i) concern exists that the regulatory approach is a 'one size fits all' solution, taking insufficient account of diversity in the range of AIFs on which the legislation seeks to impose additional requirements; (ii) a lack of global cohesion in the design of frameworks for financial regulation has led for some to speculate that SWFs will reposition their activities to minimise the impact of the AIFMD on their reporting practices; (iii) the systemic importance of different manifestations of AIFs, a preconception of the AIFMD's formation, is widely doubted; (iv) existant levels of SWF transparency are understood to be limited, and difficulties can be identified in any attempt to increase it. The fifth theme concerns potential adverse consequences of the AIFMD's implementation, with some commentators expressing concern that the legislation may have unintended consequences for the economic recovery in the EU.

3.2 Attitudes towards SWF investment

In the academic literature, two dichotomous conceptions of the issue of SWF investment exist. For some, SWF investment is an issue of national security, posing important dangers for SWF investment recipient nations (for examples, see Slawotsky, 2009). The converse view characterises SWFs as a valuable source of investment, for which issues of economic governance predominate (for examples, see Truman, 2010 and Xu & Baghat, 2010). Previously dominant perceptions of SWFs as hostile market participants have been increasingly eroded in the aftermath of the financial crisis of 2008.

3.2.1 Areas of potential concern

There is significant concern about the potential geostrategic objectives of SWFs. However, there are increasingly divergent approaches among both government officials and academic commentators regarding the nature or magnitude of any such threats to the established political and economic order of the 'West'. As experience of SWF activity has grown, and with demand for SWF investment to allow several financial institutions to recapitalize following the tumultuous influence of the financial crisis of 2008, SWF investments are receiving an increasingly warm welcome. This softening of views towards SWF investment has not eliminated the unease generated by increasing participation in Western economies by states which are not perceived as sharing the same commitment to market capitalism and democracy. This is particularly the case in relation to Russia and China.

3.2.2 Investment into strategically important sectors

Governments consider a number of sectors to be of national strategic importance and shelter them from SWF influence via a range of regulatory bodies. For example, in the US, the CFIUS has the role of reviewing investments in US firms by entities, including SWFs, owned by foreign nations (Truman, 2010), whilst currently, EU Member States implement a variety of similar checks on inward foreign investment into strategically important sectors.

In spite of the positive academic reviews of the contributions of SWF activity, negative media coverage surrounding the motivation of SWF investments has generated public concern regarding such activity, especially in the US. Truman (Truman, 2008) reports a 2008 survey undertaken among US citizens, in which close to 50 per cent of respondents expressed their belief that SWF investments had a negative impact on the US economy, and still more concluded that their activity constituted a threat to national security (Public Strategies, Inc, 2008). Interestingly, this divergence between public opinion and the increasingly warm welcome Western politicians are extending to SWFs has only occasionally been fractured by the *realpolitik* of the electoral cycle. In a 2008 presidential debate, Hillary Clinton attempted to make political capital from the widespread unease regarding perceived increasing SWF activity within the US economy arguing, “We need to have a lot more control over what they do and how they do it”. Subsequently, as Secretary of State, Hillary Clinton continued to articulate suspicion of the extent to which SWFs enjoy unfair advantages in their market activity:

> “When favoured state-owned or state-supported enterprises enjoy preferential access to government resources and special protection from competition in their markets, that harms foreign competitors and local entrepreneurs alike.” (US Department of State, 2012).

It remains unlikely that future SWF investments will be met without caution regarding the influence they could deliver for nations with which Western states continue to have turbulent relationships. Within the EU, the requirements of the AIFMD may deliver increased confidence on the part of policymakers and the general public regarding the extent to which SWFs could unfairly or unduly utilise their financial power to the detriment of Member States.

3.2.3 Impact on employment

In the system of macroeconomic and political objectives motivating governance at the EU level, financial institutions are endowed with a responsibility to contribute to the prosperity of the region by supporting a high level of employment and by providing long-term investment in innovative projects. As considered in the prior discussion of systemic risk, Malcolm et al (2009), argue that the justification for AIFMD is undermined somewhat by the possibility of unintended consequences. Taking these two points together, it is troubling for the prospects of the AIFMD that some evidence regarding the impact of AIF activity suggests that efforts to regulate it more closely may have adverse short-term effects on the growth of employment in the EU. This evidence must be considered with the accusation, often put forward by opponents of HF ad PE, that these funds have a tendency to ‘create value’ by making workers redundant in their target firms, resulting in a negative effect on employment.

Empirical investigations of the employment impact of AIF transactions suggest that the discrepancy in perceptions may be one of timescale: while a PE fund may initially encourage a firm in which it has acquired a stake to improve efficiency by firing workers in underperforming functions, subsequent performance may allow the firm to expand in other areas, taking on new staff, so that the net effect is ambiguous. Naturally, the profile of any newly employed workers will generally differ from the original employees; critics of this activity tend to focus on the employees made redundant, but from a macroeconomic perspective there is a no *a priori* reason for favouring the interests of one group over the other. The European Private Equity and Venture Capital Association (2005) considers a number of studies examining the social and economic impact of these industries. These investigations illustrate the role that PE and venture capital have played in restructuring existing companies, as well as supporting enterprises with future potential, pointing to the conclusion that the funds provided by these activities are crucial for the conservation and creation of employment at the European level.

The UK House of Lords EU Committee presents evidence supporting this evaluation, particularly with respect to investments in 'green technology'. Malcolm et al (2009), cite estimates that the number of European companies in receipt of private equity or venture capital funding increased from approximately 7000 in 2004 to 25000 in 2009.

The British Venture Capital Association estimates that 0.8 million people in the UK are currently employees of private equity and venture capital backed companies (BVCA, 2015). Bernstein, Lerner, Sorensen & Stomberg (2010) conducted an empirical analysis of twenty industries in twenty-six countries and found that industries that had received PE attention in the preceding five years tended to grow faster than those that had not. One might account for this observed correlation with the hypothesis that industries are likely to have been targeted by PE because they were already fast growing so that causation runs in the opposite direction, but the authors take special care to present arguments ruling out this possibility. For example, they note that if the analysis is restricted only to PE investments which were made two to five years before the relevant observation of industry growth, the results do not change significantly, which indicates that either PE funds are extremely prescient in their predictions of future industry growth or, more likely, that their involvement contributes to faster growth.

Davis, Haltiwanger, Jarmin, Lerner & Miranda (2011) consider the specific criticism that leveraged buyouts by private equity firms bring job losses. The authors constructed a dataset covering US private equity transactions between 1980 and 2005. They found that PE catalyses the 'creative destruction' process, by which less productive enterprises are gradually replaced with more efficient and innovative firms; the resulting reallocation of jobs across divisions with target firms is also found to be more rapid. In the light of these claims, it is perhaps unsurprising that the European Parliament impact assessment report of 2009 on the

AIFMD outlines a number of negative short-term consequences (Lilico, McCall & Conti, 2009). The assessment forecasts falls in the growth of EU GDP and a small rise in unemployment as a result of the Directive.

Gospel, Pendleton, Vitols, & Wilke (2011) are more cautious in their conclusion regarding the impact of AIF activity on employment and the treatment of workers in target firms, but they do point out a potential additional benefit of the AIFMD in this regard. In examining case studies, they test whether jurisdictions with greater employment protection will be less vulnerable to the initial employment changes brought about by AIF transactions. Their results do not support the hypothesis and instead indicate that the type of fund is an important determinant. On this basis, they conclude that for those who are concerned about the employment consequences of this activity, regulations imposed on the funds themselves may be a more effective measure than increased employee protection; they proceed to cite AIFMD as an example.

Although the evidence is mixed, the literature does provide evidence to suggest that AIFs do provide employment in the EU, particularly though PE and venture capital. Given that ongoing compliance costs are projected to fall most heavily on these two types of funds (Malcolm et al., 2009), the possibility of a fall in employment following the introduction of AIFMD must be considered. On the other hand, as in the case of the transparency measures, closer monitoring of these funds may alleviate some concerns about the treatment of the employees of companies in their portfolios.

3.3 Themes in economic theory underscoring debate around financial regulation

Before appraising evaluations offered by the literature relating to the regulations affecting SWFs, there are several sources offering useful perspectives. Evaluation both of central themes in economic theory and reference to the success of previous attempts to legislate the activity of financial markets suggests that whilst in general the impact of legislative reform is somewhat mitigated by the response of market players, some regulatory objectives are likely to be achieved. These classical themes are well illustrated with reference to the regulation of the banking industry that arose in the aftermath of the 1929 Wall Street Crash and subsequent Great Depression, a framework often considered to have established many of the competitive advantages currently enjoyed by AIFs relative to more traditional investment vehicles.

Anticipating the impact of legislative responses to the 2008 financial crisis of AIFs requires an appreciation of wider economic theory, with divergent opinion differing about the efficacy of legislative intervention in its pursuit of the alignment of market activity with the objectives of the legislating body. In particular, relevant discussions include: (i) government failure, (ii) the geopolitical reach of regulation, (iii) the correct characterisation of the financial sector, and (iv) approaches to the modelling of systemic risk. Through a consideration of these themes in turn, it will become evident that legislative reform is capable of achieving some objectives of the legislative body, although they are likely to be limited by the responses of agents impacted by the reform.

3.3.1 Government failure

Efforts to regulate AIFs proposed by the European Council, alongside similar initiatives pursued by other authorities, presuppose that governments have the capacity to achieve more desirable outcomes than those resulting from the unencumbered operation of financial markets. However, scepticism regarding the power and motivation of governments is longstanding within the literature on government failure, whereby government intervention produces a less efficient allocation of resources than that which would have occurred otherwise. Nevertheless, distrust of legislative initiatives must be tempered by recognition of the failure of financial markets in the run-up to the 2008 financial crisis.

The objection to legislative intervention is raised forcefully by Hayek (1945), who argues that the information requirements of a body charged with the central management of an economy are too great for this arrangement to be feasible. Consequently, Hayek argues that the activities of government should be limited to providing those functions the market fails to deliver, such as the prevention of fraud in transactions, and the provision of a safety net against poverty in wealthy societies. Similar views have been espoused by the 'Chicago School' group of economists, based in the Faculty of Economics at the University of Chicago. For example, George Stigler argues that regulatory frameworks and government power would inevitably be used by special interest groups to shape legislation in ways that secure economic benefits for those parties (Stigler, 1971). Eugene Fama is associated with the Efficient Market Hypothesis, which views financial markets as efficient in the sense that asset prices reflect all relevant available information, a perspective of those whose influence is blamed by many commentators for the recent 2008 financial crisis (Malkiel & Fama, 1970).

The fear that financial regulation may result in unintended consequences is predicated upon the observed behavior of investment funds in response to previous legislation; funds changing their behavior in the face of regulatory reform in order to actively minimise the impact of such regulation, which thereby undermines its objectives. For example, financial firms may be able to exploit loopholes in regulation that may, in turn, undermine financial stability and the ability of the authorities to monitor the activities of those companies. Thus, Slovik (2012) examined the effects of the regulations on risk-weighted assets contained in the Basel II standards for capital adequacy, finding that in 1992, when the standards were introduced, risk-weighted assets represented close to 70 per cent of total bank assets, so that a large proportion of banks' exposure was subject to regulation; whereas in the immediate crisis period this fell to roughly 35 per cent. Rather than representing a reduction of risk in the assets held by the banking industry, Slovik (2012) argues that the change reflected a move to unconventional business practices intended to bypass the regulatory regime. It was these practices that resulted in the subsequent fragility of the financial sector. Conversely, recent experience suggests that financial markets were unable to price certain types of risk accurately, which was manifest in excessive risk-taking. Simkovic (2009) argues that legal changes over the eighty year period preceding the financial crisis allowed debtors, principally investment banks, to hide the extent of the leverage which they were carrying, allowing them to enhance their perceived creditworthiness and borrow at more attractive interest rates. Calomiris (2009) discusses how unrealistically low assessments of the default risk associated with subprime mortgages led ratings agencies to give mortgage-backed securities (MBS) favourable ratings. While prices in unencumbered markets may convey information to market participants, they cannot be expected to do so correctly if the relevant information is not available or properly interpreted. Thus, disclosure requirements imposed by regulations, which would force AIFs to provide more information on their investment strategies, may allow markets to perform their function more effectively in this regard, contrary to concerns of critics of government intervention.

While there are arguments that markets should not be interfered with by regulatory authorities, in the specific case of financial markets the incidence of financial crises seems to make this position untenable. One of the conditions supporting the optimality of market allocations is the availability of information, and regulation could potentially play an important role in ensuring that this condition is achieved.

3.3.2 The geopolitical reach of regulation

A strand of economic theory which is important to consider when evaluating the potential effects of financial regulation concerns the appropriate level at which government activity should operate in order to deliver its objectives most effectively. The extent to which regional governments, relative to higher levels of government, should be empowered in market regulation has motivated much public debate and extensive academic literature (Weingast, 1995; Rodden, 2004; Oates, 2005). Whilst the literature has traditionally focused on questions of taxation and the provision of public services, the analysis can be extended to financial regulation, with the recognition of financial stability as a social objective and, therefore, within the remit of regional government (Prud'homme, 1999; Burki, Perry & Dillinger, 1999; Joumard & Kongsrud, 2003).

There are several classic analyses of the optimal assignment of functions to local, regional, and central government. The work of Musgrave (1939) and of Oates (1999) presents the strengths and weaknesses of different levels of governments. Both authors suggest that central governments are in a better position to determine redistributive taxation, given the mobility of individuals between different jurisdictions, and also to carry out macroeconomic stabilisation, because they are in a position to diversify between the economic risks faced by different regions, allowing them to finance one region's recovery with the revenue from another's prosperity. Local governments, on the other hand, are better placed to collect information on demands for goods and services whose consumption is limited to their own jurisdictions. Local government can, therefore, improve welfare by tailoring their provision of public services to the preferences of their communities. This perspective is supported by the Tiebout Theorem, which states that mobility of citizens between competing jurisdictions will lead to the efficient local provision of public services, as agents 'vote with their feet' on the basis of public service provision (Tiebout, 1956). A framework that ignores the costs of moving jurisdictions and assumes that agents have full information about available choices and that there are sufficiently large number of jurisdictions to choose from, supports this conclusion. However, although mobility costs seem to be an important impediment when applied to individuals moving between EU member states, there is no reason to expect that such restrictions will restrain the movement of most AIFs. Using these analyses, it is apparent that the international reach of financial markets makes financial stability a global objective, so it follows that regulation of AIFs, whose reach is global, should aim to encompass as many territories as possible.

At the EU level, regulation of AIFs represents a departure from the existing system of EU member state regulatory frameworks. On the other hand, different EU jurisdictions show divergent levels of tolerance of the activity of AIFs; the UK, for example, has traditionally been receptive to private equity (Watt, 2008). Consequently, it will be virtually impossible for an EU-level framework to satisfy the preferences of all the parties which would be affected by the changes.

Similar considerations arise when comparing the merits of centralising regulation to an EU level with the possibility of a global approach to financial regulation. Specifically, a global regulator would not have to act under the constraints imposed by the fact that investment funds may be internationally mobile and therefore able to avoid more stringent regulatory regimes by relocating to lightly regulated jurisdictions. Brunnermeier, Crocket, Goodhart, Persaud & Shin (2009) highlight as one of the fundamental problems of financial regulation the fact that effective regulation constrains regulated parties from achieving their desired, unconstrained positions, often by lowering the profitability and return on capital. This results in a shift of business towards unregulated sectors and jurisdictions; the argument, therefore, reinforces the importance of global cooperation on financial regulation, where the stance of the US, for example, will be a particularly important determinant of the effectiveness of measures taken in other jurisdictions. Furthermore, these authors point to the fear of a competitive inequality between domestically, in this case EU owned financial firms and subsidiaries and branches of foreign firms; their response to this is to argue that the jurisdiction which would be responsible for bearing the costs of a financial breakdown due to the failure of a particular subsidiary or branch should be allowed to impose its own capital and liquidity requirements.

It is clear that the mobility of investment funds calls for an EU-level framework to replace or at least augment the system of national rules. However, for the same reasons, the competitive inequalities discussed by Brunnermeier *et al* (2009) are likely to compromise the efficacy of such changes, due to differences in the strictness of the regulatory stances taken by non-EU jurisdictions.

3.3.3 Macro-finance and models of imperfect information

Traditionally, activity in the financial sector has been modelled as the result of decisions made by the agents in the rest of the economy, for instance, as they decide which assets to use for maintaining their wealth in order to fund future expenditure (Pike & Neale, 2015).

However, in the wake of the 2008 financial crisis, such modelling choice has been questioned.

Until recently, there was little formal consideration of the possibility that fluctuations in financial markets could determine behavior in the real economy. This is perhaps surprising given the rich discussion presented by, for example, Keynes (1930/1973), who highlighted the role played by short-term speculators in determining asset prices. Minsky (1975) takes this model of the economy further by arguing that confidence leads to an increase in the leverage carried by agents in the economy until it causes financial distress. However, in the 20th century, the Keynesian macroeconomic vision was interpreted using mathematical models which tended to sideline psychological and sociological forces, such as 'confidence', which Keynes described as being operative in the determination of asset prices (Akerlof, 2002). This is understandable since, from the standpoint of economic theory, it is difficult to formalise the behavior that is described in these approaches. However, the models resulting from such simplification lead us to view the economy, and particularly financial markets, as having a much greater tendency towards stability than is evidenced during major financial crises (Colander & Rothschild, 2010). With this in mind, there is an increasing awareness, in both academic and policy-oriented discussions, of the complexity of financial firms' activities and their potential effects on the wider economy. In models of asymmetric information in financial intermediation, whereby the clients of banks and investment vehicles are not able to assess the level of effort applied by the firms in the stewardship of their funds, problems may arise because the financial firms themselves are unable to judge the profitability of investments (Mankiw, 1986). In this vein, Christiano & Ikeda (2011) present models inspired by the work of Bernanke, Gertler, & Gilchrist (1999), Gertler & Karadi (2011), and Gertler & Kiyotaki (2011). Christiano and Ikeda apply the financial imperfections identified in these models to the behavior of the banking industry and discuss the efficacy of different policy options.

3.3.4 Network theory and systemic risk

Related to attempts to provide a richer characterisation of financial intermediaries is the recognition that the structure of links between firms, particularly those characterised as credit relationships, might be important in determining the level of systemic risk carried in the activities of different corporations. In order to analyse these issues, models of the banking sector have been augmented with concepts imported from network theory, a field which analyses and describes systems that can be represented as a set of nodes or points; here banks are connected by a set of links, in this case, credit relationships. These models can be used to investigate the effects of such links on the possibility of contagious, or knock-on, default. One of the principal advantages of this approach is its recognition of the fact that banks or firms in general, may be heterogeneous in the impact of their activity on the rest of the industry, and potentially, the wider economy. This is a departure from the approach of more standard economic models, which tend to examine the behavior of a 'representative' or average unit, thereby ignoring the potential difference between the firms in question.

Nier et al. (2007) investigated models of banking systems that differ in the level of connectedness between banks, the level of capitalization of individual banks, the size of interbank exposures, and degree of concentration in the system. They simulated the effects of shocks to individual banks in these systems to determine how each of the above factors contributes to the resilience of the overall structure. They find that with a sufficiently high level of capitalization, the banking system will be virtually immune to contagious defaults, whereas with low levels the probability of contagion increases in a nonlinear manner. In addition, similar systemic breakdowns are likely to occur when the size of interbank exposures is large and when the industry is relatively concentrated so that it is dominated by a few large firms. These models, therefore, suggest that a high net worth of financial firms is important to the functioning of the financial system. However, they also imply that situations in which a small number of financial firms are responsible for large levels of credit transactions in a particular jurisdiction should draw more attention from regulators.

3.4 Difficulties associated with increasing the level of AIF transparency

One of the regulatory advantages enjoyed by AIFs in comparison with other institutions is that, due to the private nature of their activities and relatively sophisticated clientele, they have been able to avoid many of the reporting and disclosure requirements that must be fulfilled by other financial intermediaries. In some jurisdictions, this might be viewed as a residual effect of the round of regulation that followed the Great Depression, where scrutiny fell upon the fragility of the banking system. As a result of this historical advantage, one of the main concerns raised by critics of these funds is the lack of transparency under which they operate; this is consequently an area where, for example, the measures proposed in the AIFMD appear to be most needed and likely to be effective.

De Bellis (2011) highlights the need for clarity in the specification of disclosure requirements when drawing up regulations for financial institutions: in a discussion of the treatment of transparency in the Santiago Principles, she calls for a higher level of detail in the requirements, arguing that since disclosure is costly for investment funds, it is important to be clear about which information needs to be available to the general public and which needs to be made available only to domestic regulators on a confidential basis. Following a similar line of argument, Van den Burg and Rasmussen (2007) assert that there is a greater need for transparency amongst PE and HF due to the changing characteristics of investors, who are increasingly not the traditional wealthy clientele but private retail investors and financial institutions serving the general public; these clients are viewed as being less likely to have the expertise, influence, or motivation to obtain the relevant information for themselves. Furthermore, these authors argue that disclosure is crucial for allowing the monetary authorities to assess the aggregate of investments and commitments, and thereby monitor the level of leverage in the financial system. This is consistent with the emerging view that monetary authorities should be empowered to play a major role in safeguarding financial stability.

Alongside the evident dividend for policymakers, investment fund clients, and the general public, which greater transparency might yield, some observers believe that the disclosure rules may be beneficial for the funds themselves since they will improve their image in the eyes of more suspicious regulators. Supporting the idea that certain AIFs may be treated as 'foreign elements' in particular jurisdictions, Schmidt & Spindler (2007), as cited in Watt (2008), Martin (2010) documents the panic triggered in the USA by the rise of the China Investment Corporation (CIC). Many people complained that the stance taken by the US authorities on investments by CIC in other AIFs and regulated financial institutions did not protect economic security (for example, see Truman, 2007). Lang (2011) highlights initiatives such as the Santiago Principles as evidence of the willingness of SWFs to become more transparent in their activities; she outlines two measures of transparency which have been constructed to document this shift. First, the Truman Scoreboard (Truman, 2010), which scores each SWF based on structure, governance, accountability, transparency and behavior. Second, the Linaburg-Maduell Transparency Index (LMTI), used by the SWF Institute, which gives an equal point weighting to ten different principles dealing with availability of information on the operations of the fund; these principles were generated using the Norwegian SWF as a model, and it is recommended that a SWF be able to meet at least eight out of the ten criteria (Linaburg & Maduell, 2008). Lang (2011) argues that the LMIT has the advantage of being simpler, whereas the Truman Scoreboard is more comprehensive; accordingly, several of the larger SWFs initially achieved low scores on the Truman Scoreboard. It has also been pointed out that 100 per cent compliance with the Santiago Principles would result in only 76 per cent compliance with the Truman standards. So the Truman Scoreboard may be useful in developing more stringent standards of transparency, which Lang (2011) suggests will be necessitated by the increasing financial maturity of SWFs.

The commitment to disclosure principles is also noted by Ramamurti (2011), with the observation that Asian SWFs appear to be moving in the direction of greater transparency. For example, Singapore's largest SWF, the Government of Singapore Investment Corporation (GIC), published its first public management report on its portfolio and the size of its losses in 2008; in 2008, CIC, the Chinese SWF, issued a relatively detailed annual report including its 2008 performance results and a disclosure regarding its staffing and organisational structure (CIC, 2008). This is broadly consistent with Behrendt's observation that a small cadre of SWFs managed by more stable governments is showing some commitment to standards of best practice (Behrendt, 2010). If this proves to be true, the transition to the disclosure standards imposed by the EU should prove relatively painless for the more prominent SWFs.

The balance of opinion relevant to the disclosure measures contained in, for example, AIFMD is optimistic about the benefits likely to flow from this aspect of the regulatory reform. These measures are seen as correcting a deficiency in the behavior of all AIFs, one that is potentially harmful both to investors and to the general public. They are also viewed as being well attuned to wider regulatory changes, such as the shift in the stated responsibilities of European monetary authorities. Moreover, there are good reasons for expecting that many AIF managers will find it beneficial to cooperate since the resulting improvement in their image might encourage a more permissive attitude from interested parties.

3.5 The AIFMD

While literature on the AIFMD is limited, there is considerable interest in the objectives and increasing influence of SWFs. The proposed control of the AIFMD over AIFs requires an investigation into whether such legislative reform is likely to achieve its desired outcomes.

Historical success in legislating financial markets suggests that, while the impact of reform is mitigated by the response of market players, some legislative goals are likely to be achieved. Regulatory developments following the Crash of 1929 support the AIFMD strategy by illustrating that it may be more effective to regulate specific activities than to limit supervision to a particular type of institution.

3.5.1 The AIFMD's likely effectiveness

Five principal issues need to be considered with regard to the effectiveness of the proposed regulation (Ernst & Young, 2012): (i) the diversity among the AIFs that it seeks to legislate; (ii) a lack of global consistency in framework design, which may vary the reporting practices of AIFs (Spangler, 2013); (iii) widespread doubt concerning the systemic importance of different manifestations of AIFs; (iv) limited AIF transparency (Truman, 2008), and (v) any potentially adverse consequences of the AIFMD's implementation (Rijkenberg, 2013).

Two alternative approaches for guiding AIF behaviors are advanced: first, indirect regulation, in which the monitoring of counterparties proxies that of the funds themselves; and second, inviting relevant industries to develop protocols in collaboration with international organisations such as the IMF (Nabilou & Pacces, 2015). The literature further suggests that the greatest potential of the AIFMD is in the sphere of AIF transparency, and that in other respects, restrictions on the behavior of AIFs are either mostly unnecessary or likely to be ineffective.

3.5.2 The AIFMD as a 'one size fits all' solution

Given the prevalent concern of identical demands being made on diverse funds, Turner (2009) suggests regulating institutions according to their economic function rather than their legal form. He also notes that leading up to the crisis, a key banking function – maturity transformation – was performed by legal institutions not subject to the requirements designed to guard against the risks associated with the practice. In response, the Commission of the European Communities (2009) proposed to give national authorities restrictive powers in exceptional cases ((COM) 207/2009). AIFs leveraging above a certain level would be required to disclose their activities and those acquiring controlling stakes in companies would need to disclose their strategies and objectives to shareholders (EC 2009).

Despite these intended safeguards, the UK House of Lords (2010) cites complaints made by the UK Financial Services Authority (FSA) and the Confederation of British Industry (CBI) that the uniform approach of the AIFMD is inadequate and may decrease investor protection (Vol. 1: Report). Scholars indicate that different fund structures present different levels of risk. For example, Achleitner, Betzer, & Gider (2010) contend that private equity investments are more motivated to leverage and transform companies from being privately owned to being publically traded; also that PE funds invest in firms with low managerial ownership, for which leverage, because of low financial distress costs can be increased (Achleitner, Betzer & Gider, 2010). Case studies by Gospel et al. (2011) observe that hedge fund objectives are directed towards providing near-term value for shareholders as opposed to longer-term considerations of the viability of the target. The Directive text (2011) also cites differences, explaining that while macro-prudential risks associated with leverage are carried by hedge funds, those associated with governing portfolio companies are mostly presented by PEs. According to the IMF, SWFs tend to be underleveraged, longer term, and more protective of depressed assets during market downturns.

Further discourse focuses on SWFs as a vehicle for large-scale capital investment in new economic powers. Though they behave similarly to private companies, SWFs carry the suspicion of being politically motivated (Balding, 2012). Challenging the uniformity of the AIFMD requirements, Backer (2009) argues that similar stringent regulation of SWFs will not necessarily give protection from state manipulation of international financial markets, citing the enormous influence of Norges Bank over public policy through its management of the Norwegian Global Fund. Faunce, Neville, & Wasson (2006) contend that industry lobbying is facilitated by World Trade Organisation (WTO) mechanisms, while Seabrooke & Tsingou (2009) discuss the 'revolving doors' through which agents in the world economy move between public and private roles, undermining any regulatory distinction between international bureaucracies and transnational private organisations. The proposal to regulate SWFs as idealised private market participants is, therefore, limited. Contrary to the risks presented by different investment funds, it can be argued that in some instances the AIFMD may not be restrictive enough. It is, therefore, expected that the legislation will not only limit the activities of fund managers in certain cases, it will also create opportunities for manipulation by investment funds in other spheres.

3.5.3 Proposed alternatives and improvements to the AIFMD

Given the challenges facing the AIFMD and the discussions surrounding international regulatory coordination, alternative approaches have been proposed. Where there is no prospect of an international financial authority emerging, various forms of self-regulation have been considered to mitigate loss and to improve the image of firms in the eyes of governments and potential clients (Giovanoli, 2009).

The first alternative is indirect regulation, which Van den Burg & Rasmussen (2007) outline as the regulation of AIF counterparties, particularly in banking, to ensure that their activities do not create significant risks. Buiter (2009) proposes general changes to restrict the activity of AIF counterparties and AIFs alike, including: (i) eliminating the role of external ratings agencies in the Basel risk-weightings; (ii) the partial payment of agencies in the securities they are rating, and (iii) requiring new financial products to be regulated and tested using the rigours applied to new medical drugs. Such measures might alleviate concerns about the opaque nature of AIF transactions, which has historically prevented observers from identifying the build-up of risks within the financial system. Yet Duncan, Curtin, & Crosignani (2011) argue that the 2008 financial crisis manifested itself most powerfully amongst highly regulated entities, such as credit institutions and investment banks, and in highly regarded transactions such as residential lending and public securities. This observation casts doubt on the indirect approach, given that such regulation has been ineffective before.

The second self-regulatory alternative is cooperation between AIFs and international bodies to develop industry standards for 'best practices'. As previously discussed, the Santiago Principles are more inclusive of governments not traditionally involved in global financial networks. De Bellis (2011) and Backer (2010) argue that the 2008 OECD Declaration on SWFs and Recipient Country Policies limits host country regulations on issues of national security and so may result in greater market access to sovereign funds. Such initiatives address some of the limitations of the regulatory approach followed by the EU. However, Badian & Harrington (2009) underscore the scepticism about these efforts by emphasising the voluntary nature of the programmes, which leads to the perception that they are 'soft' measures, as nations may choose not to comply with industry standards that do not favour them.

Certainly, given the international nature of the activities of financial intermediaries, regulations require some degree of cooperation and transparency between governments. The EC Proposal (2009) concedes that European regulation will be ineffective without similar efforts being made in other key regions. Without regional parity, more heavily regulated member states, such as the UK, may be at a competitive disadvantage compared to states with more liberal jurisdictions. Citing the US Bill for a Private Fund Investment Advisers Registration Act of 2009, the House of Lords EU Committee (2009) asserts that US measures are likely to be much less demanding than the AIFMD requirements, and Deutsche Bank further warns of regulatory arbitrage across jurisdictions, as EU fund managers shift more of their activities away from Europe to exploit a more favourable regulatory environment. To sum up, where new, mandatory regulations present too stringent a regime, it may drive funds out of the EU and put EU-based AIFs at a global disadvantage.

3.5.4 Standards by which the effectiveness of the AIFMD can be measured

The EC is due to review the effectiveness of the AIFMD by 2017. Yet while the negative impacts of the regulation may be readily apparent within that timeframe, the broader stability being generated by the Directive may take longer to be evidenced. More guidance is needed to develop the criteria used to assess the impact.

Regarding transparency, leading SWFs do demonstrate willingness towards greater transparency, which encourages the architects of the AIFMD and creates a possibility for similar regulation directed at SWFs in the future. A comparative study of existing and newer transparency provisions, including the Truman Scoreboard, the LTMI, and the Santiago Principles, would gauge the strictness of the Directive’s requirements and evaluate the extent to which these would deter global SWFs from investing in the EU.

As for alternatives to the AIFMD, the only schemes considered in any depth to date involve self-regulation, though few sources deny the need for more regulation of AIFs. Scholarship on AIF regulation does, however, need to consider the specific restrictions between various types of banks and AIFs and to discuss whether an extension of the pre-existing UCITS standards would be adequate or fail categorically, given the current economic state of the EU.

The main arguments relating to the likely impact of regulation on the positioning of SWFs parallel discussions of the impact of previous legislative responses to international financial turmoil. Consequently, the notable successes and limitations of the Glass-Steagall Act of 1933 may elucidate the potential impact of the current attempt at securing financial stability through regulatory reform.

3.6 Glass Steagall's impact on competition and comparison with the AIFMD

During the Great Depression – the beginning of which was marked by the US stock market crash of 1929 – the American banking system teetered on the edge of collapse. Depositors attempted to withdraw their funds *en masse* as fears of market instability spread, causing several bank runs and dramatic falls in the value of assets (Fisher, 1932). For US legislators, these events highlighted both the fragility of the banking system and its importance for the functioning of the wider economy. Consequently, a round of banking regulation was introduced by the Glass-Steagall Act of 1933 (or Banking Act, HR5661), which aimed to improve the resilience of the banking industry.

In particular, the measures sought to ensure that commercial banks limit themselves to safe lending to finance the production and sale of goods and that they should not be active participants in the securities markets that were linked to the crash (Friedman & Schwartz, 1971). The regulations sought to address some of the abuses and conflicts of interest that had been uncovered by the Pecora Commission of 1932, which investigated the causes of the Wall Street Crash of 1929.

The main provision of the Glass-Steagall Act brought about a number of significant changes in the conduct of banking services in the USA: (i) the Federal Deposit Insurance Corporation (FDIC) was created to provide deposit insurance for banks that were members of the Federal Reserve System; (ii) commercial banking was separated from investment banking activities, and (iii) the use of bank credit to support speculative activities was restricted by the requirement that each regional Federal Reserve Bank monitor local member bank lending and investment.

These measures had clear effects in restricting the activities of commercial banks. Kuttner (2007) argues that contrary to fears that the restrictions would threaten the recovery, the regulations actually improved the efficiency of the financial sector by ensuring transparency and reliability. Minsky (1982) attributed the post-war success in avoiding protracted depressions to the structural and regulatory interventions that arose from the Great Depression. The restriction of banking activity was reflected in the proportion of the assets of US financial institutions held by commercial banks, which fell considerably during the post-war years (White, 1991).

However, loopholes in the legislation allowed certain non-bank financial firms and markets to provide replacement services for corporations in need of credit and for depositors seeking higher returns. Specifically, Glass-Steagall covered only Federal Reserve member commercial banks; it did not prevent securities firms from owning separate subsidiaries that were non-Federal Reserve member banks, even if those banks were insured by the FDIC. This would later be the basis of the concern that large commercial banks might seek to leave the Federal Reserve system in order to avoid affiliation restrictions (Reinicke, 1995).

Loopholes and anomalies began to emerge in the post-war period. For example, 'Regulation Q' placed restrictions on interest rates for commercial bank deposits (Gilbert, 1986), and in the context of rising market interest rates in the late 1960s and 70s (Friedman, 1975), this created an incentive for depositors to redirect money towards non-bank investments that could take advantage of the higher rates. Thus helping to give rise to the market for 'commercial paper' (Cussen, 2014), where companies borrowed directly from capital markets rather than banks (Abken, 1981). This deepened a schism between traditional regulated bank lending and relatively unregulated direct lending by players in capital markets, and the emergence of differences in quality between the two. Some have argued that the system left commercial banks with poorer quality loan assets, as higher quality borrowers took advantage of the unsecured commercial paper markets that lower quality borrowers could not get access to (Garten, 1988).

The size and development of commercial paper capital markets expanded in the US, and 'money market' funds – which pooled together investors' money to invest in short-term assets like commercial paper – grew. These enabled large investment-grade corporations to get short-term funding from people seeking safe, relatively liquid investments that could be redeemed at short notice.

Moreover, the development of securitisation techniques that allowed the heterogeneous risks of small-scale borrowers and below investment-grade ('junk') corporates to be homogenised and pooled, allowed access to these growing non-bank capital markets for even riskier players (Kendall & Fishman, 1996; Jobst, 2008). Residential mortgages were among the first assets to be securitised in the late 1970s, meaning that while banks initially provided the funding to originate loans, the final funding came from capital markets. In the 1980s, this activity expanded into a range of other assets issued by borrowers who previously had no access to capital markets (Macey, 1993).

These ‘disintermediation’ trends operated on both sides of the banking sector’s balance sheet. The new range of facilities – such as the money market funds – came to resemble bank checking accounts for depositors, whilst a new range of funding options – such as the commercial paper markets – became available for borrowers seeking loans.

Other financial institutions took advantage of this. The savings and loans (S&L) industry – which operated out of the Federal Reserve System – developed “negotiable order of withdrawal accounts” (NOW accounts or checking accounts), which offered similar functions to bank checking accounts, with people in effect using their savings accounts to engage in payment (Kaplan, 1973). Furthermore, foreign banks began to take advantage of this by establishing branches in states with permissive regulatory stances and then gaining stakes in securities firms.

The development of ‘banking-like’ functions by non-banking firms and capital markets constituted a relatively unregulated ‘shadow-banking’ competitor to the regulated banking markets (Kregel, 2014). These new players could often provide services more cheaply, and Garten (1988) argues that the regulation of commercial banks began to fail when these unregulated financial firms and capital markets were able to provide replacements for bank services, thereby reducing the profitability of commercial banking. This mirrors the sequence of events described by Brunnermeier et al (2009) in which business shifts from the regulated to the unregulated sector.

The downfall of Glass-Steagall was related to the emergence of this shadow banking sector, which put pressure on regulators to ‘level the playing field’ that put commercial banks at a competitive disadvantage. The response of legislative bodies created support for moves to repeal some of the banking regulations. By the late 1980s, large banks were arguing that the Glass-Steagall Act prevented US banks from competing internationally as other jurisdictions were concomitantly ending their prohibitions of links between commercial and investment banking (Ferrera, 1990). Throughout the 1980s and 1990s, studies were published arguing that the underwriting standards of affiliates of commercial banks dealing in securities in the 1920s were no worse than those of autonomous securities firms, see, for example, White (2009).

In 1987, Alan Greenspan testified to Congress that the Federal Reserve Board supported repeal of the Glass-Steagall Act, particularly with regard to the restrictions on affiliations between banking and securities firms. These measures would eventually be repealed under the Clinton administration in 1999; they were supported by arguments about the competitive position of the US banking industry and the possibility that such a move could actually produce a more stable financial sector by diversifying the product offerings and revenue streams of financial firms.

3.6.1 Lessons for future regulation

The development of banking regulation in the US after the Great Depression illustrates several issues that may confront attempts by the EU to tighten regulation of AIFs. Kuttner (2007) points out the similarity of the contexts faced by the architects of the Banking Act and current regulators in terms of the abuses and risks which they were called on to eliminate, such as excessive leveraging, a lack of transparency, and conflicts of interest between financial insiders and the public which their firms serve. The two episodes also raise similar concerns, that effective financial regulation will shift activity away from the regulated sector or jurisdiction, perhaps in favour of players like SWFs.

While, as indicated above, some argued these fears were eventually confirmed, the predictions of their negative effects on the rest of the economy were certainly supported by the experience of the US economy in the immediate decades following the changes. Minsky (1982) characterises the period up to 1966 as one of stable economic progress, where liquidity and conservationism were both evident in financial markets; it was only once the memory of the Great Depression began to fade, and regulations and standards were relaxed, that financial instability and associated macroeconomic dysfunctions returned as a feature of the US economy.

However, with specific reference to SWFs, there is also an immediate difference between the two cases: while the collapse of the banking industry during the Depression was clearly identifiable in the wake of the recent financial crisis, the role played by AIFs, including SWFs, is not as clear. While it has been argued that the behavior of some funds, particularly hedge funds, may have increased the volatility of financial markets, the main source of the breakdown has again been identified in the banking industry (and indeed, the subsequent regulatory reforms have been aimed at the banking industry, e.g. Vickers Reforms in the UK).

Two important arguments might arise from this observation:

i. First, the AIFMD might be seen as too restrictive. For example, in the UK banking industry, the stance taken by the EU on financial regulation will tend to put European financial firms at a competitive disadvantage, which will, in turn, create pressure for some of the restrictions to be loosened. This situation may be exacerbated by the fact that EU countries in which AIFs conduct more business may suffer disproportionately from the changes.

ii. The US experience illustrates the effects of a regulatory framework that is too narrow in respect of the institutions to which it applies. One of the reasons why competitive pressures mounted for banking firms was that non-banking entities, including various types of investment funds, were not prevented from engaging in the riskier activities, thereby attracting sophisticated investors (Garten 1988). There is, therefore, a justification for the attention which is now being paid to the AIFs; their regulation is crucial for the success of the regulatory changes which deal directly with the banking industry.

In the light of the claim by commentators that the gradual removal of the Glass-Steagall Act facilitated some of the activity which led to the 2008 financial crisis, it is likely that the second of the two perspectives considered above will come to dominate the discussions on financial regulation, and the AIFMD in particular it highlights that SWFs have an unfair advantage by not being included under AIFMD.

To the debate on the necessity of regulation for alternative investment funds and its effectiveness, this discussion has considered the possible contributions of general themes in economic theory and the experience of US financial regulation after the Great Depression. Economic theory provides several perspectives which highlight the risks associated with an unregulated financial sector, and also highlight, as a major limitation of the proposed regulatory measures, the likely shift of activity away from regulated AFMs, into lightly regulated investors such as SWFs. This concern is reinforced by the historical record of US banking regulation, which was eventually undermined by the competitive inequalities which regulation imposed on commercial banks. However, this episode can be interpreted as evidence of the need for reforms beyond the AIFMD. These conclusions establish a context for the consideration of the specific, although currently sparse, literature concerning SWF regulation.

3.7 Other regulation of SWFs

With regard to the difficulties in arranging cross-jurisdictional coordination on issues of financial regulation, SWFs are again identified as presenting a particular problem; Deutsche

Bank emphasises the importance of reciprocity in the level of market access given to SWFs in host countries. In support of this, De Bellis (2011) discusses the Santiago Principles, a set of best practice principles drawn up by the International Working Group for SWFs and the IMF. The Santiago Principles, also known as the Generally Accepted Principles and Practices (GAPP), feature twenty-four voluntary principles dealing with desirable legal frameworks, institutional frameworks, and governance for SWF. An early criticism of the guidelines was their voluntary nature, although some commentators argued that weaker principles are more easily adopted and this has encouraged some of the more secretive SWFs to comply with the standards. On the other hand, Behrendt (2010) observes unevenness in the implementation of the principles, arguing that a small group of funds, mainly from democratic countries, have shown a high degree of compliance while SWFs from the Gulf Arab region have yet to reach satisfactory implementation levels. De Bellis (2011), however, describes the Santiago Principles as innovative because of their inclusion of countries not typically involved in global financial networks. For example, governments of nations which are rich in commodities, and whose prominence in global financial markets is often dictated by commodity price levels, have been able to participate in the development of best practice through their SWF. As a potential obstacle to this, Lang (2011) discusses how the progress of these funds might be halted by the fact that they are often viewed by host countries as pursuing geopolitical objectives. These suspicions appeared to be maintained in the face of a lack of evidence for such behavior. Bu (2010) examines the rise of Chinese SWFs in the context of fears that their investment choices may be politically rather than financially motivated and may, therefore, threaten national security, particularly in the US, and financial stability internationally. Bu (2010) concludes that there is no evidence to support these concerns, and his argument proceeds to determine that even though there is currently no specific national or multilateral regulation of SWF investments, the existing regulatory regimes should be sufficient to protect against potentially threatening investment strategies.

The balance of opinion relevant to the disclosure measures contained in AIFMD is optimistic about the benefits likely to be accrued through this aspect of the regulatory reform. These measures are seen as correcting a deficiency in the behavior of all AIFs, which is potentially harmful. They are viewed as being well attuned to wider regulatory changes, such as the shift in the stated responsibilities of European monetary authorities. Moreover, there are good reasons for expecting that many SWFs will find it beneficial to cooperate since the resulting improvement in their image might encourage a more permissive attitude from host nations.

Certain SWFs have shown a willingness to work with international regulatory bodies to develop standards of best practice. De Bellis (2011) portrays the development of the Santiago Principles as being more inclusive of governments that are not traditionally involved in global financial networks; in this sense, initiatives like this address some of the limitations of the regulatory approach followed by the EU. Backer (2009) considers the 2008 OECD Declaration on SWF and Recipient Country Policies, which amongst other things attempts to limit host country regulations to issues of national security and demonstrates how these guidelines, in conjunction with the efforts made by SWFs, might result in greater market access for sovereign funds. However, Badian & Harrington (2009) sum up the underlying scepticism towards these efforts when they emphasise the voluntary nature of the programmes, which leads to the perception that these are 'soft' measures.

3.8 Lack of global cohesion in the design of frameworks for financial regulation

One of the dominant concerns raised with respect to national or regional approaches to financial regulation in general is that, given the international nature of the activities of financial intermediaries, regulations do not prove effective without some degree of cooperation between governments. Accordingly, there is, running through the literature considering the AIFMD, a theme which suggests that the stance of the EU may be undermined by the relative laxity of other regional initiatives.

The issue of cooperation beyond EU nations is identified in the European Council's proposal for the Directive (Commission of the European Communities, Proposal for a Directive of the European Parliament and the Council on an Alternative Investment Fund Managers, 2009), which conceded that although regulation at the European level is important and necessary, it will not be effective without similar efforts being made in other key regions. In the case of the EU, this creates a special political economy issue, since the economy of the UK, which is viewed as a major financial centre, would suffer disproportionately. In particular, much of the thinking on financial regulation has had to accommodate the constraint that the more heavily regulated regions may find themselves at a competitive disadvantage compared with jurisdictions adopting a more liberal approach. This argument is made forcefully in the report by the UK House of Lords EU Committee (2010), which asserts that the AIFMD cannot succeed without international coordination. Committee members pointed out that while the stated intentions of regulatory changes in the US appear to be favourable to the European stance, for example, the release of the Bill for a Private Fund Investment Advisers

Registration Act of 2009, in practice the measures taken by US authorities are likely to be much less demanding than the requirements of AIFMD. Moreover, the committee cites Deutsche Bank's submission warning of the possibilities for regulatory arbitrage across jurisdictions, as EU fund managers shift more of their activities away from Europe to exploit a more favourable regulatory environment. If we consider that the same comments have been made with respect to proposals for banking regulation in EU countries, the dimension of the dilemma becomes more readily apparent (Goff, 2011).

Froud & Williams (2007, p. 416) raise a similar possibility with their claim that while "(…) it is widely acknowledged that Europe provides better private equity opportunities than the USA (…), the more adventurous funds are increasingly looking further afield in India, Russia and China". Malcolm et al. (2009) use these observations to argue that the changes are unlikely to result in a decrease in the availability of funding for SMEs; while funds based in the EU may be forced to share the compliance costs with their investors, funds based outside the EU are able to seek funds from non-EU investors for their operations, allowing them to escape many of the obligations imposed by the AIFMD. This would, however, leave European AIFs at a considerable disadvantage. These perspectives are linked to a recurring theme in the financial regulation literature, namely, that poorly designed frameworks could elicit countervailing responses undermining the stated goals of policy makers.

Given the complications associated with the unilateral regulation of AIFs embodied by proposed regulatory reform and its consequential limitations, there is some scepticism regarding the true motives behind reform at this level. Payne (2011) observes that many national regulators, including the FSA in the UK, have already introduced rules for corporate governance and risk management for AIF managers, and, therefore, the additional level of regulation imposed at the EU level requires special justification. Harmonisation at the EU level constitutes possible justification, given that the problems of competitive advantage and regulatory arbitrage, outlined above, become even more acute between competing jurisdictions within the EU. However, Payne (2011) argues that there is not a great deal of diversity in the regulatory regimes of different EU jurisdictions, and, in any case, harmonisation at the EU level is not feasible without global cooperation. These considerations support Payne's conclusion "(…) the correction of deficiencies at national level does not seem to have been a driving force of this Directive, but rather a desire for the EU to assert control in the regulation of this area". This assertion is corroborated by Watt (2008) who cites analyses (for example, see Schmidt & Spindler, 2007) portraying PE as a 'foreign element' in some contexts, such as in the German financial sector. It is this that generates the perception that PE activities are more harmful in these regions. The decision to introduce new regulation may, therefore, be motivated to some extent by the desire of some parties in the EU to limit the impact of activities in other national jurisdictions which they view as undesirable, rather than the need to design an internationally competitive regulatory regime.

3.9 Key conclusions and shortcomings in existing literature of SWF's

As stated at the beginning of chapter one, lack of communication between various participants, such as academics, media, politicians, legislators and fund managers, hinders consideration of the gaps and anomalies in understanding SFW regulation; the situation is worsened by the paucity of written information. We noted, for example, a lack of critical assessments or detailed studies of the position of SWF managers in the political and the investment framework, as well as a lack of academic analysis of several areas of regulation.

Such shortcomings were apparent in considering the 2008 financial crisis, which provoked a global rethink of financial regulation. It threw into relief the sharp differentials between treatments of different financial institutions whilst also highlighting the difficulty of categorizing them. Shadow-banking activities take place within non-bank institutions, and the growing power of such institutions has inspired regulators to turn their focus towards plugging regulatory gaps. The systemic importance of alternative investment firms like hedge funds and private equity funds has been identified and is the focus of new regulations such as AIMFD.

In this context, SWFs continue to operate in a regulatory blind spot. They resemble private market actors – and their long-term focus potentially makes them important for financial stability in a short-term focused market – and yet they are subject to geopolitical concerns, and operate under the banner of sovereign nation states. The claims levelled for and against them thus need to be assessed critically. While the potential for politicised investment into strategically important sectors needs to be taken seriously, there is also the risk of making unrealistic or ill-fitting demands on them.

One area largely missing from the literature is a critical assessment of whether SWFs truly represent a coherent class of financial institutions with clearly demarcated characteristics from which we can generalize. There are large numbers of hedge funds and private equity funds, and – on average – they tend to follow certain basic trends of behavior, partly because they are competing for external investor money and thus must ‘fit into’ certain categories to market themselves externally. SWFs are under no pressure to attract external investors, and furthermore, are much fewer in number. They thus have much greater potentiality for idiosyncratic and divergent behavior that may make generalizing about them inappropriate.

Furthermore, much of the literature on financial regulation acknowledges that regulation is a highly politicized activity, but normally it is conceived of as an interrelation between a state body – the regulator – and a private sector market actor that has different motives and incentives. A shortcoming in the literature is a lack of sufficient critical assessment of whether such a framing is appropriate in the case of SWFs. Are these quasi-state entities really ordinary ‘market participants’, and can we imagine SWF regulation – in which states place conditions upon the investment activities of financial vehicles representing other states – as being more akin to an act of geopolitics?

To answer the above questions also relies upon detailed studies – of which there are currently very few – on the relationship between SWF managers and the various layers of state institutions that sit above them in the hierarchy. Are they accountable to single or multiple state departments, or do the managers have degrees of autonomy. Do they have the ability to shield themselves in a manner to act as ‘private sector’ investors within the global market, despite being state-controlled?

These shortcomings in the categorisation of SWFs form the backdrop for another shortcoming in the literature. There is a lack of analysis of the impact that new hedge fund and private equity fund regulation might have on the activities of SWFs. While legal firms and financial consultancies that represent hedge funds and private equity funds mention this as a concern on online briefings for clients[1], academia has not analysed it. The focus has been on the relationship between bank regulation and hedge fund and private equity regulation. For example, much analysis of ‘shadow-banking’ argues that regulation aimed at banks leads to quasi-banking activities within hedge funds and similar vehicles. The next step is to analyse

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[1] See for example http://www.lexology.com/library/detail.aspx?g=622b9d24-66b0-4d2e-9bf3-d6d4bb00310b The impact of the Alternative Investment Fund Managers Directive on private equity transactions - key issues and practical thoughts Dechert LLP

how regulation aimed at hedge funds and private equity funds might in turn transmit advantages and new opportunities into the comparatively unregulated SWF sector.

Chapter 4: Research Methods

The research undertaken for this thesis sought to answer the following research questions:

Phase 1

i. Is the *manner* in which SWFs are currently regulated appropriate and proportionate?
ii. Could SWFs' exemption from the AIFMD give them an unfair competitive advantage?

Phase 2

iii. Does the *behavior* of SWFs suggest the need for any particular form of further regulation?

In order to answer these questions it was important to consider a broad spectrum of topics related to the questions highlighted above. During our interviews some of the major areas of research suggested important subsiduary topics which included but were not limited to the following:

i. Motivation of investment activities of SWF's, in particular Russia and China.
ii. SWF's responses to financial regulatory reform in their respective countries.
iii. How regulatory reform has in recent years shaped investor activity, and how it may do so in the future.
iv. How regulation has reformed and impacted relationships between governments and investors.
v. The behavior and reaction of SWF's when faced with the possibility of new regulation.

4.1 Post-positivism and interpretivism

The methods selected for use in the research for this thesis draw on the approaches of post-positivism and pure interpretivism. In the first phase of the study, the empirical data are reviewed and discussed, taking a post-positivist approach; in the second phase, interviews are conducted, and this work draws on the interpretivist approach. One must keep an open mind when shaping a methodological framework for research, and critically reflect their philosophical position, and the impact of one's epistemological, and ontological viewpoints

(Creswell, 2013).

In this study, we use objectivism and subjectivism. Interpretivism evolves from subjectivism, whilst positivism and diversity arising from it come from ontology of objectivism. Professionals and academics who have a preference for the ontological perspective of objectivism, believe that the social phenomena persist in reality, whether we concern ourselves with our existence or not (Scotland, 2012). Academic discussions regarding the ontological positions which writers chose and have a preference for, subsequently create clear categories of study paradigms and methodologies (Scotland, 2012).

One of the more popular types of ontology is objectivism, which theorises that social systems and presences are coexistent in daily life and occur independently from us being affected by them. This view highlights the architectural characteristics of social systems and proposes that social dynamics may be after all relatively consistent (Creswell, 2013). When a researcher selects an objectivistic approach towards social systems, it does not mean that they believe in all systems being equal; rather, they are more likely to argue that these systems maintain their core architecture across different contexts (Ryan, 2015). A subjectivist ontological view supports the idea that phenomena in the social sciences are an outcome of peoples' behaviours and views, which in turn makes them useful carrying out research in the area of social sciences.

An epistemological view selected in a study sets acceptability measures defining the type of findings and information acceptable as original knowledge (Saunders *et al.*, 2016). Choosing a particular epistemology also suggests that researchers must carefully plan as to how it will impact their data mining, and what alternative analysis they may choose from. In order to de-risk the chance of bias, research influence and subjectivity, those using positivistic research cannot participate closely in data gathering (Hay, 2011). In all cases, researchers, must not self-identify with, or effect, remaining sources of influence which may not be possible to eradicate from the study dynamics.

4.1.1 Post-positivism

The epistemology of positivism is recognisable by its philosophical orientation in respect to the natural sciences. Professionals and academics who work within this epistemological perspective as part of their research methodology tend to concentrate on bringing together quantitative data, and would not directly communicate or engage with the participants during that process. Observing is core in positivistic studies and determinative to the quality of research. This is due to the fact that knowledge acquisition and positivism depend on the testability and reliability of the findings. This is why social science researchers using the epistemology of positivism depend on the research design, method and investment components which are commensurate with qualitative research (Creswell, 2013).

Post-positivism shares the main assumptions of positivism (use of the scientific method through deductive reasoning, empirical evidence and the results of hypothesis testing), whilst taking a more relativistic approach. The view is that knowledge is by nature partial and is dependent on human experience. Although, the world is actually objective, the knowledge about it is processed by the experiences of human beings and is thus potentially less objective.

4.1.2 Interpretivism

Interpretivism integrates human experience into research: "interpretive researchers assume that access to reality (given or socially constructed) is only through social constructions such as language, consciousness, shared meanings, and instruments" (Myers, 2009, p. 38). Positivism, the underlying philosophy of interpretivism, on the other hand assumes that social phenomena are dependent on their ability to change to fit the situation arising, thus are sophisticated and dynamic. Therefore, these researchers believe that the social architecture evolving from each participant, or a group, acts as a window through which we can experience reality (Balsvik, 2017). Interpretivism depends on the conviction that study based on human behavior and thought must take into account the social dynamics that are relevant to the possible variables and the subject of the research.

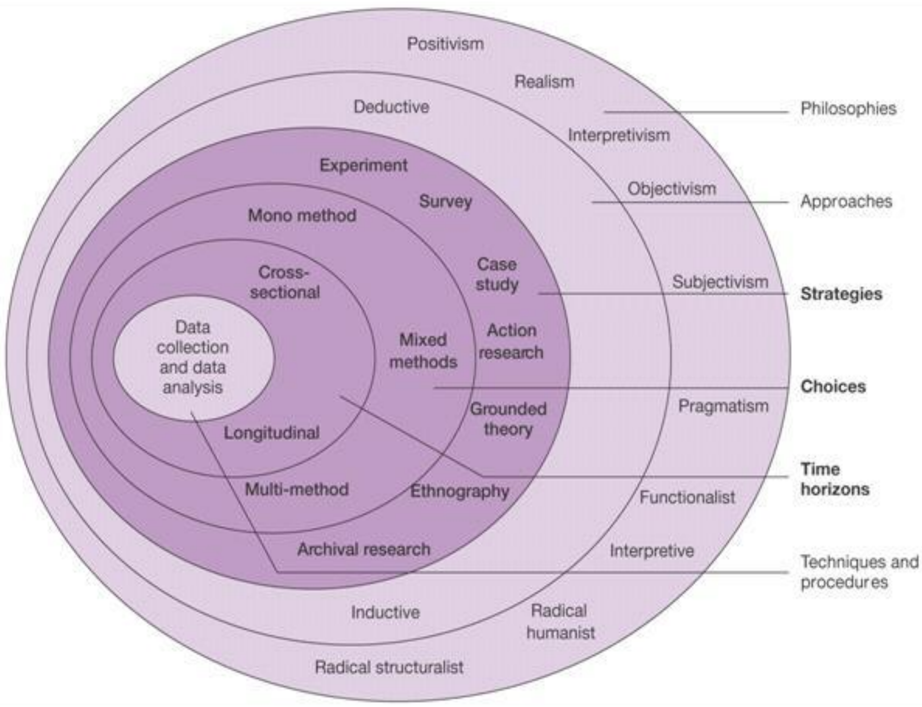
The information gathered in an interpretivist study is recognised as being qualitative and based on subjective human experience. The approach typically uses a very small number of subjects and relies on detailed examination of human experiences. Even though the use of an interpretivist philosophy allows for the gathering of detailed data on a particular issue, it is rare that those researching it are able to generalize from the ensuing data beyond the scope and qualities of the study sample.

The development of the philosophy of interpretivism stemmed from a reaction to the limitations of the philosophy of positivism. Positivism is quantitative, does not use subjective human experience, and focuses on empirical evidence and hypothesis testing. Social phenomena cannot exist independent of people, and their subjective collective and individual participation. Interpretivism in social science research is argued to be a functional and useful method for analyzing the factors that lie behind human behaviours and decision making (Balsvik, 2017).

Interpretivism is “associated with the philosophical position of idealism, and is used to group together diverse approaches, including social constructionism, phenomenology and hermeneutics; approaches that reject the objectivist view that meaning resides within the world independently of consciousness” (Collins, 2010, p. 38).

Thus, reality is based on many subjective experiences, meanings and understandings on experiential levels. This approach does not, therefore, recognise the possibility of ‘objective’ knowledge; instead, knowledge is based on the many experiences of human beings.

Figure 1: The place of research methods



Source: (Saunders, Lewis & Thornhill, 2016).

Positive economics is understood to constitute identification of undisputable statements, free of subjective judgment, which may include empirical statements, conclusions of hypothetical arguments, and conclusions logically following from a system’s axioms and propositions depending upon empirical content. In contrast, normative economics consists of or makes reference to assertions that are subjectively preferable. The objectives of the EU Commission in introducing the AIFMD are normative, as they are implicitly based upon the identification of low levels of transparency in AIFs as being economically and politically disadvantageous. Consequently, the 2017 Commission review of the impact of the AIFMD also constitutes a normative analysis, in which outcomes will be measured against the valued objectives of modifying AIF activities.

Heyne (1978, pp. 184-185) has argued for "a universal agreement to abandon the positive-normative distinction in economics", on the basis that economics cannot hope to be purely scientific, descriptive, and value-free. The research undertaken for this thesis illustrates the difficulty in categorising economic research neatly into either the positive or normative frameworks. It is likely that SWF decision makers, academic commentators, and those involved in the formation of the regulation will have value-based judgments regarding its impact (Weston, 1994). However, the interviews undertaken and their subsequent coding and analysis as part of the research for this thesis provides an objective (positive) account of their responses.

4.2 Research methodology and design

The research design consisted of two phases of data collection and analysis. The first phase consisted of examining the academic literature, documentation and media sources, with the second phase consisting of the conducting of interviews.

Data regarding the activities of SWFs is not always freely available. The principal decision makers within SWFs were identified and where possible were interviewed alongside EU and national regulators. In addition to an evaluation of the published academic research relevant to the principal research questions identified here, interviews with leading policy makers and academics working in the field of the SWF activity were undertaken.

To provide a body of evidence sufficiently large to be credible, it was necessary to collate, by means of interviews and a standardized questionnaire, the opinions and ideas of a good cross-section of SWF managers.

A broadly representative sample of SWF managers was sought to meet the requirements of theoretical saturation; responders were generally willing to participate. The initial sample size was selected on the basis of anticipated generalisability of findings, completeness of the sample in relation to the diversity of AIFMs and access to principal decision makers.

To give some context to the types of research questions regarding SWF investment that have called for more rigorous scrutiny, and which are central to the purpose of this work, it is instructive to recall certain stylised facts and basic theories which have been developed to account for the investment patterns of government-sponsored funds.

Bernstein, Lerner, & Schoar (2009) outline several perspectives which have been put forward to explain the motivations of state-owned financial companies and can be applied to the activities of SWFs. The first, pursued by Atkinson & Stiglitz (1980), is a development motivation, whereby governments try to use savings for strategic long-term projects, overcoming market failures, and fostering growth. Shleifer & Vishny (1994) take a 'political' perspective, hypothesising that state-owned enterprises may have incentives to finance inefficient but politically desired projects, in the 'agency perspective', where an agency refers to the shareholders' problem of delegating the management of an organisation to an individual or team which does not necessarily share its objectives. State-owned banks channel resources to socially profitable activities, but public managers exert less effort than would their private counterparts due to the fact that they are exposed to lower financial risk if they fail. These complementary characterisations of state-sponsored investment bodies have been put forward in various forms to rationalise the following general observations regarding SWFs:

- SWFs are attracted to investments in financially distressed or cash-constrained companies (Fernandes, 2009; Kotter & Lel, 2011). This preference became especially clear at the beginning of the financial crisis of 2008.
- SWFs have a preference for investing in low-risk government debt, particularly the securities of the US government or government-linked agencies. Balding (2008) notes that SWFs demonstrate a distinct preference for low-risk debt securities as a major portion of their portfolio; Norway's SWF, for example, allocates a near constant 55 per cent of its portfolio to debt securities.
- As is true of global FDI in general, SWFs are also thought to prefer regions with strong legislative and regulatory institutions, which, therefore, make developed country targets attractive.

The theories outlined above are by no means exhaustive. SWFs are generally viewed as having more complex agendas. Deeper analyses revealed a more nuanced picture of the determinants of their decisions, comprising a combination of economic and financial factors, the governance structures of the funds and regional or cultural biases.

4.3 Data collection and analysis

Our literature review argued that since these different fund categories refer to investments at different stages in the development of the organisation, their activity is encouraged by slightly different sets of influences. This distinction thus allows us to identify a wider set of factors which determine the level of activity in these industries. In order to identify attributes of potential regions that attract direct investment, evidence was drawn from Russia's and China's SWF decisions. In Russia and China case studies we looked at alternative investment determinants, for SWFs, into the pressures that will shape their activity over the next few years. In order to examine the likely effects of increased regulation of alternative investment activity more closely, the analysis investigated the factors identified as determining wider AIF investment decisions.

Statistical models of AIF investment activity provide evidence that the level of investment in different locations is positively related to the level of economic activity, the liquidity of financial markets, and the quality of institutions which support the creation and operation of businesses. These characteristics suggested by the literature are captured using measures from the World Bank Databank. World Bank indices alleviate the difficulties of establishing a generally acceptable measure for multidimensional components of investment performance and the variable availability of data. These indices are based on techniques for measuring the efficiency of procedures that have been introduced relatively recently into the academic literature. The arguments suggest that while the scale of the EU's economy gives it a competitive advantage as a destination for SWFs, the region faces strong competition from smaller economies, particularly in South East and East Asia, which are forecast to have faster growth and provide a more supportive atmosphere for business without demanding the same level of transparency and disclosure.

The discussion also contemplates the likely effect of regulation, both mandatory and voluntary, on the EU's relative attractiveness as a destination for SWF investment. Mandatory universal regulation could strengthen the European AIF market by improving standards of investor protection and creating a more transparent, socially responsible, homogenous investment environment. In addition, components of the World Bank indices dealing with disclosure standards and investment protection recognise that a binding stricter global regulation designed to promote these ideals will not present an obstacle for SWFs future investments.

4.4 Interviews

Semi-structured interviews were designed to ensure that sufficient information was gathered to constitute a perceptive survey of opinion from leading decision makers and subject matter experts.

We selected forty-three individuals for interview, and divided them in to four groups as follows:

4.4.1 SWF and PEF Managers (twelve interviewees, group one)

Chosen on the basis of their experience and track record in running and managing SWF and PEF investment portfolios globally. These individuals are responsible for ensuring that the funds, which they manage adhere to their prevailing regulatory environment.

4.4.2 Government Officials/Regulators (twelve interviewees, group two)

Selected on the basis of their involvement in drafting and/or monitoring regulations pertaining to AIFs on both domestically and internationally. These professionals have a wealth of experience with AIFs and their behavior patterns and responses in regulatory environments. They also possess a high level of knowledge of the evolution of relevant regulation.

4.4.3 Advisers/Lawyers (eleven interviewees, group three)

A select group of top professionals from the reputable national and international legal practices, possessing decades of experience in advising AIF and SWF clients on how, by investing differently, to adopt and adapt and at times avoid certain regulatory challenges. This group was chosen for its in-depth knowledge of SWFs reactions and behavior and their granular implementation and adherence to regulation and new regulatory environments. They are able to compare and highlight weaknesses in regulation, as well as to suggest beneficial regulatory reform. They have intimate knowledge of SWFs' investment patterns and clear views on the quantum of the investment activities.

4.4.4 Academics (seven interviewees, group four)

A group of significant importance to our research in helping to bridge the gap between our primary and secondary sources. We invited top international academics with deep cultural knowledge of various SWFs. This group has observed and studied SWF investments for decades, having worked hand in hand with international organisations, and other market participants, to share, cultivate and further our understanding of the reasons behind investments by SWFs as well as their regulation and behavior patterns.

4.5 Selection process

The selection process used to identify appropriate participants was aided by referrals from the 'gatekeepers' within the finance industry. Some interview candidates were contacted directly via email with an interview request. Contact with the interviewees was undertaken serially, allowing details of discussions with other interviewees at a similar level to be incorporated into introductory correspondence. (Undertaking interviews serially allows appropriate expansion and focus of interview questions to ensure emerging issues are addressed and the gaps are filled.) The academic purpose of the enquiry was emphasised to assuage any natural suspicion on the part of interviewees that information of a commercially sensitive nature might be shared. If it was necessary any correspondence was co-signed by the supervisor, allowing the recipient to check the credentials of the researcher. Because of the nature of this research, the interviews fell into the category of 'elite interviewing'. The individuals interviewed are prominent figures and well-known experts in the field. Initial contact and interviewees' positive response to agree to the interviews in person was considered as informed consent to proceed with the interviews for the purposes of the study.

4.6 Data collection method

The data collection method was individual interviews, of around forty-five minutes in length. Interviews moved from the abstract to the concrete, the nature depending in part on each individual's area of expertise. Notes were made by hand throughout the interview and then written up after the interview. To maintain confidentiality and the participants' comfort, the interviews were at a time and place agreeable to the participant. Care was taken to assure anonymity/confidentiality during the interview process, with all notes anonymised. There were forty-three participants in the study, all of whom were high-level managers in their respective organisations. The selection criteria for participation in the research study was:

i. Experience with SWF investments (through business transactions, academic research, regulatory/legal advice).
ii. Professional attainment of executive or above management positions within their respective organisations.
iii. Familiarity of the regulatory frameworks under consideration.

Interview guides were generated for each category of interviewee to be used to assist the researcher in initial interviews. However, in accordance with grounded theory, the interview questions were reviewed, modified, and reprioritised in the context of iterative analyses so as to achieve theoretical saturation of emergent themes. Further semi-structured discussion aimed to elucidate a rationale for continued support or otherwise of new regulation. A total of forty-three professionals from forty different establishments were interviewed over a nine-month period.

4.7 Questionnaire design

Each of the four questionnaires centered on the questions at the core of this thesis, chosen for their relevance to the aim of answering the main issues set out in chapter one. The order of the questions posed corresponded with their importance to the topic, so even if the interview ended unexpectedly or strayed off topic, we would have the highest likelihood of obtaining material that is complete and meaningful to the overall body of research.

We designed the surveys with the participants and their professions in mind, as well as their roles in the organisations they represent. For example, we anticipated each interviewee's area of expertise and expanded further interview questions in the relevant direction, to allow us to maximize the probability of gathering useful data from the interview. Further, by steering the interviews in the direction of the interviewee's greatest area of knowledge we were able to bring the answers together while going through the survey in a timely and accurate manner. This gave us enough time to return to particular questions where there was a need to probe for more information and to double check answers.

Because some of the interviewees may have had 'vested interests', when considering the issues under analysis their responses were analysed and interpreted with that in mind. Setting aside SWF managers' answers to questions about regulations that were set in broad terms, rather than calling for a yes or no response, our method of questioning invited discussion and answers based on experience and unbiased, informed thought.

A significant benefit of our research questionnaires was the ability and willingness of interviewees to relate to the questions asked, and to enter into discussions during the interviews; this allowed them to open up on issues at the core of the questions posed. Most of the interviewees participated with enthusiasm, offering detailed answers, and were open to discussion throughout the interview, and, if required, for subsequent clarification. Because of the anonymity offered, participants could afford to be honest and direct in their thoughts and answers, leaving little space for the pushing of 'vested interests'.

4.8 Grounded theory and theoretical saturation

Grounded theory, first systematically formulated by Glaser and Strauss in the 1960s, is well-suited to initial investigations in unexplored fields: Strauss & Corbin (1994, p. 273) identify it as a "general methodology for developing theory that is grounded in data systematically gathered and analysed. Theory evolves during actual research, and it does this through continuous interplay between analysis and data collection".

Theoretical saturation is the point during research when further collection of data is unable to provide new insights, themes or issues regarding a category of data. Consequently, once theoretical saturation has been reached, new data can be assigned to categories already established (Charmaz, 2003). Hyde (2003) uses 'theme saturation' in which data were sought until each of a number of identified themes had been 'adequately explained'. The advantage of that approach for this thesis was that many of those interviewed placed a high value on their time and research questions could, therefore, be prioritised on the basis of the need to reach theoretical saturation in a given theme. This is consistent with Morse et al. (2002), who establish that there is no requirement to saturate individual study participants, only to ensure that the gathered information from a pool of interviewees is sufficient to saturate the themes established.

4.9 Data coding and thematic analysis

Sentence and paragraph segments of transcribed interview notes were coded to transform textual data into manageable groups of statements relating to a finite group of themes. Themes were developed alongside the research process via the constant comparative method based in grounded theory. In line with Strauss & Corbin (2008), coding was employed at open, axial, and selective levels.

4.10 Data management plan

Several tools were used throughout the research process to manage data collection and the sheer amount of information collected. A journal was used to record insights, comments, to track the process. Computer software Atlas.ti was used to assist with traditional analysis and data management such as theme identification, keyword identification, pattern identification, data retrieval, and project management and organisation. Data collection and management tools are essential in ensuring accuracy, consistency, and depth, thus helping to collect and maintain a valid and reliable database of information gathered.

4.10.1 Ethical considerations

Our research topics of regulatory compliance and legislation are sensitive for some of the professionals involved. Prior to commencing the interviews, all procedures to get clearance for our research by the University ethics approval process were followed and satisfied. Great care was therefore taken to prevent unanticipated personal identification or identification of the organisation with which the participant was affiliated. No names of the participants or the organisations are mentioned other than with express agreement and written permission to do so. All participants were told beforehand that should they become uncomfortable or unwilling to participate during the interview process, they could withdraw at any time, and all the information from the interview would be destroyed.

4.10.2 Reliability and validity

With regard to the extent to which the data and the results of the analysis conducted on the data could be considered reliable and valid, a number of issues were considered. Kirk & Miller (1986) discussed three types of reliability within the context of quantitative research: (1) the degree to which a measurement remains the same when taken repeatedly, (2) the stability of a measurement over time, and (3) similarity of measurements within a given time period. Within the context of qualitative research, reliability has been defined as the extent to which results are consistent over time and an accurate representation of the total population under study is referred to as reliable if the results of the study can be reproduced under a similar methodology. (Joppe, 2000: 1; see also Golafshani, 2003)

The extent to which a reproduction of the current study would provide similar results using a similar methodology is inevitably uncertain at this time. However, through the qualitative analysis conducted, along with the associated review of the data in aid of these analyses, it does appear that the data collected consists of an accurate representation of the population studied. The homogeneity found within each of the four groups of respondents studied suggests that similarity of measurements was present within the context of the current study.

Validity determines whether the research truly measures that which it was intended to measure. With the concept of 'construct validity' the construct consists of the "initial concept, notion, question or hypothesis that determines which data is to be gathered and how it is to be gathered" (Wainer & Braun, 1988; Golafshani, 2003). Additionally, the application of a test or other process is generally used by quantitative researchers in order to validate their investigation. Essentially, within the context of all research, validity relates to whether measurements are accurate and are accurately measuring what they are intended to measure. With respect to the current study, the process used during the analysis, which included a careful review of the data analysed, suggests that these data were sufficiently valid for the purposes of our study.

4.11 Limitations

This study contained a series of limitations. First, due to the use of convenience sampling, the generalisability, and hence the external validity of the results found is limited. Any generalisations of these findings to a larger body of individuals would need to be made tentatively at best. While very challenging in general in the context of qualitative research, as well as more specifically with respect to the current study, the use of random sampling would allow for generalisation of any results found in the sample analysed to the larger population from which the sample was selected. With regard to overall sample size included within this study, this was felt to be adequate, though future studies incorporating larger sample sizes may help to discover the true extent of the homogeneity within groups, as well as additionally explore group differences, and may also provide additional findings to those that were found in the present study.

Confirmability describes the extent to which the results found in the present study could be confirmed or corroborated by others (Trochim & Donnelly, 2006). Several strategies exist for improving confirmability and include documentation by the researcher of the procedures used for checking and re-checking data throughout the study, along with the researcher taking a very critical role with respect to the results and documenting this process. Actively searching for negative instances which serve to contradict previous findings can be used to enhance confirmability of the study. A data audit can also be conducted by the researcher, which serves to examine the data collection and analysis procedures, with the researcher making judgments about the potential for bias or distortion. With respect to the current study, after the qualitative analysis was complete, the researcher went back and checked the data to enhance confirmability. Similarly, the researcher took a critical stance with respect to the results found and also actively attempted to find and document negative instances which contradicted previous findings. Overall, it is felt that the current study could be corroborated by other researchers analysing the same data.

Chapter 5: Interview Results

5.1 Introduction

Our research reported in this chapter consists of a thematic qualitative analysis in which interview data were reviewed multiple times for the purposes of determining relevant themes, with the two dominant themes identified during this analysis being:

i. The respondents' conceptualisation of SWFs as having either a positive or negative impact on the general public. SWF and private equity managers almost unanimously viewed SWFs as positive contributors to public good, but the other respondents had more mixed views.
ii. The second primary theme is the conceptualisation of existing or new regulation as either positive or negative. SWF and private equity fund managers almost unanimously consider more regulation to be negative, while the majority of the remaining respondents had more mixed attitudes.

In the forty-three interviews we spoke to highly skilled professionals who deal directly with SWF and AIF regulation. Interviewees included SWF managers, academics, lawyers, regulators, and government officials. In this chapter we discuss and critically analyse the responses of the interviewees and consider the two dominant themes arising from the interviews. We also consider these interview outcomes further in relation to our two country case studies, on Russia and China, in chapters six and seven, where we look deeper into the material gathered during the interviews, as well as revisiting some of the findings from the current chapter where they relate to Russian and Chinese SWFs today.

5.2 Theme 1: SWFs as contributors to the public good

Within this theme there are a number of sub-themes:

i. The mission of SWFs is to benefit their home countries.
ii. There are public concerns that SWFs' actions have hidden geopolitical objectives.
iii. SWFs may play a stabilising role in foreign countries at times of crisis.
iv. In particular, SWFs played a stabilising role in the 2008 financial crisis.
v. SWFs may have the potential to cause future crises.

5.2.1 The mission of SWFs is to benefit their home countries

The fund managers generally characterised SWFs as long-term prudent investors employing best-practice financial investment techniques. But they also pointed to the fact that the reason why they do this has an explicitly public interest – and thereby political – dimension to it. Their goals are broader than a standard investment fund and include socio-political aims such as creating intergenerational equity in their home country by investing the state's surplus wealth for the benefit of future generations. In so doing, they are also diversifying their economies for economic stabilisation and resilience. In the words of three of the respondents:

> "We have a wide range of objectives, they include macroeconomic stabilisation and intergenerational equity." (I1C8 Fund Managers)

> "Some aim to maintain the country's wealth for the next generations, while others serve as economic stabilisation funds and still others aim at achieving social causes such as expanding the middle class population." (I1C1 Fund Managers)

> "A number of SWFs participated in the stabilisation of their own domestic markets during the crisis." (I3C7 Advisers/Lawyers)

Another respondent suggested that a strong SWF can send a positive signal to those considering inward investment into a country, by providing a buffer that can protect an external investor:

> "Investors for example are willing to lend money on better terms to countries which have a Sovereign Fund or have a significant amount invested in them by a SWF. Especially when a state has a SWF, assets will often be held in 'safe' currencies like US dollars or euros. It may be perceived to reduce the risk of default as the Sovereign Fund could be raided in the event of a crisis." (I4C1 Academics)

Within media and political circles, SWFs' aims within foreign countries are often presented in negative terms.

SWFs have explicit mandates to work for the long-term financial interests of the sovereign states they represent, but there remains a general ambivalence towards them outside those countries. A prominent sub-theme that emerged was the belief that there were popular misconceptions, misrepresentations, and inaccurate generalisations regarding SWFs, especially in the media, including:

i. Being portrayed as destabilising villains in the press.
ii. Not being recognised as forces for stability in international markets.
iii. Being confused with banks when they should not be treated the same.
iv. Being portrayed as being more powerful than they actually are.

Fund manager respondents were especially sensitive to this. One respondent expressed concern over being painted by the media as ‘monstrous, opportunistic businesses’. It was also suggested that SWFs have been wrongly blamed for contributing to the 2008 financial crisis, as opposed to investors that helped to restore order during the crisis. Two respondents suggested that they have been wrongly conflated with banks. In the government officials and regulators group, one respondent felt that:

> “Presently the overall size of the SWFs and the amount invested in international equity is a fraction of the figures you see in the media; consequently, the reports are mostly exaggerated when it comes to the estimates of SWFs potential impact on the international capital markets.” (I2C8 Regulators)

5.2.2 There are public concerns that SWFs actions have hidden geopolitical objectives

Media misunderstanding of the objectives and impact of SWFs may be related to a popular sense of mystery surrounding the funds; as one fund manager noted:

> “There is a lot of fear towards the unknown and the investment vehicles, especially SWFs, are somewhat mysterious to the public.” (I1C6 Fund Managers)

Underpinning some of this fear is the suspicion that SWFs pursue geopolitical objectives under the guise of long-term investment. For example, two academics noted that:

> “Over the years European banks and businesses have supported and encouraged the prospect of long-term investment from SWFs. It was the politicians and the media that have expressed their worries and long-term concerns regarding SWFs close ties to governments. Governments that do not

> always stand for liberal democracy and open global markets." (I4C3 Academics)

> "SWFs are different from other AIFs, although not entirely, but it is public money and investments can be much more geopolitical." (I4C7 Academics)

Two academic respondents suggested that SWF's controversial equity investments in Western firms have caused concern:

> "SWFs have come to the attention of the public do to their controversial and questionable equity investments in Western companies that happen to have a stake in large deposits of natural resources. Sometimes they have access to what are considered to be icons of national identity or target businesses which are able to provide owners with access to military secrets." (I4C4 Academics)

> "SWFs are causing concern to governments which are worried that the sheer size of foreign savings may distort sovereigns' incentives, shifting them from beneficial diversification toward zero-sum game policies. We live in a world where financial globalization has reached the point of creating a serious cause of concern to certain states. Especially to the states receiving foreign investment; when the investing countries purchase controlling positions in foreign firms with proprietary knowledge, or increasing control of financial and paramount infrastructure abroad, which includes, but is not exclusive to energy and telecommunication sectors, ports, airports or major manufacturing plants." (I4C4 Academics)

This view is by no means uncontested, though; another academic respondent suggested that:

> "To date, SWFs have acted as model investors and have not sought to leverage their position to pursue political ends." (I4C6 Academics)

If nothing else, we can conclude that the objectives of SWFs are viewed as being subject to greater ambiguity than the objectives of other – perhaps more straightforward – funds like hedge funds. As one fund manager put it:

> "SWFs are unique institutions: they manage very large pools of capital and their objective functions are often quite complex and do not only focus on financial returns alone." (I1C12 Fund Managers)

5.2.3 SWFs may play a stabilising role in foreign countries at times of crisis

The discomfort felt by the fund manager respondents at the mischaracterisation of SWFs is linked to the fact that they – by contrast – tend to perceive SWFs as a force for temperance in international markets, perhaps to be contrasted with potentially more reckless, highly leveraged players such as investment banks and hedge funds. In particular, they argued that rather than reactively following the herd, SWFs can take strategic and contrarian long-term positions that contribute to a more diverse and resilient market. The funds do not generally use leverage, which means that at times of crisis they are not subject to amplified swings in the value of their portfolios. Their long-term investment horizon means they can ignore short-term dislocations in markets, ride out business cycles, and search for undervalued assets. Overall, this provides balance to the markets. In the words of two fund managers:

> "As a long-term investor I think we (SWFs) have a contribution to make to global market stability. I do not believe we have been destabilizing. Our agenda and purpose is to achieve long-term returns responsibly. Of course there are different players out in the market, but there is a lot that can be said for having a group of market participants who are significantly more dedicated to delivering long-term investment results as opposed to short-term, mark-to-market gains." (I1C6 Fund Managers)

> "SWFs are market stabilizers due to their relatively longer investment horizons and unleveraged positions. For policy makers, the stabilizing role of SWFs is attractive when the effect is present in crisis periods." (I1C2 Fund Managers)

Fund managers unanimously viewed SWFs as providing positive benefits to the global economy. This is perhaps unsurprising. It must be noted that such managers are likely to have a personal economic interest in presenting a positive view of the funds they manage; they are more likely than most to buy into internal institutional ideologies regarding the positive effect of SWFs (or perhaps, those that do not or might not last for long inside such an institution). That said, a notably high degree of consensus was found among respondents from other groups on this point. For example, an academic respondent suggested that:

> "It is important to note that SWFs bring substantial benefits to the global markets. In many circumstances they are able to take a long-term view in

> their investments, ride out business cycles and deliver great results. This ability to wait and see, brings much needed and significant diversity to the global financial markets. SWF investment qualities can be very beneficial, especially, during times of financial turmoil, political instability, or macroeconomic stress.” (I4C5 Academic)

5.2.4 In particular, SWFs played a stabilising role in the 2008 financial crisis

One particular area of consensus among different respondent groups was the belief that SWFs did not play any significant role in causing the 2008 financial crisis. Fund managers especially believed that SWFs – to the contrary – helped the global community regain balance after the crisis. As one fund manager stated:

> “The fact that sometimes SWFs are blamed for contributing to the financial crisis in 2008 is not new or surprising, but they were more of a balancing act for a very distressed economy globally. They helped restore balance and sadly not always made a profit, even when the investment really seemed less than altruistic.” (I14C Fund Managers)

> “I think that SWFs helped the global community to regain balance post the 2008 financial crisis, they didn’t contribute to causing the problem, but were there to help in the aftermath.” (I1C1 Fund Managers)

Respondents from the government officials and regulators group generally echoed this; for example:

> “SWFs didn’t majorly contribute. There were some poorly managed investments, but the lessons have been learned and they now employ their nation’s and international top talent, producing executives whose insights could prove valuable for the companies they invest in.” (I2C10 Regulators)

> “They were not innocent bystanders, but they didn’t cause the recession either.” (I2C11 Regulators)

Advisers, lawyers, and academics also did not in general feel that SWFs contributed in any way to destabilising the financial markets, and generally felt SWFs were actually a positive force promoting stabilisation during the crisis. Specifically, they did this by making investments in failing institutions that other investors preferred to avoid during the crisis. Two academic respondents stated the following:

> "The SWFs didn't contribute to the beginning of the financial crisis in 2008. They were looking for places to invest and if anything ended up helping to bail out the Western economy by making purchases and investments in areas that banks and financial institutions as well as private high net worth individuals were prepared to stay away from during the crisis." (I4C1 Academics)

> "No hard evidence has been present to prove that SWFs were major contributors to the 2008 financial crisis. If you look closely at the investments made during that time, the SWFs have in fact played a positive role, in particular by participating in the recapitalization of a certain number of financial institutions in difficulty. SWFs have overall contributed to strengthening the global banking system and bringing back confidence in the international financial system." (I4C6 Academics)

The general argument is that a long-term, unleveraged investor might be more prepared to take contrarian, unpopular positions during times of crisis, especially when they think the prices of assets are artificially low. They are long-term value investors who will step in when others step out, and because of their size, they can prop up large failing businesses to keep them afloat. Specifically, SWFs played a role in rescuing US banks. As noted by one fund manager:

> "Among the more prominent investments made by SWFs were those that inserted capital into the US banks following the onset of the credit crisis in 2008. For example, China Investment Corporation acquired a USD 5 billion stake in Morgan Stanley, while Abu Dhabi Investment Authority purchased a USD 7.5 billion stake in Citigroup." (I1C3 Fund Managers)

A number of individuals characterised SWFs as having 'bailed the system out', but the tendency to paint SWFs as useful in bailing out economies risks suggesting that this is a 'purpose' of SWFs. Their role in supporting distressed institutions is probably best understood as a side-effect of their long-term investment horizon and large pools of available capital. Unlike prominent central banks or a multilateral financial institution like the IMF, SWFs have no particular mandate to maintain global economic stability. One respondent alluded to this by saying that SWFs are neither a positive nor a negative force, but are instead just another market participant which may or may not help at different times. Regardless of whether SWF managers overtly perceive themselves as ‘white knights’, all interviewed fund managers felt that they were socially responsible investors, albeit one pointed out that social responsibility was to some extent in the eye of the beholder. The concept of ‘social responsibility’ does allow for interpretation, potentially meaning anything from not causing economic disruption to helping remedy social and environmental problems. To some extent, fund manager respondents exhibited signs that they felt they may have a ‘mission’ or ‘responsibility’ to support the global economy. One respondent stated:

> “As a long-term investor I think we have a contribution to make to global market stability. Our primary goal is to achieve long-term returns responsibly.” (I1C6 Fund Managers)

5.2.5 SWFs may have the potential to cause future crises

The general sense gained from interviews was that SWFs did not contribute in a major way to causing the 2008 financial crisis, and that so far they have not been a source of global financial instability. This does not mean, however, that SWFs were necessarily perceived as virtuous bystanders, or that they have no potential to cause crises. While fund manager respondents expressed explicitly positive attitudes towards the role or impact of SWFs in the global economy, some government officials, regulators, and academics had misgivings, noting that SWFs can cause structural imbalances. Such outlier views include responses like:

> “It would be hard to argue that they did not have a significant impact, and have not contributed to the problems we are having. We have to admit that the US Fed and the financial intermediaries were right to have followed the policies that are now being criticized. The SWF investment surpluses would have brought financial turmoil and threatened global prosperity. Situation could have been far more damaging to the global economy. Yes, of course new regulation is time consuming and it is costly, but it is necessary.” (I2C2 Regulators)

> "It has been found that SWF investments generally lead to destabilizing effects on the stock markets, however, SWF with saving objective provides [sic] a stabilising impact especially in the crisis period." (I4C2 Academics)

In contrast to views of SWFs as responsible long-term investors seeking to balance risk with return, some suggested their potential to concentrate too much on profit generation. When asked if SWFs contribute to destabilisation, one regulator respondent answered:

> "Maybe somewhat. There was too much concentration on revenue generation, profit and loss, and they made some big investments in to firms that were responsible for the Western economic infrastructure." (I2C6 Regulators)

While the overall sense from the interviews was that SWFs have not played a major role in financial market destabilisation to date, an underlying – and understated – theme was the potential for these funds to cause destabilisation in the future. This is implicit in responses like:

> "They have the finances to be able to tip the markets, but they have not destabilized, only helped balance so far." (I1C11 Fund Managers)

> "The amount of liquidity that the SWFs of the world hold is large and we certainly would have the capability to destabilize, but we only are interested in stabilization and profit." (I1C8 Fund Managers)

> "No impact thus far, but they are getting bigger and becoming more sophisticated as an investing force." (I3C9 Advisers/Lawyers)

A government respondent suggested that the capacity of SWFs to destabilise the financial markets is a strong justification for proactive – rather than reactive – regulation and tighter control on an international level:

> "They certainly have the capacity to do so and create economic distortion, which is why regulation and tighter control on an international level is a significant step towards securing a balanced economy world-wide." (I2C12 Regulators)

An academic respondent, however, suggested that while it may be the case that SWFs have large individual positions in the markets, and that shifts in their assets or currency allocation could theoretically lead to large price impacts, higher volatility, and herd behavior, SWFs do not behave in this way:

> "The popular belief is that because SWFs have large positions in the markets, any sudden shift in the asset or currency allocation could result in significant price impacts, higher volatility and herd behavior which, in turn, could pose a potential threat to the entire financial system. However, large positions by any financial institution could pose a potential threat to market stability, but SWFs do not shift their portfolios rapidly." (I4C7 Academics)

Furthermore, while SWFs might have individually large holdings, they collectively still represent a comparatively small share of global markets. The respondent goes on to note that:

> "The share of SWFs in the global markets is too small, so it is hard to accept the claim of the opponents that sovereign funds could… destabilize financial market." (I4C7 Academics)

5.3 Theme 2: Views on regulation

This theme showed more divergence of opinion than the first, with some viewing regulation as positive and some viewing it as negative. Fund manager respondents perceived increased mandatory regulation in largely negative terms. Given their largely positive view on SWFs, this is perhaps unsurprising. Nevertheless, the relationship between these views is ambiguous. Positive views on SWFs might be expected to cause negative views on increased regulation, but equally – given that the burden of increased regulation falls on the fund managers – negative views on increased regulation might inspire positive views of SWFs.

It is important to note that fund managers were not against regulation in principle. Positive impacts of both voluntary regulation – such as the Santiago Principles – and mandatory regulation like AIFMD in case of PE firms were noted to include promoting transparent, accountable, and responsible commercial activities. In general, though, participants had an 'ideal regulation' in mind, one that current regulation did not necessarily correspond to. One respondent stated:

> "We are pro good regulation that is clear and consistent and drafted with us and our line of business in mind along with all the complexities and

> possibilities in mind. A real life legislation, not a hypothetical and idealistic one." (I1C12 Fund Managers)

The majority of fund managers had a bias towards viewing the following as negative:

i. More regulation, causing a burden or distraction to core activities.
ii. Complex, unclear or impractical regulation, causing confusion or uncertainty.
iii. Regulation must take into account the specificities of SWFs.
iv. Regulation without participation from fund managers in the drafting process.

Each of these is discussed in turn:

5.3.1 More regulation, causing a burden or distraction to core activities.

A number of participants noted that more regulation causes a burden or distraction to core activities that are already 'well-regulated' and that any further regulations or stricter regulations would constitute overregulation, placing an unreasonable and distracting burden on fund managers. Respondents felt that SWFs are either regulated enough as it is or overregulated. Thus, in response to whether SWFs should be more strictly regulated at an international level, one individual replied with the following:

> "No. There already is so much regulatory criteria out there, we have to have, show and share (information), such as investment strategy, governance, engagement practices, capabilities, environmental, social and governance (ESG) practices, and disclosure." (I1C1 Fund Managers)

The cost and time associated with adhering to any regulation were mentioned by respondents, with one respondent suggesting that it requires a great deal of administration:

> "We worry about being over regulated and spending time with our legal team in order to constantly revise the new laws, instead of concentrating on investing and delivering the best results." (I1C1 Fund Managers)

Mandatory regulation would require stricter reporting, including the publication of reports, disclosure of employee remuneration, and liquidity reporting to national regulators. The required reporting would be an issue as noted by a number of fund managers:

> "New regulations are expensive in terms of compliance, we need to transform data tracking and gathering systems, reporting functions and our organizational structure." (I1C5 Fund Managers)

> "Regulators are requesting large sets of data and complicated calculations that need to be aggregated from a variety of sources." (I1C6 Fund Managers)

> "Dealing with a complex reporting data challenge, these are new systems for improved operational standards and transparency. We are not concerned about the transparency, but the implementation of the increased automation in reporting. In the long term it will be cost effective, but right now it is burdensome for a number of reasons." (I1C1 Fund Managers)

This reporting and compliance burden was an issue recognized by other respondents:

> "Accountability standards and transparency will need a lot of reporting, so operations and governance are heavily impacted. Reaching satisfactory implementation levels will take time and funds. Becoming compliant with any new regulation shows that you are truly dedicated to reaching satisfactory transparency and accountability levels." (I2C2 Regulators)

> "Regulatory changes require higher levels of sophistication in terms of client servicing and technological acumen. AIFs will have to invest more in human capital that is capable of addressing changing needs. Operational technology is fundamental for success and AIFs will need to improve their "big data" capabilities in order to sufficiently meet regulatory needs and function efficiently." (I4C7 Academics)

5.3.2 Complex, unclear or impractical regulation, causing confusion or uncertainty.

Additionally, fund manager respondents felt that current regulatory frameworks are often 'one size fits all', paying too little attention to the specific dynamics of SWFs. As one participant put it:

> "SWFs are well regulated, but regulation doesn't take all the nuances regarding the special position of a SWF as an investor fully on board." (I1C12 Fund Managers)

> "The regulatory reform should have a more balanced approach to the way it imposes the laws on AIFs. All of us are very different and regulating us in such a similar manner is not right." (I1C2 Fund Managers)

> "It has to be tailored to the needs of the SWFs and be flexible, as SWFs are a very 'different' institutional investor." (I1C12 Fund Managers)

> "More stringent regulation is not necessary, but a more adaptable one that focuses [sic] on particular needs of SWFs may be a good idea." (I1C7 Fund Managers)

A number of advisers and academics agreed that regulation should be more specifically tailored. When asked how new regulations could be drafted and improved from their predecessors, the following comments were noted:

> "By creating a set of sub regulations concentrated on just the SWFs based on consultations and research from the professionals solely from this field. Make it focused and valuable." (I3C2 Advisers/Lawyers)

> "Review the 'one size fits all' approach to regulation, and make it more specific, and better-tailored to the nature of SWFs as investors." (I3C11 Advisers/Lawyers)

> "The one size fits all approach is however its weakness. There could be a specific part to it that deals solely with sovereign investment managers and focuses on geo-political and governmental side of things more." (I3C5 Advisers/Lawyers)

This problem does not go unnoticed by regulators. As one of the regulator respondents noted:

> "Unfortunately sometimes the regulation ends up engulfing everything and becoming a bit of a one size fits all solution. It's debated and maybe it needed a little more time." (I2C5 Regulators)

5.3.3 Regulation must take into account the specificities of SWFs

Others focused upon the changes that SWFs might potentially have to make, such as changing the manner and location of investment. The implication is that SWFs could potentially leave, or at least reduce their focus upon, those areas with strict regulation. For example, two fund managers noted:

> "Funds will think twice about certain investments in the EU. It takes opportunity away from the companies within the EU that would benefit from an injection of capital and create returns and jobs for the residents of the European Community." (I1C4 Fund Managers)

> "We will look for more opportunities in developing markets than before." (I1C7 Fund Managers)

The impact of any new regulation on the investment priorities of SWFs was also picked up on by two respondents within the advisers and lawyers group:

> "SWFs will look across the board for investments climates that are welcoming, beneficial and not overregulated. I would see SWFs spending more in domestic markets." (I3C7 Advisers/Lawyers)

> "We can see already a reaction to the implementation of other regulations on AIFs, for example, a certain percentage of fund managers started investing heavily closer to home, especially into infrastructure in neighboring states." (I3C8 Advisers/Lawyers)

5.3.4 Regulation without participation from fund managers in the drafting process.

The disjunction between fund manager respondents' views on their ideal regulation and the actual regulations in place leads to views on what needs to change. For example, it was suggested that routes for stakeholders to influence legislative formulation should be clearer and less complicated, with a disconnection being perceived between regulators and SWFs. When asked whether they had been consulted on drafting relevant regulation, respondents said:

> "Somewhat. More consideration to our comments should have been given." (I1C5 Fund Managers)

> "The reason we didn't participate too actively is due to the fact we didn't feel like we were being heard." (I1C9 Fund Managers)

> “Our legal team took part in the feedback process and we had good interaction with the legislators. Do we feel like our points were taken on board the way we expected them to be? No.” (I1C1 Fund Managers)

On the one hand, it appears that SWF managers might have a genuine grievance with the level of their participation in regulatory decisions. On the other hand, asking for regulation to be more sensitive to their views also seems to presume that the job of regulators is to look after the needs of SWFs. From the perspective of regulators, though, who are in theory mandated with protecting the broader public interest beyond the private interests of fund managers, such a complaint does not necessarily hold much weight. Aside from the level of participation, fund managers argue that regulations on state and international levels should be more practical, adaptable, and focused on the specific needs of SWFs, and also that the implementation required by regulations should be clearer and more straightforward. Responses include the following:

> “Not more strictly, but more clearly would be helpful.” (I1C5 Fund Managers)

> “Less regulation, but more practical regulation ought to be put in place.” (I1C6 Fund Managers)

> “It could be more clear at times and of course more flexible.” (I1C4 Fund Managers)

> “They should really work alongside our legal teams and learn from our experience. Take into account our track record and our returns. They need to create a more flexible, tailored set of guidelines.” (I1C4 Fund Managers)

Some fund managers clearly felt a sense of ‘injustice’ in the regulations. When asked what needs to change in the drafting process, the following was reported:

> “I do not know where to start, but to begin with stop seeing us as the bad guys. We are not banks, we are merely players in the financial sector, we cannot be treated the same. It will not work.” (I1C11 Fund Managers)

> “More reasonable view towards SWFs general approach to funding, withdrawal, and spending operations. Investment routes should be more approachable.” (I1C12 Fund Managers)

5.3.5 Views from government officials, regulators, advisers, and academics

In contrast to fund managers, government officials and regulators showed greater preference for stricter future regulation of SWFs at the international level. When asked whether it would be beneficial to bring SWFs into line with existing "best practice" regarding disclosure and transparency, regulators responded with statements like:

> "It would be a welcome move." (I2C3 Regulators)

> "Very beneficial." (I4C5 Academics)

> "It is a much needed move." (I2C8 Regulators)

> "It is an ambitious project to have a unified regulatory system that works across the AIF space. One that works specifically with SWFs to bring them together and stabilise the relationships globally is certainly beneficial." (I2C2 Regulators)

Some respondents also stated that while regulations should be more stringent, they should also be specifically tailored to monitor and guide SWFs on their investments. As one respondent noted:

> "We would all benefit from a clear set of strict regulations that are enforceable and only concern SWFs and their investments." (I3C2 Advisers/Lawyers)

Among academics, it was also commonly felt that SWFs should be more strictly regulated at the international level and that there should be a stringent set of mandatory regulations specifically set out to monitor and guide SWFs on their investments. With regards to data available on SWFs, one respondent stated:

> "It is perhaps unfortunate, but today there no comprehensive or accurate data on where SWF investments are taking place, either geographically or by sector. How can we try and improve transparency and disclosure of SWFs when we lack data to investigate the current situation? Creating a comprehensive database of investments would also aid developing countries in which SWFs might consider investing. We absolutely must press for transparency from SWFs and their sponsor states. The information we have

> today, does not allow us to accurately report where investment is flowing, which countries and industries are benefiting most from it. There simply is not enough data to draw conclusions and get comprehensive answers to help solve a lot of pressing issues in the SWF investment area." (I4C2 Academics)

5.3.6 Voluntary vs. mandatory regulation: self-regulation as an alternative?

Of all the interviewee groups, fund managers showed the most tendencies towards favouring the voluntary self-regulation of the Santiago Principles as opposed to mandated regulation. Fund managers made comments like:

> "Santiago Principles are a great set of good practice rules. Regulations like AIFMD for example are too stringent and very limiting."(I1C10 Fund Managers)

> "We have Santiago Principles. They are sufficient. They cover all the necessary issues. They cover legal framework, objectives, and coordination with macroeconomic policies. They also discuss the institutional framework and governance structure; and provide investment and risk management framework."(I1C11 Fund Managers)

One fund manager suggested that SWFs are responsible institutions that do not need external laws to behave well:

> "Self-regulation is not a bad thing in a world that is already overregulated. Hard law keeps on evolving and we have to constantly update our investment plans, it is hard. We need to be able to concentrate on the work we actually are here to do and that is to invest money and to do so well and justly. Our operations are transparent. It is not in our interests not to be a socially responsible company." (I1C2 Fund Managers)

Respondents from the other interview groups were less than convinced by the idea of voluntary regulation, though, or perhaps showed less faith in the inevitability of voluntary good behavior on the part of fund managers. Above all, regulators viewed voluntary regulation as inefficient and ineffective compared with stronger mandatory regulation. Comments included the following:

> “Reacting to the backlash in mature economies towards the SWFs' 'investments Santiago Principles were created, and their implementation is highly uneven.” (I2C2 Regulators)

> “Santiago Principles do provide for clear undertakings by SWFs, but they do not in any way constitute binding or enforceable obligations… For a host state that is genuinely concerned about SWF’s intentions or governance, the SWF’s simple endorsement of the Santiago Principles is unlikely to provide much comfort absent additional actions, disclosures, or undertakings by the SWF.” (I1C2 Regulators)

> “Santiago Principles are legally not enforceable as such, so it’s just a gesture of goodwill for as long as the fund is in a good mood about life. There ought to be a more stringent set of international rules. In theory, if countries are happy to be on board with a voluntary set, what is stopping them from committing to a binding regulation?” (I2C4 Regulators)

Advisers and lawyers also pointed out the shortcomings of voluntary regulation, noting – with some degree of cynicism – their use for public relations:

> “Binding regulation does what it is set out to do, which is risk management, it has its complexities, but it is enforceable. Santiago Principles are all notes of goodwill, you cannot hold anyone accountable for breaching them in a legal sense, as they are not binding.” (I3C1 Advisers/Lawyers)

> “Voluntary regulation is simply inconsistent and inefficient. SWFs would benefit from mandatory reporting.” (I3C8 Advisers/Lawyers)

> “As for Santiago Principles, they are barely to be taken seriously if it’s not for PR reasons.” (I3C3 Advisers/Lawyers)

> “The main limitation of the Santiago Principles is their non-binding nature. They are also vague and potentially insufficient in scope. SWFs use it for PR.” (I3C11Advisers/Lawyers)

The views were not dogmatic, though. As one regulator stated:

> "By comparing mandatory regulation to voluntary I believe that mandatory works better. However some studies and research have shown that voluntary regulation encourages market participants, including regulators, to acknowledge that companies do in fact have incentives to adopt better governance practices. They are better off doing that voluntarily. Companies also place themselves in a more favorable position with the public when they become more transparent voluntarily." (I2C12 Regulators)

In general, though, the overriding sense was of the Santiago Principles being well-meaning but unenforceable, in contrast with the stricter and enforceable mandatory regulation. For example, one respondent stated:

> "I stand by mandatory regulation. Santiago principles are a great concept as a concept, but they need to have an enforcement mechanism. Companies/funds/investors need to be regulated and held accountable by the law and one of the ways it will do this is to implement mandatory legislation." (I3C7 Advisers/Lawyers)

> "Santiago Principles are excellent, but the trouble with them is that they are only efficient at a very low level. If they were mandatory they would have a much better and far reaching effect." (I4C3 Academics)

5.3.7 Striking a balance: between voluntary and mandatory

One respondent proposed a hybrid regulatory system, stating that:

> "Current systems are not very efficient and I would argue that an optimal governance regime is a hybrid one. Such a regime would look at accepting and using the best practice guidelines in their daily business mandate voluntarily. However, when it comes to transparency of corporate governance practices reporting should be mandatory for all." (I3C3 Advisers/Lawyers)

An academic respondent suggested reworking the Santiago Principles by making them mandatory:

> "If Santiago Principles were reworked and made mandatory perhaps we would have a very different outlook in the way SWFs work and invest today. Regional mandatory regulation for SWFs is a welcome contribution, but it is

not as far reaching as one would want the regulation like this to be on an international scale.” (I4C1 Academics)

5.4 Reflection and analysis of interviewees responses to the dominant themes

In the theme ‘SWFs as contributors to the public good’, it is important to note the following fundamental differences of opinion of the four different interview groups on SWFs investments and their impact on the public good. Although all participants had knowledge of SWF investments, they also looked at the subject researched from at times very different experiences and areas of expertise. Clearly their particular experiences shaped their views on the subjects discussed, including on whether the regulation of SWFs should evolve further, with stricter implementation in the future.

5.4.1 SWF and PEF Managers (twelve interviewees, group one)

Overall, SWF and PEF managers saw the possibility of more mandatory regulation as a form of further constraint in their ability to pursue their current and potential investment interests. The majority believe that they function in an already overregulated field, on the basis that they have to adhere to the at times very specific demands of local and national regulations in the jurisdictions they are making investments in, added to the financial and regulatory responsibilities already applying in their own countries. They see investment as a way to increase their profits and those of investee companies, often over a long time horizon and appear genuinely aggrieved by the negative sentiment expressed towards SWFs in the media and by extension the general public.

There is a sense of disappointment that the public is not informed of the positive impact that SWF investments have brought over recent years in bailing out sections of economies, often at a financial loss to the funds in the short term. The public only hear of investments as opportunistic, not recognising that a SWF’s investment strategy maybe no different to the business practices of any other fund in the investment community. However, when asked about transparency as a way to improve their public image, along with engaging in an open dialogue with the press and the ‘concerned’ public, SWFs responded that such transparency is likely to be fruitless, since they are seen as representatives of the states that fund them, and not as independent investors, which is how they claim to act. This instantly paints them as geopolitical, creating a perception that they should be appropriately vetted and regulated.

All but one fund manager was happy to discuss further regulatory possibilities for SWFs, and to provide input on the appropriate levels of regulation.

5.4.2 Government officials/Regulators (twelve interviewees, group two)

One role played by this group is to ensure that the general public is protected from inward investments which may carry risk possibly with geopolitical agendas. They aim to firstly ensure that investors who invest in a responsible manner are recognised, and secondly encourage others to do likewise. A recurring theme amongst this group of interviewees was a lack of any firm opinion either for or against SWFs as investors who might make unethical and geopolitical investments. The group was careful not to tip the balance towards more mandatory regulation of SWFs as a result of their reputation following the 2008 financial crisis. Eight out of twelve interviewees chose neutral phrases to describe the impact that SWF investments have had on the world economy since the 2008 crisis.

"They certainly have the capacity … to create economic distortion." (I2C12)

"It would be hard to argue that they did not have a significant impact." (I2C2)

It was generally agreed that there is a need for more regulation to ensure transparency around the motives for certain investments by SWFs, especially SWFs from China and some Middle Eastern countries. That, judging by their past record, SWFs from these states are more likely to be secretive and geopolitical in their choice of investments. However, all participants welcomed a dialogue to explain why they believed that such funds ought to be regulated more strictly. Transparency should become a matter of mandatory regulation to allow for the parties involved to prove the ethical nature of their investments, and to clarify their prime objectives for making certain deals.

Three out of the twelve interviewees in this group relied more on their experience in working with SWFs, and perceived them as positive partners in creating public good, highlighting SWFs as reliable and responsible long term investors, who are only in the market looking for the best competitive deals, which would enrich their portfolios with profitable investments, creating wealth for future generations.

5.4.3 Advisers/Lawyers (eleven interviewees, group three)

The above turned out to be varied in their views, experiences and responses to the questionnaire. All the discussions developed a range of insights. Nine out of eleven interviewees considered that SWFs are becoming much more knowledgeable and sophisticated investors, bringing with them experience gained first hand through both successes and failures during the 2008 financial crisis. In some cases investments that seemed to be ‘real winners’ turned out to be costly, as they failed or required further capital to avoid total loss.

One of the reasons this group had a different view to other interview groups was their access to ‘real time’ financial dealings of the SWFs in the market. On a daily basis they participate in, negotiate and monitor SWF investments. They are familiar with SWFs’ most pressing issues and concerns, and have first hand access to the numbers and statistics within some of the investment portfolios that they handle on behalf of their clients. Naturally, such information is privileged and confidential, but the fact remains that the existence and handling of this information on SWF investments by their advisers/lawyers, or as they are referred to ‘trusted gate keepers’, means that they have a certain view that becomes shaped by the information that they process and the experiences that they share with their clients (SWFs).

This group stated almost unanimously that SWFs are just like any other investment fund looking for profit, except that they face more obstacles because SWFs are increasingly seen as representatives of the governments whose money they are investing. Deeper analysis shows that SWFs are often an independent arm of their government’s investment funds. They are just like most other AIFs seeking investments, but of course they are still seen as public money. SWFs participated in the stabilisation of their own domestic markets during the 2008 financial crisis, and there is an argument that at the time of the 2008 financial crisis and immediately after, any surplus cash that SWFs had was earmarked for assets that promised a handsome long term return once the markets had finally stabilised.

Today SWFs look for potential investments in all parts of the world, and as the interviewees in this group stated, they are interested in investing long-term, and in areas where there are less regulatory hurdles. They have the means to seek the best legal counsel, and therefore are equipped to solve issues of regulation, in most cases by adhering to a bare minimum of requirements. However, if the pressure to increase transparency through new regulation were to become too severe, SWFs might instead choose to invest in developing states. This is not due to their investment goals being unethical, but because SWFs often prefer to avoid public accountability for the sums they owe, control, own, and invests, and the reasons for which they make their investments.

Interestingly, most SWF clients are happy to disclose broad parameters of their investments and assets of interest; however, regulators, and increasingly, the public want more in-depth answers, being no longer satisfied with the low level of information provided to date.

The interviewees in this group were keen to participate in amending current regulation, and discussing any possible future regulatory change. As a group they see the positive impact of proper and fair regulation. They advocate a unified and balanced approach that is clear and fair and takes into account the sovereign nature of SWFs.

5.4.4 Academics (seven interviewees, group four)

This was the most well-rounded and balanced group in terms of their multifaceted knowledge of SWFs, their history, investment patterns and regulatory constituency. We recognise the limitations of their knowledge, caused by the lack of accurate data and reliable reporting. For example it is unknown exactly how much money SWFs have at their disposal or what their investment portfolios are currently worth. These academics – like other researchers - as well as most researchers work on the data and facts available to them, with a good proportion remaining guesswork.

Academics interviewed came from a variety of cultural and international backgrounds, all with sound knowledge of the history and the present state of SWFs. This includes how SWFs have developed in the public eye throughout the decades and how their perception changed after the 2008 financial crisis when the world began taking notice of their existence. Once it became evident that they were significant investors, academics continued to follow their evolution from newcomers to international financial powerhouses with strong, experienced and modern Western investment teams.

Academics see SWFs as a positive group of investors, and are keen to point out that, in most cases, whereas media and politicians have expressed public concern about SWF investments and their alleged ties to their respective governments, Western banks and businesses have been keen to work with SWFs and have encouraged long them to invest for the long term.

> *"To date SWFs have acted as model investors." (I4C6)*

This group of interviewees appear to have a more relaxed and well-rounded view of SWFs investments; their view is not distorted by having to belong to any particular 'side' of the investment community or regulatory 'camp'. They analyse facts and patterns of SWF investments, and for them the most disturbing area of SWF investments is their resistance to transparency, so that no one truly knows the real extent of their investment in any particular area or the reality of their scope in terms of magnitude and sphere. Overall, academics interviewed see SWFs as having a positive impact on the general public and the economy, both domestically and internationally, both for the investing state and the receiving country. Where there is investment, there is opportunity for jobs, infrastructure and education. Investments work both ways and SWFs appear to want to build communities and strengthen them, rather than favour short-term investments and disinvestment at the time of financial or other crises.

Finally, with the exception of a few Western funds there are not many ways to validate the information provided on the SWF websites or press releases to the general public. This makes research difficult but not impossible and as our research shows it is possible to make a valuable contribution where we are able to gain access to the main players in the SWF investment and regulatory field.

It is important to begin a dialogue on the subject of SWFs with participants of the calibre we have worked with. The research reported in this thesis meets the combined objectives of being contributory to the subject of learning more about SWFs, and creating the opportunity to discuss and question first hand the four groups of interviewees in order to begin to put together recurring topic patterns, concerns, issues and questions. Value is added whether or not this discussion unites or divides participants.

5.5 Conclusion

After in-depth qualitative reflection on forty-three interviews, distinct themes emerged from respondents. Within the fund managers, there was a distinct bias towards seeing the negative sides of mandatory regulation. This was set against the backdrop of their sense of frustration that SWFs were unnecessarily demonised by the press and that their positive role relative to other financial institutions was not sufficiently recognised. The increased compliance burden leads them to speculate that SWFs may begin to focus on investments outside the EU in developing markets. Whether this is likely to occur in reality, or whether it is just posturing, should be subject to further study.

When analysing the materials and data sourced from the interviews, it became noticeable that on a number of occasions, participants were willing, while giving concrete answers to the questions asked during the interviews, to discuss contrary points of view. They were clear and forthright in their views and robust in controlling the level of detail they were prepared to give in their answers. Where time permitted we were able to return to clarify or confirm certain answers and to probe the interviewees as to why they responded in a certain way, or had a particular view on an issue discussed.

We were keen to see if respondants were willing to look at the topic from a different angle, for example whether a fund manager could relate to the questions asked though the prism of a government official or regulator of the state that they were about to invest in; or if an academic could look at the possibility of new mandatory regulation through the eyes of a SWF manager. It became noticeable to us and to them that were their roles reversed, their responses to the interview questions might be correspondingly different. It surprised us that some of the participants clearly munderstood how weaknesses in, or lack of, regulation might cause difficulties for other industry participants.

Most surprising, perhaps, were the answers from some lawyers who had worked with both regulators and AIF/SWF managers, with their opinion that more regulation did not necessarily mean better control systems or more accountability, arguing that experienced and wealthy clients would always find the right advice and if needed amend their relevant investment interests.

It was gradually acknowledged that, although regulation can add time, complexity and expense to potential investments, especially those in new territories, it also contributes to the protection of both the funds of the investment community and the assets they invest in. Further, this can impact upon the wellbeing of the general population of the state or company in which the investment is being made. Managers pleasantly surprised us by discussing the need for real and fair regulation, especially where they were consulted on its drafting and implementation, as they no longer wish to be seen as destructive, greedy, opportunistic investors, but rather as long term and reliable partners, especially in times of crisis.

Overall, when reflecting on the interview material, and considering the meaning of the data, more and more ideas emerged on how regulators and SWFs might benefit each other. Even though it would seem from the majority of answers that imposed, mandatory regulation, is not welcome and is frowned upon, the investment community as a whole is keen to participate in self-regulation, or to submit to mandatory rules, which could lead to a sensible process for the creation of further binding regulation in the future. Interviewees generally understood the benefits of appearing to be transparent, accessible and responsible in their investments, whilst of course wishing to maintain their profitability.

While regulators were not unsympathetic to some of the concerns of fund managers, they generally channelled a more positive view on mandatory regulation. Fund managers might see elements of strict mandatory regulation as being 'out of touch with reality', but it must be acknowledged that their reality may be characterised by different pressures to the reality experienced by regulators. Regulators must, in theory, respond to concerns beyond the immediate ease and commercial interests of SWFs. Whilst realising that the 'one-size-fits-all' nature of regulation can be a problem, this did not make mandatory local regulation any less important in their eyes, suggesting that, in the long run, SWFs would benefit from being brought into line with 'best practice' standards of transparency.

This view – with some variations – was also generally shared by advisers, lawyers, and academics, most of whom suggested that mandatory regulation was preferable to unenforceable voluntary regulation. To some extent, this belief is based upon an underlying concern that, while SWFs have not previously been implicated in causing global financial crises, they nevertheless have the future potential to cause instability.

Going forward, it appears that there is more scope for fund managers to collaborate with regulators in developing more nuanced regulation. Several parties suggested that more specific regulatory guidelines should be developed for SWFs, in particular, to break the 'one-size-fits-all' criticism. This could be a positive collaboration, provided that SWF managers do not use it as an opportunity to cynically water down regulation, and provided that regulators do not allow prejudices related to the nature of SWFs to guide their actions. One fruitful area of research going forward might be in how to develop guidelines for productive collaboration between such parties, one that takes into account the different interests in a balanced manner.

However, it is perhaps hard to generalise at this global level. In order to consider these issues in more detail, therefore, we next focused on two country case studies, Russia and China, as reported in the following two chapters respectively.

Chapter 6: Russia Case Study

6.1 Introduction and background

The better to understand the background against which the Russian SWFs operate, and to identify the problems which arise from meeting their particular objectives, we held discussions with academics, lawyers, politicians, and practitioners, whose opinions and suggestions are detailed in this case study. In these discussions, we placed emphasis on the need or otherwise for more comprehensive regulation and an acceptance of greater transparency.

The Stabilization Fund of the Russian Federation was established in 2004. Its objective was to use windfall oil and gas revenues accumulated during the boom years of the late 1990s to allow the Russian government to dampen the economic volatility caused by energy price fluctuations, by providing a buffer against the negative impacts on Russia's budgetary revenues of potential oil price falls. A secondary purpose was to use any windfalls for stabilising prices (Tabata, 2007), and – according to some – to ensure that such windfalls would be reinvested in productive sectors rather than being subject to profligate government spending (Bush, 2005).

In 2008, the fund was split into two separate entities: the Reserve Fund, which has the aim of maintaining economic stability by covering government budget shortfalls, and the National Wealth Fund, which is used to bolster the country's national pension scheme by investing in a broader range of securities (SUNY Levin Institute. Globalization 101; Pismennaya & Tanas). The NWF was ranked the 19th largest SWF in the world by the Sovereign Wealth Fund Institute, with a 2016 portfolio value of $73 billion, whilst the Reserve Fund was ranked 24th, with a 2016 portfolio value of $65.7 billion (SWFI, 2016). The combined assets are some way below the portfolio value of larger players like the CIC (with a portfolio value of $746 billion), but the funds are nevertheless a significant force in international markets.

This case study focuses in particular on the administration of the NWF. To understand its context and operation, it is important first to consider it within the broader trajectory of the Russian economy in recent years.

The Russian economy is heavily dependent on crude oil and petrochemical products, with oil and natural gas accounting for 68 per cent of all Russian export revenues in 2013 (Matelitsa, 2014). Russian economic performance grew by 40 per cent in real terms between 2000 and

2006 (Astrov, 2007), but this created a dependence on high or rising prices for those commodities. Unlike the Organization of Petroleum Exporting Countries (OPEC) – which is perhaps the most important influencer of crude oil prices (EIA, 2015) – Russia has little ability unilaterally to influence oil prices: it is a crude oil 'price taker', and volatility in those prices significantly impacts the budget position of the Russian government. Russian finance minister Anton Siluanov estimates that oil prices must exceed $70/bbl for the Russian government to operate without a budget deficit (Graeber, 2015).

6.1.1 Characteristics of the Reserve and the National Welfare Funds

It was in the context of increasing dependence on oil revenues that the Stabilization Fund was set up, and the 2008 split created two entities with different purposes.

The Reserve Fund has a shorter-term focus, investing in low-risk securities that can readily be liquidated in the event of Russia needing the funds. According to the Ministry of Finance (MinFin, 2016):

> "The Reserve Fund is a part of the federal budget assets. The Reserve Fund is dedicated to ensuring financing of the federal budget expenses and maintaining federal budget balance in case oil and gas budget revenues decline. The Reserve Fund contributes to stability of the Russian Federation economic development by means of reducing inflationary pressure and insulating national economy from volatility of earnings generated by export of non-renewable natural resources."

NWF, has a longer-term focus, being authorised to invest in riskier securities that may be more volatile in the short-term but that promise potentially higher longer-term returns. This mission is reflected in the fact that the original name for the National Wealth Fund was the Future Generations Fund.

> "NWF is a part of federal budget assets. NWF is dedicated to supporting the pension system of the Russian Federation to guarantee long-term sound functioning of the system. The fund's prime assignments are to co-finance voluntary pension savings of Russian citizens and to balance the budget of the Pension Fund of the Russian Federation (MinFin, 2016)."

So the NWF has the characteristics of a more traditional long-term focused SWF, while the Reserve Fund may be more accurately defined as a stabilisation, or a 'fiscal sterilisation' fund (Revenue Watch Institute, 2013).

Both funds are managed by the Ministry of Finance, which in turn is accountable to the Prime Minister (Medvedev), who is appointed by the President of Russia (Putin). The bank accounts for the funds are at the Central Bank of Russia.

According to the official Russian Ministry of Finance statistics, the NWF had almost $73 billion under management in June 2016, down from a high of $94 billion in May 2011 (MinFin, 2016). The Reserve Fund invests almost exclusively in sovereign debt of other nations, primarily dominated in US dollars, euros, and British pounds – it is not allowed to invest in Russian securities. By contrast, the NWF, is authorised to invest in a wider range of securities, including higher risk equities, corporate bonds, and securities issued by Russian companies (MinFin, 2016).

There is also a significant connection between the NWF and Vnesheconombank, a state-directed financial institution set up to support strategically important elements of the Russian economy. Deposits placed by the NWF at Vnesheconombank is one route via which NWF money can be directed towards Russian state-owned enterprises (SOEs). NWF money placed at Vnesheconombank has been directed towards loans to Russian banks, to SMEs, and to The Agency for Housing Mortgage Lending, as well as for the purchase of equity stakes in Gazprom (MinFin, 2016).

6.1.2 The funding system

The Ministry of Finance operates a three-tiered system to direct money into the funds (MinFin, 2016). Revenue in the form of oil and gas production taxes and export customs duty on crude oil, natural gas, and oil products are initially transferred directly to the government to finance expenditure. Any revenues left over are then transferred to the Reserve Fund according to a formula in which the 'maximum size of the Reserve Fund is limited to ten per cent of the Russian Federation GDP forecasted for the corresponding fiscal year'. Once that cap is hit, any remaining revenues are transferred into the NWF. There is a thus a 'spillover' system, where the NWF receives new inflows only if the other two tiers are 'filled up'.

6.1.3 Russian SWFs in the context of Russia's politicised business environment

A frequent claim made about Russian SOEs is that they have privileged access to the key figures in decision-making within the Russian government (Rutland, 2011; Orttung, 2006). Such ties lead to advantages for certain enterprises at the expense of other companies in the market. For example, the arrest of Vladimir Yevtushenkov (Walker, 2014), president and major shareholder of Sistema – the largest publicly traded diversified holding company in Russia – was a politically-motivated raid to transfer assets controlled by Yevtushenkov to Rosneft – controlled by Igor Sechin, a close confidante of President Putin – to refinance Rosneft's borrowings (Weaver, 2014).

If there is a government-business relationship that significantly influences the Russian economy, state investment funds that were officially created to protect the broad interests of the Russian citizenry can potentially become captive to narrow political interests. If there are weaknesses in governance, the funds could become 'politicised' or 'captured' to advance the private interests of powerful figures.

The term 'politicised' needs to be clarified. On the one hand, the fund has a political mandate to protect the budgetary position of the Russian state, and it is run by the Ministry of Finance, a political body. Given that the SWFs are set up in part to help offset budget deficits, we would expect money from them to be drawn on in times of budgetary crisis – and the available evidence suggest that the funds in the Reserve and the NWF have in fact been used to offset the government's budget deficits (Peaucelle, 2012).

In order to fulfil its mandate, though, the NWF invests in securities which under normal circumstances would be expected to be 'apolitical' and 'economically rational' investments such as investment grade bonds and blue chip shares. That said, the investments it makes to fulfil its political mandate might also be 'politicised' decisions to invest in enterprises for reasons other than strict financial criteria. For example, this might include investing in failing businesses linked to the state in order to bail them out. Alternatively, they may be investments to project Russian state power beyond its borders.

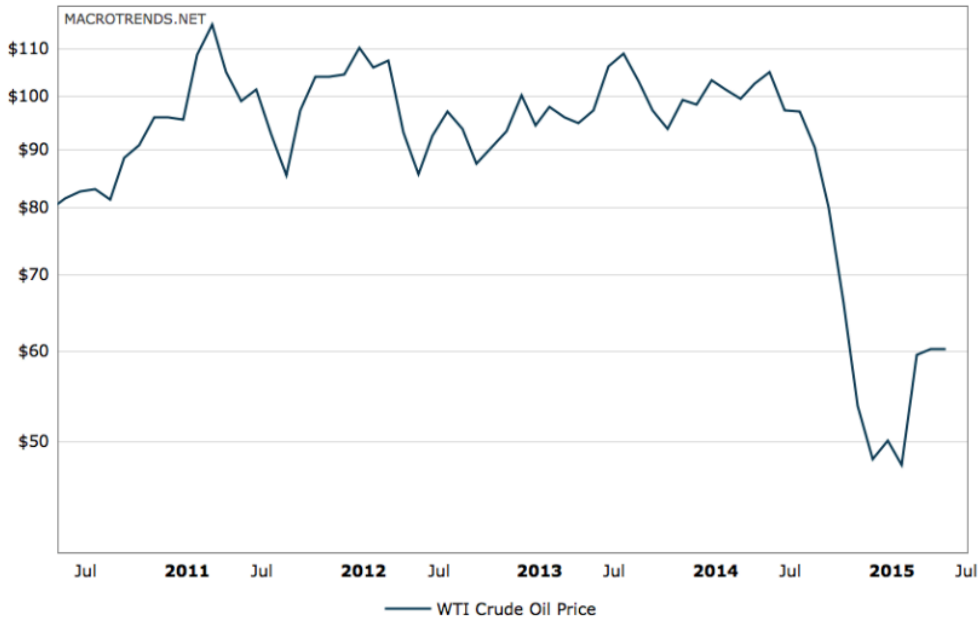
The line between these is blurred by the fact that the state may perceive the health of certain state-owned businesses to be linked to the budgetary position of the state. Thus an 'investment' in a distressed state-owned enterprise could be presented as part of the broad agenda of protecting economic stability, and therefore, the revenues of the state.

A potential key issue is that supporting SOEs is a different activity to bolstering the national pension fund, which is what the NWF was set up to do; so if money being used for SOEs comes at the expense of the pension fund, then rather than characterising the action as money being 'invested' for future pension security, we might characterise it as money being 'appropriated' or 'raided'.

6.1.4 Support of strategic national industries and SOEs in economic downturn

One of the most significant trends causing an impact on the Russian economy is the decline in crude oil prices, which began in mid-2014. Figure 1 below shows the evolution of West Texas Intermediate crude oil prices (in $US/bbl) over five years beginning July 2010.

Figure 2: Five-year crude oil prices in US$



Source: www.macrotrends.net (accessed on 10 January, 2016)

The sustained decline in oil prices to below $70/bbl has led to a doubling of the Russian government budget deficit to 10.5 per cent of GDP in February 2015, up from 4.2 per cent of GDP in January 2015, due to contractions in revenues (Ostroukh, 2015).

This came at a time when Russia had also been subject to economic sanctions, following the decision in March 2014 by President Barack Obama to impose "sanctions on people responsible for Moscow's military intervention in Ukraine's Crimean Peninsula, including travel bans and freezing their U.S. assets" (Holland & Mason, 2014). The US and EU declared that Russian involvement in the Ukrainian political crisis constituted an attack on Ukrainian sovereignty. As the conflict in Ukraine progressed, other states joined the US in imposing sanctions on Russia. The range of sanctions spread from targeting specific individuals or their assets to restricting non-Russian companies domiciled under their jurisdiction from engaging in business transactions with Russian firms in various industries like finance, energy, and defence (Rampton & Holland, 2014). Michael Emerson at the Centre for European Policy Studies (CEPS) argued that economic sanctions on Russia had the potential to have a significant impact and to freeze Russian companies out of Western financial markets (Emerson, 2014).

A truce in Eastern Ukraine, signed on February 2015, lessened political tensions. The subsequent decrease in credit default swap spreads on Russian government bonds reflected lower sovereign risk assigned to Russia (Colvin, 2015). In March 2015, the World Bank suggested that the impact of economic sanctions may be somewhat dulled by stabilisation in oil prices and signs of political stability and that in the long run the Russian economy is expected to adapt to the changes (Hansl, 2015). Russian unemployment figures remained at historic lows despite the low oil prices and continuing sanctions. The World Bank identified higher military expenditures as one of the important drivers of the Russian budget deficit. If the truce with Ukraine is strictly enforced, the budgetary deficit could be reduced through a reduction in military expenditures, offsetting some of the losses due to lower oil prices.

Zhavoronkov (2014) argues that one of the results of the decline in global oil prices and the sanctions against Russia is that the funds of the NWF are being redirected towards refinancing the debts of SOEs and other government-favoured firms while the funding of their workers' pensions has been frozen.

The relationship of Russia's NWF to Russian SOEs has become an object of potential controversy, with media outlets reporting that these funds have been redirected to serve powerful interests in SOEs. In 2015, The Moscow Times noted that funds within the NWF declined by $5 billion in March 2015 as the funds had been used to provide financial assistance to SOEs, noting that "state-owned companies have lined up for handouts from these funds over the past year as the economy veers toward recession and sanctions over Russia's actions in Ukraine cut off firms' access to Western capital markets" (The Moscow Times, 2015).

Much of the funding is directed towards major infrastructure projects. This includes funding Russian Railways to modernise the railway infrastructure and backing other SOEs building nuclear power plants and road infrastructure (MinFin, 2016). Funds in the NWF were also redirected to investing in key banks like VTB, Russian Agriculture Bank and Gazprombank (Anishchuk, 2014). The Moscow Times also reported in 2015 that, “Almost half of the Fund is already committed to domestic projects and companies — close to a 60 percent cap that limits investments within Russia”.

Henderson (2015) reports that:

> “One further source of significant funding for the Russian oil industry, which Rosneft and others are keen to tap into, is the National Welfare Fund (NWF), which was set up using surplus revenues from oil taxation to support the country’s state pension scheme. While its sister fund, the Stabilization Fund (also financed by oil taxes), is used to support the state budget, the NWF has been used to support banks and companies during times of crisis and was extensively used in 2008/09. However, because the fund ultimately has a pension mandate, its loans must theoretically be used for projects that will ultimately generate a return for the state, and not for paying off debt. As a result, any companies applying for funds must show exactly how the money will be used.”

In 2014, Platts reported that Transneft was looking for funds from the NWF (Griffin & Bowles, 2014). Khromov (2016) notes that the support is directed via Vnesheconombank:

> “In the course of 2008–2010 crisis, the banking sector also received significant amounts of public funds (…) A number of major banks obtained subordinated credits from Vnesheconombank at the expense of assets from the National Wealth Fund (NWF) placed on depo accounts with Vnesheconombank.”

It seems unlikely that the NWF can be characterised as an independent asset manager that invests funds to achieve the best possible risk-adjusted returns for future pensioners. It has characteristics, at least in part, of a strategic industrial policy fund seeking to bolster state objectives. Gelpern (2011) notes that the NWF’s mandate seems to have changed as the fund has grown, beginning to appear less of a pensions savings fund and more of a stimulus fund for Russian enterprise. Its funds have been used to defend the ruble during the 2008 financial crisis, to invest in the Russian equity markets, to support Russian banks and strategic domestic firms, and also to finance construction loans for the Sochi Olympic Village.

From a traditional investment management perspective, this raises certain concerns. For example, SWFs should ideally seek to diversify risk internationally as a hedge against declining economic performance in their home country. If the NWF invests additional amounts within Russia, the correlation between the fund's performance and the Russian economy is thereby increased. It is difficult to argue that strategic investment in state industries necessarily aligns with the broad objective of supporting pensions in the long term.

6.1.5 Have the funds been used to project international geopolitical influence?

Weidemaier (2016) notes that the Russian state used the NWF to buy Ukrainian sovereign bonds. Upon the bond default, the Russian state engaged in legal action to recover funds. As Weidemaier puts it:

> "The Russia–Ukraine dispute is unique in the annals of sovereign debt litigation. It is a politically and militarily fraught conflict wrapped in a garden-variety, English-law contract dispute."

It is questionable whether investing in Ukrainian bonds would be an action that a standard non-politicised investment fund would do. Moreover, the investment was made despite the fact that Ukrainian credit ratings were lower than the credit rating limitations set by the NWF mandate (Hille, 2013). As the IMF (2015) notes, "The bond was acquired by Russia's NWF pursuant to a decision by the Russian Government to provide assistance to Ukraine". Far from being an investment for future generations and pensioners, this appears to have been a clearly politicised investment for geopolitical purposes. Again, according to the IMF (2015):

> "Since the NWF's investment guidelines did not permit investment in Ukrainian bonds (due to the credit rating requirements), a specific government decision was needed to amend them. This implies that the NWF, in acquiring the Eurobond, was acting on behalf of the government."

6.1.6 Governance weaknesses

Revenue Watch and the Vale Columbia Center on Sustainable International Investment produced an assessment of the governance of Russia's Reserve Fund and NWF (Revenue Watch Institute, 2013). They noted that the funds had:

- Clear deposit rules, with clear demarcation of where money is drawn from – oil and gas revenues and export customs duties – and clear rules for which the funds would receive money, and under what circumstances.
- Clear investment rules, with little ambiguity in how they were supposed to invest.

Nevertheless, there are:

- No clear withdrawal rules: No clear rules for how much can be withdrawn in any one year from the funds.
- Little transparency, with no publication of specific investments.
- No publicly available audits (either internal or external) and questionable oversight of managers.

In particular, they note that while the NWF withdrawals are supposed to be used for the national pension fund, "exceptions have been made to finance extra-budgetary spending, but no regulations exist regarding such exceptions".

Indeed, 'exceptions' exist at various points, including what the NWF can invest in (its investment portfolio), and what it can be used to support (withdrawal rules). The Federal Assembly (Russian parliament) is supposed to provide oversight, with input from the Accounts Chamber that audits the funds' activity, but this is limited. No civil society groups monitor the funds, and the only public disclosure is of the size of the funds and the deposit and withdrawal amounts.

The modern Russian environment is conditioned by the sweeping changes that occurred after the collapse of the Soviet Union. Many of the Central and Eastern European (CEE) countries that had been under communist rule took the option of gradual reform, but Russia took the more radical path to swift privatisation of significant assets in the formerly centrally-planned economy. Pohl and Claessens (1994) argue that it was unrealistic to expect that transition economies like Russia would be able to swiftly develop the complex system of legislation, regulators, and institutions that in the developed Western economies have evolved over long periods.

This is a factor in the failings of Russian SWFs when it comes to transparency and governance. Russian SWFs are overseen by the Russian Ministry of Finance and are officially accountable to the Russian public via the pension system, but the lack of transparency in both the Reserve Fund and the NWF means that information disclosure appears to operate on a 'need to know' basis. For instance, the Federal Law of the Russian Federation, dated the 17th December 2009, and the accompanying government resolution, dated 21st of April 2010, "Of suspension of action of government acts relating to formation and use of the oil and gas incomes if the federal budget comes under control of National Funds", stipulated that the financial ministry will not publish any information about the use of the funds in the Reserve Fund and in the NWF (Peaucelle, 2012). This makes it difficult to verify whether the Reserve or the NWF strictly follow their mandates or whether they are called upon by the Russian government to execute tasks that are not strictly within their mandate. This lack of transparency extends to the governance structure of the funds themselves. There are no available details on the overall management of either the Reserve Fund or NWF, and it is probable that the Russian Ministry of Finance manages them directly without external fund managers (Mehrpouya, Huang & Barnett, 2009).

The Russian SWFs have been scored on their adherence to the Santiago Principles. Many of the principles concern transparency, reporting, and clear governance. Other principles explicitly try to reduce political influence within SWFs, suggesting that 'SWFs investment decisions should aim to maximise risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds', and that the funds should not get privileged access to sensitive information. The Russian SWFs scores have been poor relative to those of other countries and have not improved over time (Bagnall & Truman, 2013).

As can be seen in the review conducted by the Peterson Institute for International Economics, Russia scores below most other members of the IWG despite having been involved in developing the generally accepted best practices (Bagnall & Truman, 2013).

The UN Principles for Responsible Investment (PRI) is a voluntary initiative by institutional investors that encourages consideration of environmental, social and corporate governance (ESG) factors when making investments. The PRI was initially formulated by a consortium of institutional investors under the auspices of the UN, but neither the Reserve Fund nor the NWF is a signatory of the Principles (Mehrpouya, Huang & Barnett, 2009).

On balance, there is little evidence to support the idea that the Russian SWFs are independently governed, as recommended internationally for best practice. That said, the impact and effectiveness of global best practice recommendations have been questioned. Halliday (2008) argues that the SWF governance rules and regulations are unrealistic in the context of some states in the Middle East, China, and Russia. For example, if the need to provide a response to a financial crisis conflicts with the original motivation of using the fund for pensions, these legal constraints may not necessarily bind the sovereign fund. Governments may need flexibility to respond to crisis situations, and not to be bound by rigid mandates.

In Russia, there is little separation between the state and private interests, and the prevalence of opaque governance structures means it is perhaps naïve to believe that ethical investing guidelines and codes of practice will have any major impact on the way business is conducted. Halliday (2008) argues that ensuring that SWFs behave in socially responsible, inclusive ways requires more than 'soft touch' expectations of conformity to best practice codes of conduct, and that host countries of SWF investment should restrict the activities of SWFs from countries like Russia.

Some evidence exists that pressure from the West may lead to Russian institutions improving their practices. For example, it was found that negative coverage in the Anglo-American press could be used to pressure Russian companies into improving their governance, as such coverage can adversely impact the international image of Russian corporations. This kind of attention and pressure could also force Western regulators into action against the ways Russian companies operate (Dyck, Volchkova, & Zingales, 2008).

6.2 Interview results

It is against the backdrop of this chapter's Part One secondary research that primary research was conducted in the form of interviews with policymakers, fund managers, lawyers, consultants, and academics. The following were themes that emerged.

6.2.1 The role of Russian SWFs in the global financial system

The Russian SWFs are less prominent or controversial in international markets than bigger SWFs like China's CIC. They have a conservative investment approach and are not known for aggressive private equity investments in foreign companies. An adviser noted the context in which the Russian SWFs were set up and their risk aversion:

> "SWFs have an interesting timeline. At the beginning the government sets it up as a saving mechanism. That's why even in times of uncertainty like now we are seeing a lot of sovereign funds being created or as in the case of Russia restructured, because it's a saving mechanism after all. There are going to be more SWFs because it's a saving mechanism for the country. They are very adverse to risk." (I3C6 Advisers/Lawyers)

An experienced consultant points out that unlike the Chinese CIC, the Russian SWFs have never been active outward investors, rather focusing on more passive conservative strategies.

> "If you look at Russia they have a Reserve Fund and the National Wealth Fund, but they were very dormant funds, and they did not have much activity." (I3C10 Advisers/Lawyers)

Further, there was consensus that the Russian SWFs played a minimal role in the 2008 financial crisis. Furthermore, as a fund manager notes, the crisis made them more inward looking:

> "If you look at 2008 onwards, the financial crisis caused some of the sovereign wealth to be more introspective (…) funds like Russia started having issues, so they started to invest more heavily internally." (I1C1 Fund Managers)

This conservatism may be related to an awareness of the precarious and finite nature of oil supplies. One academic notes that the Russian SWF has started to create alliances with China, India, and other states for investments and development of trade in the context of a possible future decline in oil revenues:

> "The latest crisis is interesting because of course those like Russia, that are partially dependent on national resources for funds for the first time in a long

> time realised that the resource not only is finite but is not worth what they think it is worth.” (I4C7 Academics)

That said, a legal adviser to Russian SWF investments noted how SWFs can contribute to asset price hikes:

> “First objectives of SWFs are to invest into regulated infrastructure to create yield. SWFs like to spend more than a quarter of a million to make a sound investment. When you add all these funds together, looking for assets like this puts asset values through the roof. This means there are too many people chasing too few assets.” (I3C1 Advisers/Lawyers)

According to one adviser, the Russian SWFs make long-term investments in real estate but still do not focus heavily on outward investment:

> “Once they are up and running and have a buffer to play with what we call alternatives, real estate normally is the first asset they invest in. Russian SWFs have also done that. Not in the same amounts that the Saudi or the Chinese have, as Russia does not invest too heavily in outward investments.” (I3C4 Advisers/Lawyers)

It became evident through our interviews that Russian SWFs are uniquely close to their internal ministry of finance. The SWF has been used as a mechanism for internal investment on a large scale, especially in SOEs. From our data we can assume that due to the finite nature of the resources available in Russia, there exists an unspoken internal policy of ‘Russia First’, meaning SWF resources have been focused upon building strong and lasting infrastructure, including but not limited to that which allows access to free medical care and higher education nationwide.

Russian SWFs make few public statements concerning their investments in the West, but the data from our interviews tells us that the Russian SWF is keen to publicise joint projects with Asian and Middle Eastern states. Within the Russian community such collaboration is widely discussed and celebrated, as a precursor to successful deals in the future, besides encouraging cultural expansion and the support of neighbor states for each other.

We learned that the amount of capital openly disclosed as having been invested by the Russian SWF in the West (according to ‘officially available’ information) is insignificant when compared with the overall scale of the funds at its disposal. There is a trail of investments in real estate and blue chip companies in the West, particularly Great Britain (London) and the USA (Miami, NYC and California). Overall, however, it is impossible to draw on concrete numbers to estimate the total sum of outward investments by the Russian SWF in any jurisdiction. The values cited differed vastly, depending on the respondent approached for this information. One thing is clear: Russian investment is prominent worldwide, but it takes place quietly. Another observation from our interviews is that private collaborations with Russian sovereign money are widespread. These investments frequently remain private.

Overall, we concluded that compared with the sums invested in the world markets by the Chinese and Middle Eastern funds, the Russian SWF does not have a material impact upon the global financial system, nor on any particular country, or specific investment sphere. The money appears to be invested proportionally across a variety of interests in a quiet and discreet way, focusing foremost on fostering opportunities domestically.

6.2.2 Transparency and accountability

It is generally accepted that the Russian SWFs are not transparent. For example, a regulator noted that they do not place transparency or CSR high on their agenda:

> "Russian SWFs are not especially responsible or transparent. There are very few socially responsible investors." (I3C11 Advisers/Lawyers)

That said, interviewees expressed some ambivalence about whether the funds should be transparent within Russia. While it is generally considered to be a 'good thing' if funds are transparent, there is a certain 'realist' sense that we should not expect that in the socio-political situation of Russia.

For example, when asked if the funds should be subject to greater regulation for transparency, a fund manager suggested that the fact that they report privately to the government is enough:

> "In my personal opinion, it's no, but this is because their ultimate goal is to be full shareholders, so to their government they are fully transparent, and they report on everything that they have to, but why should they report to the rest of the world on what they do." (I1C13 Fund Managers)

This attitude goes against the grain of what civil society groups in many European countries expect. But it is suggested that perhaps this expectation does not exist in countries like Russia. One legislator notes that the general public in China and Russia have seldom put pressure on their SWFs, and that an external foreign state trying to put that pressure on Russia and China would be unlikely to succeed.

> "I think reporting practices are important within the country as well, because public opinion will force that change if these things are exposed. The Chinese and the Russians do not have a great track record and if you attack their wealth funds I think you would do more harm than good." (I2C7 Regulators)

An academic speaking about the importance of transparency in reporting and the requirement for regulation that is stringent at a domestic level said that high expectations at home would mean a more responsible investor abroad.

> "We need to address the issue of SWF transparency globally and the importance of having mandatory regulation enforcing reporting, as well as their regimes. It is fundamental in advancing the industry and clearing it of its opaque reputation. We have to do more, expect more and demand more. For every SWF, responsibility begins at home." (I4C4 Academics)

A regulator noted that transparency of SWFs differed by country and commented on how difficult it would be to create regulation that is universally acceptable and legally binding:

> "It depends what transparency you are seeking to achieve. It's good to stop organised crime and money laundering but some of these are secretive because of the way their countries are set up. Some of the Middle Eastern sovereigns are organised in a way that is pretty transparent but some are a lot less so, because they are owned by the royals. For example, the Saudi royal family does not have much transparency about what they own. In Russia, the situation is similar; a lot of investments are in the private interests of the politicians and their businesses." (I2C1 Regulators)

Throughout the interviews participants did not show great faith in the accountability and transparency patterns of Russian SWFs. The lack of disclosure and dialogue from the Russian side, particularly in the light of the sanctions and sensitive political situation, means that the Russian government is reluctant to authorise the SWF to release any information. It is important for Russia to maintain face domestically and abroad and to sustain the perception of strength in its approved investments and collaborations.

Our analysis showed that there is a significant amount of information, albeit unverified by any form of independent audit, on the details of Russian SWFs' planned and current investments, as well as collaborations with, amongst others, India, Egypt, the UAE and China. Our data also highlighted that most, if not all, the states that the Russian SWF collaborates with appear to lack transparency and/or accountability. One of the theories emerging from our interviews is the presence of a 'like attracts like' mentality, meaning the Russian SWF is likely to invest in and collaborate with other states with a similar cultural outlook on business and the same level of accepted transparency/accountability. This is consistent with the secondary research findings reported in chapter two above.

6.2.3 Do the Russian SWFs pose a strategic risk?

Unlike the Chinese CIC, the Russian SWFs are not widely viewed as being geopolitically controversial. Asked whether the Russian SWF poses a strategic or geopolitical risk to countries it invests in, an academic noted that:

> "Not at all, you have to think that the majority of sovereign funds are financial investors so they barely look into the company actions. The preference is to buy minority stakes, 20 per cent is the preferred equity state for private companies; for real estate it's different: sometimes they like to go for the majority of the property but it depends on the tax regulation." (I4C6 Academics)

Our interviewees agree that while Russia invests strategically in real estate, blue chip/technology firms and research and development in third world countries, even without the benefit of up-to-date and defensible figures, it is unlikely that Russian SWFs pose a strategic risk.

Indeed, among their SWF peers, Russian SWFs are not viewed as geopolitically controversial or as aggressive investors. Our data show that Russian SWFs are seen as rather conservative and prefer to focus on hard assets in secure and stable locations, or in partnerships with neighboring states, focusing on building infrastructure and long-term development for co-operation in the future. This is particularly notable in Russian multi-generational plans for the future (discussed on the website for both the SWF and Ministry of Finance), where the investment plans heavily favour local SOE, education and furthering national production.

6.2.4 Should the Russian SWFs be subject to greater international regulation?

It is generally agreed that the Russian funds fall short on various transparency and accountability grounds, especially within Russia itself, but the fact that the funds do not seem to pose an international threat seems to diminish the sense that they need greater regulation.

A legal adviser to Russian SWFs did not feel an increase in binding regulation was required, and that greater reporting requirements did not add any value:

> "I don't think they should be treated any different to anyone else. They are only financial investors looking for investments. They would end up becoming too long and no one would read them." (I3C2 Advisers/Lawyers)

Some respondents had ambivalence towards regulation in general that influenced their view of specific regulation for Russian SWFs. A legal adviser noted how inefficient overregulation can be, especially when it is not thought through and implemented properly:

> "The regulation put in place in the 1990s and 2000s did not stop the financial crash but if you had a pot that had the money saved from regulations you may have been able to save the financial crisis. It's not autocratic regulation it's a democratic regulation and you end up getting something which is something that is imperfect." (I3C8 Advisers/Lawyers)

An investment adviser to the Russian SWF spoke of the difficulty of creating appropriate regulation:

> "There should be more intelligent regulators, people who go into organisations and ask certain questions, yet if you do that, your regulation is becoming political. It is a difficult balance to create and maintain" (I3C11 Advisers/Lawyers)

The challenge of creating standardised regulation was noted by a lawyer:

> "I think creating more transparency would be very challenging, because it's different countries and different investments; how would you standardise the relation across the world? I think it would be challenging but it wouldn't be

> the first time the government has asked for more transparency and the fund gets cold feet and doesn't want to proceed anymore. I wouldn't say if it should be or shouldn't be but it would be challenging." (I3C2 Advisers/Lawyers)

A lawyer/adviser who has worked with the Russia SWFs spoke about helping them with regulations:

> "As a firm we do that. We have drafted regulations for sovereign wealth funds and we have experience in helping them with their regulations. Our investment funds practice advises if they have to be in compliance with the AIF regulations. We have worked with Russian clients. The nature of what we do means there is a huge amount of regulation that they have to adhere to; which means they are already very highly regulated." (I3C3 Advisers/Lawyers)

Yet, the Santiago Principles are only international voluntary regulations for SWFs. A regulator reflected on whether they needed to become binding regulations:

> "There are only guidelines right now, because it isn't mandatory. Right now there are 30 funds that are compliant; it doesn't mean they are fully compliant but that they follow the majority of the guidelines. Some of the guidelines are a bit difficult but some of them are easy to follow. For example, one of them states that if you are not buying a company for financial reasons you must state your reasons and I don't think to my knowledge any fund has done that and admitted they are not buying for returns. Nobody will say that but they are taking small steps towards it." (I2C4 Regulators)

The two groups, lawyers/advisers and regulators/government officials, are agreed in their belief that SWFs should be subject to greater and clearer international regulations. Their views are supported by the academics we interviewed. Although the interviewees do not believe that Russian SWFs are predatory investors, they agree that they lack transparency. There ought to be more international regulation, which would allow for accurate, annual disclosure of the quantum of investment by sector and geographical location.

Information provision ought to be made in conjunction with an independent audit, perhaps set up as a part of a working group on SWFs, providing an opportunity for SWFs to submit information supplemental to the audit, adding their own numbers and commentary where they deem it necessary.

SWF managers support the lawyers/advisers opinion that greater mandatory regulation will be properly challenging, which is why an agreement on the main points for basic accountability could be a way forward. As previously stated, SWFs are keen to keep their sovereignty when it comes to certain detailed reporting, which no doubt would be on the agenda of any possible new regulation in the future.

6.2.5 SWFs in the context of AIFMD

What is the relationship of the Russian SWFs and AIFMD? Why are SWF managers exempt from the AIFMD? Is there a benefit for SWF managers in being exempt from AIFMD?

A legal adviser talked of the possibility of drafting an equivalent to AIFMD for SWFs, but noted that:

> "I think it would be difficult to compare alternative investment funds to sovereign wealth funds." (I3C7 Advisers/Lawyers)

A lawyer working with AIFMD summed up the issue:

> "AIFMD was designed to regulate the fund manager of a fund as opposed to the investors in the fund. SWFs are state owned and therefore you would be talking about creating regulation to regulate another state or an official working for another state. That is not viable and cannot be replicated in the AIFMD type of format." (I3C11 Advisers/Lawyers)

An academic noted this from the perspective of investor protection:

> "The AIFMD legislative framework is intended to protect third party investors and in particular private individual or "retail" investors from investing in products that are unsuitable for them. SWFs are not products in that they are not marketed to individuals or institutions to participate in, so there is no need for SWFs to be regulated in the same way as AIFs". (I4C4 Academics)

Another lawyer looked at it from a more geopolitical angle and stated that:

> "A SWF is rather the arm of a sovereign government used to invest its surplus assets. As a sovereign backed entity, they can effectively do what they want, subject to local laws that may regulate their constitution and activities (the Norwegian SWF, for example, makes investments that are subject to parliamentary oversight)." (I3C5 Advisers/Lawyers)

When it comes to regulating investments by such sovereign entities, a legal adviser suggested that it is most likely to be regulated by individual country regulations, rather than by international regulations:

> "Other rules may apply to SWFs in the country where the investment is being made. For example, most countries have some form of legislation that prevents other countries from buying up their core assets or participating in private enterprises in the defence industry; and each country may legislate differently for the taxation of entities that are controlled by sovereigns. Some countries may view a particular investing entity as taxable or subject to local withholding taxes while others may take the view that the same entity is a sovereign entity and therefore is not subject to local taxation based on the principles of sovereign immunity." (I3C5 Advisers/Lawyers)

The interviewees took a dim view of AIFMD being redrafted to bring SWFs into focus. The recurring argument seems to be the one of sovereignty. SWFs are very different bodies to other AIFs, even though they perform almost identical investment functions in the market.

SWF and PEF managers had opposing views: SWF managers categorically believed that AIFMD is not a type of document that would benefit the SWF community, and if a new regulation to mirror AIFMD were set out just for SWFs it would have to take into account a number of factors that make SWFs unique. Although they are the same type of investor, their cultural differences, geographical locations, and above all complex politics make their situation different to other AIFs. SWFs are likely to demand a more flexible regulatory approach than that which governs investment funds.

On the other hand our data show that PEF managers believe that AIFMD does not offer a "level playing field"; other members of the investment community have different or 'preferential' regulatory treatment; AIFs are not allowed to act according to a select set of self reporting rules (like the Santiago Principles); that is not beneficial for the investment community as a whole. In the context of AIFMD it is notable that opinions vary. This research shows that there is a demand for more binding regulation; it is deemed by some to be more acceptable and legitimate than voluntary agreements and sets of principles. The issues voiced by the participants from all four groups of this study demonstrate a clear desire for fair regulatory treatment of all AIF investors.

6.3 Conclusion

The NWF is characterised as a long-term focused SWF. This suggests it should be focused on investing surplus oil revenues in a diverse range of foreign investments that are non-correlated with the performance of the Russian oil sector. That said, it appears to be a hybrid entity that also acts to bolster struggling parts of the Russian economy via strategic investment into state owned enterprises. This is achieved, for example, via its relationship with Vnesheconombank, which may be characterised as a state investment fund that strategically supports Russian industry. For example, Vnesheconombank has invested into Russian banks, the Agency for Housing Mortgage Lending, and Gazprom. In this sense, the NWF exposes itself to enterprises that are correlated with the broader Russian oil sector.

This raises a tension in the meaning of 'political investment'. The long-term political mandate of the NWF is likely to be achieved by investing in an internationally diversified portfolio of comparatively low-risk bonds and shares, but this clashes with shorter-term political objectives to provide immediate support to politically powerful industries or companies.

It also reveals a tension in economic development theories. On the one hand, there is a more passive and defensive theory that suggests the key is to focus on competing on markets in industries that a nation has a comparative advantage in, and to then use the proceeds to hedge against a downturn in those industries by passively investing abroad. The more active path is to engage in direct strategic bolstering of national industries and infrastructure, spending surplus revenues on expanding economic capacity at home. The NWF appears torn between these missions, on the one hand passively investing abroad, whilst also dispensing money to Russian infrastructure projects and national industries. This latter activity inevitably runs the risk of being labelled as non-market and inefficient state-directed 'crony capitalism', and yet clearly has legitimate political appeal.

This ambiguity is reflected in the governance shortcomings of the fund. While it has clear deposit rules – stipulating how money enters the fund – the withdrawal rules are opaque and there is little transparency in how it dispenses funds. Thus there is flexibility built into the structure, which opens the fund up to potential political abuse, but also does not hamstring or constrain it.

It should be noted that the Santiago Principles – with their insistence on clear procedures and 'best practices' – can imply subtle ideological messages. The suggestion built into them is that a state-directed fund should act like a private market player. For many states though, this is an ideologically-controversial position. If a state is mandated to be an active shaper of a nation's economic fortunes then it is not obvious that surplus revenues should be invested passively in the manner of a pension fund. Furthermore, if a state is an executive body that needs flexibility to respond to changing circumstance, then pedantic adherence to clear rules, stated objectives and mission statements seems unnecessarily rigid, and even silly.

This cuts to ideological views on states. Are they trustworthy bodies mandated and motivated to serve the needs of a population they represent – a view that calls for flexibility and an active stance – or are they unreliable and quasi-parasitic bodies that should have strict curtailments placed on their power, strong procedures to 'protect them from themselves' and a narrow mandate to passively facilitate the active stance of private sector actors? The Santiago Principles – forged in the context of the historically pro-market IMF – tend to imply the latter. Thus, whether the Russian NWF respects such guidelines partly depends on whether they respect the ideological assumptions.

The Russian fund is controversial at home, but does not stir significant controversy in its overseas investments in the manner that the Chinese CIC does. It appears to keep a lower profile, and spends less time on public relations exercises than CIC. As a small indicator of this, CIC has a professional website to give a reassuring outward facing image, and produces annual reports. The NWF on the other hand has little publicity and gloss. It does not appear to want to impress.

We can, however, note an alliance of interests between civil society and opposition groups within Russia and external bodies that call for greater transparency. Internal political dissent and opposition is geared towards providing a check on the power of the state executive from within the country, in order to prevent oppression, social injustices and environmental degradation. This is likely to create calls on the NWF to be less subject to the political influence of the incumbent regime. The external pressure, on the other hand, is either geopolitical – seeking to curtail or contain or monitor Russian ambitions in general – or it is related to creating a stable global financial system, a task that requires all actors to participate in increasing transparency.

Allowing for the limitations imposed by political and cultural differences, we followed broadly the same procedures in relation to The China Investment Corporation (CIC), as set out in the next chapter.

Chapter 7: China Case Study

7.1 Introduction and background

The China Investment Corporation (CIC) was established in 2007 to help manage the Chinese government's foreign exchange reserves, and it has grown to be the world's third largest SWF, behind Norway's Government Pension Fund and the Abu Dhabi Investment Authority (SWF Institute 2016a). With a portfolio value of $746 billion, it ranks 5th in the league tables of the largest public funds in the world (SWF Institute 2016b), making it a formidable investor by global standards. Its assets are split between its three subsidiaries, CIC International, CIC Capital, and Central Huijin, and they have significantly expanded since its founding (Sovereign Wealth Center, 2015).

To understand the context and operation of CIC, it is important first to set it within the context of China's changing position in the global economy.

Under the leadership of Mao Zedong until the late 1970s, the economy of China was managed according to state communist principles. Key industries were nationalized, and international trade was regulated to support a centrally devised economic plan. In 1978, Deng Xiaoping and Li Xiannian introduced a series of market-oriented reforms designed to end China's economic stagnation (Zheng, 2013). This included opening up China's trade system, a move that initiated an expansion of China's role in the world economy.

In the pre-reform period, exports were permitted to the extent that they generated sufficient foreign exchange for imports, which were in turn intended to fill gaps in the country's productive capacity. Lin & Schramm (2003) argue that, as a result of these institutional features, there existed great inefficiencies in the Chinese foreign trade system. They highlighted three features in particular which were the major targets of subsequent market-oriented reforms: (i) monopoly, (ii) central planning and (iii) centralised accounting. Early changes in the trade system would, therefore, introduce competition in Chinese markets, allow more decentralised decision-making that would empower firms to make investment decisions and change the basis on which information relevant to economic decisions was disseminated and updated.

Between 1979 and 1985, Chinese firms established 185 non-trading affiliations with foreign companies, mostly in the form of joint ventures with firms based in the developing world (Cai, 1999). The majority of these affiliates operated in industries such as catering, engineering, finance, and consulting, and they allowed Chinese companies to gain a foothold in industries that were underdeveloped within China (de Bettignies, 1996). There was heavy government involvement in determining which ventures were permissible as part of the state's economic plan, with developments being mainly administered by the centrally-sanctioned Foreign Trade Corporations (FTC) and Foreign Business Oriented Corporations (FBOC). These investments often had a political imperative, as in the case of investment in strategically sensitive nations like Hong Kong and Macau (Zhang and Van den Bulcke, 1996).

From the mid-1980s, trading activity accelerated and diversified. Outward investment grew, and foreign affiliates were established in a much wider range of industries, such as minerals, petrochemicals, electronics, transportation, and tourism (Cai, 1999). There also emerged signs of a loosening of government regulation, as organisations outside the state-controlled group of FTC and FBOC began to establish foreign ties.

Lin & Schramm (2003) explain the changes that were made to China's foreign exchange system in order to support its growing interaction with the global economy. In the early reform years, the purchase and sale of foreign currencies were tightly regulated to uphold the value of the Renminbi and protect China's domestic financial system. In November 1993, the Third Plenum of the Fourteenth Party Congress adopted a new reform model for establishing a socialist market economy, which involved a comprehensive reform of the official exchange rate system. Foreign exchange controls on imports were loosened, and importers were given permission to purchase foreign exchange through designated foreign exchange banks upon presentation of import contracts and valid commercial documents.

In April 1994, further development occurred when the China Foreign Exchange Trading System in Shanghai became operational as an interbank foreign exchange market. This began the process of uniting the separate foreign exchange banks into a single, national foreign exchange market. In implementing this round of changes, the Chinese authorities relinquished a large part of the control over trade decisions which they had retained in the early phase of the reforms.

By the mid-1990s, the exchange rate was essentially operated under a pegged rate regime, with foreign exchange authorities maintaining a narrow floating band around a reference rate published by the People's Bank of China for interbank transactions. Without central bank intervention, the increased demand for Chinese goods and assets would have created pressure for the value of the Renminbi to increase, eventually making Chinese goods relatively more expensive and slowing down the expansion of China's exports. In order to support continued growth of these exports, the government maintained a policy of keeping this exchange value low, which required the PBoC to accumulate large quantities of foreign currency.

By the mid-2000s, the country's export-led growth strategy was driving the accumulation of one of the world's largest reserves of foreign currency, which would ultimately create pressures for more active investment so as to earn higher returns on this wealth. This established the conditions for the creation of China's Sovereign Wealth Fund.

7.1.1 Creation of the CIC

In achieving its own aims and to satisfy potential international doubts, the CIC faced an initial problem caused by the possibility that it would become merely the agent for the Chinese government and its political objectives. In 2006, China became the world's largest holder of foreign exchange reserves, which the State Administration of Foreign Exchange (SAFE) usually invested mostly in US Treasury and agency bonds, making China the largest holder of US treasuries (Sekine, 2009). UBS (2007) estimated that between 2003 and 2006 China's earnings on these reserves amounted to only 2-3 per cent, because of the low-yielding nature of US Treasury and agency bonds (Anderson, 2007).

CIC was established in September 2007 with the mandate to actively manage and diversify a portion of China's growing foreign exchange reserves. As the CIC states in its 2014 Annual Report:

> "The company was established as a vehicle to diversify China's foreign exchange holdings and seek maximum returns for its shareholder within acceptable risk tolerance."

The decision to establish a vehicle for more active investment of China's reserves was made at the National Finance Work Conference, Beijing, in January 2007, and led to the CIC establishment several months later (Cognato, 2008). Rather than CIC being created under the umbrella of SAFE, which directs the reserves held by the People's Bank of China, it was created as an entity accountable to the Ministry of Finance (MOF). To capitalise the fund, the MOF issued Yuan bonds to raise Y1.55 trillion, which were bought in different tranches by the People's Bank of China (PBoC) and by the public. The money raised by the MOF was used to buy $200 billion in foreign exchange reserves from the PBoC, which was transferred into the newly formed CIC as its registered share capital, with the condition that the CIC pay dividends to the MOF so it could service the bond repayments (Yu, 2009; Chung & Eichengreen).

The money raised was also used by the MOF to purchase Central Huijin – the holding company for the Chinese State's shareholdings in major Chinese banks – from SAFE and to transfer it to CIC. SAFE had obtained these holdings during a recapitalisation of the banks. It remains unclear actually how much of the $200 billion went to CIC in the form of cash and how much was as Central Huijin shares.

The CIC thus became the parent company to two separate entities:

i. CIC International: which is tasked with investing the original $200 billion (Hu, 2014; Chuen &Gregoriou).
ii. Central Huijin: which is tasked with holding major stakes in all major Chinese banks, including China Development Bank (47 per cent shareholding), Industrial and Commercial Bank of China (34 per cent shareholding), Agricultural Development Bank of China (40 per cent shareholding), and Bank of China (64 per cent shareholding) (Central Huijin Investment).

The resulting structure gives rise to various political dynamics and questions:

- The relationship between the MOF and SAFE/PBoC: Why was the CIC a creation of the MOF rather than a creation of SAFE?
- The relationship between CIC International and Central Huijin: What is the implication of their being under the same parent company? What is the relationship between CIC leadership and Central Huijin: Do they really control it, or are they just custodians?
- The relationship between the CIC and the MOF, and by implication, the Chinese state more generally: Is CIC International independent of MOF and state objectives, or beholden to them?
- The international reception of CIC International in light of geopolitical concerns over the Chinese state: do countries block investment from the CIC on political grounds?
- The relationship between CIC International and the large SOE sector that still dominates the Chinese economy, and which has its own outward foreign

investment objectives. ‘State-influenced’ investment can take the form of FDI by SOEs or foreign portfolio investment (FPI) by CIC. One possible hypothesis to explore is whether the CIC might be an attempt to create an entity that is beyond the normal politics of SOEs and the Chinese state.

- The relationship between Central Huijin and the SOEs. Liew & He (2012) note that “CIC’s foreign investments have attracted global attention, but its support for China’s SOEs through its banks might turn out to be more significant.”
- In 2015, CIC International hived off its ‘direct investment’ activities – which entail direct private equity transactions – into a separate entity called CIC Capital. This may – perhaps – be the most politicised entity, because private equity transactions involve taking control of companies, rather than having minority stakes in them

7.1.2 CIC and the power dynamic between MOF and SAFE

Historically, the stewardship of China’s growing foreign exchange reserves was entrusted to SAFE, but the 2007 establishment of the CIC saw the Ministry of Finance take a greater role in the management of reserves.

Indeed, Liew & He (2012) argue that the ‘CIC, as its stands today, is a derivative of the contest between the People’s Bank of China and Ministry of Finance for control over the nation’s financial assets’, and that the ‘contest takes place amidst China’s desire to avoid significant appreciation of its currency to protect its export markets and yuan value of its state-owned foreign financial assets.’

The money used to start CIC came from SAFE at the PBoC, but via special bonds issued by the MOF (Hu, 2014; Chuen &Gregoriou). Thus, the CIC does not manage foreign exchange reserves on behalf of the central bank. Rather, it is accountable to the MOF, which is essentially borrowing from the PBoC. One unique feature of this financing structure is that it places a substantial burden on the CIC – they need to pay an estimated $40 million per day to service the debt (Martin, 2008). This means they must seek sufficiently profitable investments to cover the bond servicing requirements. This setup might, perhaps, suggest that the CIC will be deterred from pursuing unprofitable politically-motivated investments.

Bell & Feng (2013) describe the politics of CIC’s founding. Although SAFE was technically subordinated to the PBC, it is directed by the State Council, which means it has prominence within the PBC. It was traditionally responsible for managing reserves, but when the reserves ballooned after 2006, the MOF argued for the creation of the CIC, something that the PBC tried to hinder. As Bell & Feng (2013) note, the 'MOF has long been vying for a way to secure some control over the foreign reserves'. The unusual financing of the CIC reflects this rivalry: the PBC vetoed the direct transfer of reserves to the CIC and forced the MOF to raise money via bonds to buy the reserves from the PBC.

The result is one of dual management of foreign reserves between SAFE and PBC, and CIC, under the influence of the MOF. Hua (2009) points out that there are 'demarcation problems existing between the corporation [CIC] and State Administration of Foreign Exchange', a reference to the fact that SAFE continues to engage in other forms of foreign reserve investment beyond that of CIC (see Sekine 2009 for description of SAFE's activities). They conclude that 'rationally defining investment scope between China Investment Corporation and State Administration of Foreign Exchange' would be a positive step.

7.1.3 CIC International and Central Huijin

As noted on its website, Central Huijin was obtained by the MOF from SAFE as part of the original deal that set up CIC:

> "In September 2007, the Ministry of Finance issued special treasury bonds and acquired all the shares of Central Huijin from the People's Bank of China. The acquired shares were injected into China Investment Corporation as part of its initial capital contribution. However, Central Huijin's principal shareholder rights are exercised by the State Council. The members of Central Huijin's Board of Directors and Board of Supervisors are appointed by and are accountable to the State Council."

Thus, while CIC technically finds itself in control of ownership stakes in all the major banks, it is questionable whether it plays any part in their control (at least by a traditional shareholder conception). In a 2014 TV interview, CIC president Gao Xiqing downplayed the relationship between CIC and Central Huijin, describing the relationship as one of a custodian holding assets that they do not directly control (Fuchs, 2014). In his opinion, the real job of CIC is to manage the investments of CIC International, whilst Central Huijin is a more hands-off affair.

There has been controversy about whether the structure works. Hua (2009) advocated 'peeling off Central Huijin Investment Company Limited' from CIC, and Li (2009) argued that "the dual role the China Investment Corporation plays as a quasi-administrative agency at home, and a quasi-commercial entity abroad is the crucial factor responsible for its opaqueness and multi-billion dollar loss in value", proposing that "the administrative function should be separated from commercial operations, and that a firewall should be erected between the Corporation and relevant administrations to depoliticize its investments."

In official CIC communications there is an acute awareness of the need to downplay the political connotations of state investment in banks. They explain the connection between CIC International and Central Huijin by noting that a "strict operational firewall exists between the overseas business run by CIC International and CIC Capital and the domestic business run by Central Huijin" (CIC). They also try to dampen the perception of Central Huijin as being an unambiguously political body, asserting that Central Huijin does not interfere "with the day-to-day operations of its investee institutions", but rather "exercises its shareholder rights and performs its obligations to the extent of its capital contribution, in order to preserve and enhance the value of state-owned financial assets".

Regardless of these attempts, the association of CIC with the inward-facing Central Huijin impacts the international reputation of the outward-facing CIC International. The tension has been noted by Pozen & Gu (2011) in a Harvard Business School case study, where they note that:

> "CIC was unusual in that it had a strictly commercial orientation and market-driven investment mandate to invest in foreign assets but also served as the parent company of a 100 per cent-owned subsidiary, Huijin, that invested solely in key state-owned financial institutions in China."

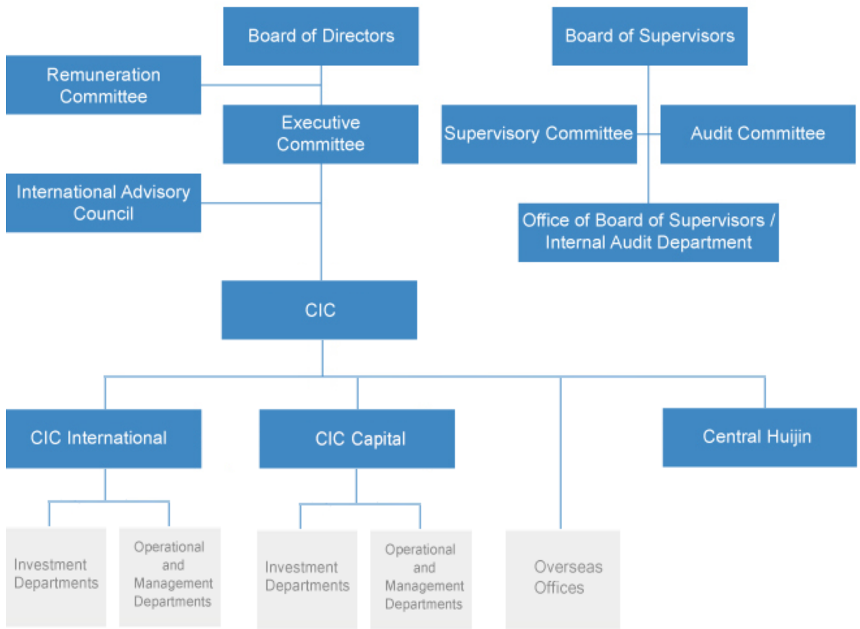
This means that, unlike a straightforward SWF, CIC gets drawn into any international scrutiny of Chinese banks. As noted by Pozen & Gu 2011 (and by Guo 2010), the nature of the relationship between CIC, Huijin, and the Industrial and Commercial Bank of China (ICBC) had to be carefully articulated in order to allow ICBC to "expand its business in the United States while exempting CIC and Huijin from certain types of Fed oversight".

7.1.4 CIC as an agent of the MOF and the Chinese state in international eyes

The fact that CIC is directly accountable to the MOF and the Chinese State Council, and also owns major stakes in major Chinese banks on behalf of the Chinese State Council makes it liable to being perceived internationally as a 'political' body likely to make 'politically motivated' investments. As noted above, the ambiguous nature of the relationship with Central Huijin has been one factor, but more generally there is the question of the extent to which the CIC is independent of MOF and Chinese state control. Sekine (2009) notes that since its inception the CIC has sought to make improvements in its governance. They have established four lines of authority:

- A Board of Directors.
- A Board of Supervisors.
- The Executive Committee.
- The State Council, which 'exercises shareholders' rights on behalf of the State' (CIC).

Figure 3: China Investment Corporation organisational structure



Source: http://www.china-inv.cn/wps/portal (accessed in March 10, 2016)

In addition to establishing this structure, the CIC has consistently sought to present itself as a 'non-political' body, characterising itself as a 'financial investor', by which it means an investor solely interested in the most profitable or prudent investments. The CIC's articles of association explicitly state that it has commercial objectives (CIC):

> "The Company shall operate in compliance with applicable laws and regulations, appropriately bear the cost of the funds received from the government, enhance its operating results and establish effective corporate governance. The Company shall separate its commercial activities from governmental functions, make its business decisions independently and operate based on commercial grounds."

This is something the CIC reiterates on its main website, stating (CIC):

> "As a financial investor, we are guided by the concept of CIC Portfolio and the principle of long-term investment and risk diversification. Driven by research and allocation, our investments are on a commercial basis, with the objective of seeking maximum returns for our shareholder within acceptable risk tolerance, rather than seeking control of the companies in our portfolio."

This communication has to be seen in the light of the historical experiences of the CIC as an international investor. Almost all research papers or analysis related to CIC includes some reference to political resistance to its operations. Although it is not openly articulated by CIC leadership, it is apparent that the biggest conflict has been related to the US. Some of the earliest research papers on CIC include the 2008 papers:

- 'Would China's Sovereign Wealth Fund Be a Menace to the USA?' (Wu & Seah, 2008)
- 'China Investment Corporation: Threat or Opportunity?' From the US-based National Bureau of Asian Research (Cognato, 2008)

2008 also saw the publication of the US Congressional Research Service report for the US Congress entitled 'China's Sovereign Wealth Fund' (Martin, 2008), the central theme of which was national security concerns relating to the fund. This theme is continued in the 2010 Congressional Research Service paper 'China's Sovereign Wealth Fund: Developments and Policy Implications' (Martin, 2010), which alludes to 'some commentators' being concerned about the political nature of the fund.

In a 2013 interview on CCTV, the then president of CIC Gao Xiqing noted that "At present we actually have some very difficult problems with some difficult countries". When asked if it is the US, he responds, "I wouldn't want to name the country, but you know it". He goes on to say that, "Very often these countries, especially the large and important – self-important –

countries, would treat us like the instrumentalities of the [Chinese] government" (Tian, 2013). He argues that this is simplistic and crude, noting that:

> "We've been dealing with [Western companies and governments] for the past 20-30 years, so why all of a sudden people come out and say 'oh we're very suspicious that you guys are trying to do something to sabotage our economy'. That's very self-serving, because during the financial crisis, and right after, many of these governments would come and say 'ok, we welcome your investment with open arms and… have absolutely no problem with the colour of the money…' but today they turn around and now they feel a bit more comfortable about their economy and they say; 'ok, we do care about the colour of the money.'"

The story is complicated by the fact that the CIC was established at around the same time as the 2007-2008 financial crisis began to escalate, and so was immediately presented with the opportunity to make various emergency investments in struggling US financial institutions. Between 2007 and 2008, the CIC thus adopted an opportunistic investment strategy focusing mainly on the US financial sector (Wu, Goh & Hajela, 2012), taking, for example, a $5 billion stake in Morgan Stanley (Clark, Dixon & Monk, 2013).

However, with the collapse of Lehman Brothers in September 2008, it became apparent that CIC had exposed itself to large financial losses, which with hindsight did indeed turn out to be loss-making. The fund has come under criticism for these rash decisions, and the management has characterised these 'early years' as ones where they were 'still learning'.

The CIC subsequently diversified into new investments: in energy, natural resources, and real estate, besides continued investment in the financial sector. On the one hand, this was for reasons of financial prudence: the fund's Chairman Lou, when accounting for CIC's diversification in its global portfolio, noted that "We have to be in everything because you never know what's going to happen in the world" (Wu, Goh & Hajela, 2012).

On the other hand, the CIC's push to diversify its holdings and reduce concentration in direct investments from 2009 onwards was probably also in response to the increasing concerns of Western governments about CIC's geopolitical positioning. If the characteristics of 'political' investment are large concentrated holdings in particular industries in particular countries, then the characteristics of 'apolitical' investment might be smaller holdings in a wide range of industries in different countries. To stay under the US government's radar, the CIC nowadays tries to emphasise that holdings are generally under 10 per cent, and that it does not seek to vote against the board or get board members.

It is interesting to explore the extent to which the suspicion around CIC may be due to cultural misunderstanding, ethnocentrism, and caricatures of Chinese authoritarianism in the eyes of Western businesses and policymakers, or whether it is an authentic concern. Gao Xiqing pointed to the concept of 'China Inc', the idea that there is a single monolithic entity called 'China' with single interests rather than a multifaceted body with multifaceted interests. It appears likely that the CIC is actually something in-between a 'commercial' and a 'political' entity, continually managing a conflict between its position as a potential instrument of the Chinese state and the fact that its commercial success is in the interests of the Chinese state too.

7.1.5 The investment portfolio

To pinpoint the political tensions of investment, it is worth considering the breakdown of CIC International's investment departments, portfolio, strategy, and changes to its strategy.

CIC International has four investment departments:

i. The Department of Asset Allocation and Strategic Research: Creating the broad overall strategy of the fund.
ii. The Department of Public Equity: Focusing on listed global equity investments.
iii. The Department of Fixed Income and Absolute Return: Focusing on bond markets and investments in hedge funds.
iv. The Department of Private Equity: Focusing on investment in private equity funds and also direct private equity investment, co-investment, and real estate investment.

Of the resulting portfolio, 67.7 per cent is managed by external fund managers, and 32.3 per cent is managed in-house. Their asset allocation, as of December 31, 2014, was:

- Public equity: 44.1 per cent (of which 45.6 per cent in the US, 33.5 per cent in other advanced economies, and 20.9 per cent in emerging markets).

- Long-term investment in direct investments, private equity, resources/commodities, real estate and infrastructure: 26.2 per cent.
- Fixed income investment in sovereign, corporate and agency bonds: 14.6 per cent (of which 57.4 per cent in sovereign bonds of advanced economies, 24.9 per cent in investment grade corporate bonds, and 17.7 per cent in emerging market sovereign bonds).
- Absolute return (hedge funds): 11.5 per cent.
- Cash: 3.6 per cent.

The fund has a relatively high allocation of investments in illiquid long-term asset classes like private equity, infrastructure, and real estate, suggesting it h"investment horizon and can take risks that more short- to medium- term investors cannot. As noted on p. 37 of its annual report:

> "CIC has a long-term investment horizon and low liquidity requirements, and is able to harvest favorable long-term returns by exploring inefficiency in the long-term assets market and capturing illiquid premiums of long-term assets."

'Illiquid premiums' refers to the undervaluing of companies that are not listed on a stock exchange, due to the fact that investors who require liquidity avoid them. From one perspective, investing privately in such companies is argued to be a prudent investment strategy for a very long-term investor, and is one followed by large US endowments, for example (Markwat, Molenaar, & Hoek, 2015). On the other hand, it could be in the area of large, direct private equity stakes and obtaining control of businesses, that direct political investments might be most likely to occur.

7.1.6 The direct investment vehicle: CIC Capital

In 2015, CIC International created a separate legal entity – CIC Capital – in order to take care of all direct investments. This might be thought of as CIC's internal private equity fund and its activities should be distinguished from CIC's externally managed private equity portfolio, in which the CIC delegates money to external fund managers to make private equity investments. Of all the CIC investment units, this is potentially the one with the most sensitivity. In particular, it has been stated that CIC Capital "will be responsible for making direct investments in markets outside of China in partnership with Chinese companies wishing to expand internationally" (Pfeuti, 2015).

For example, according to a press release on 10th December 2015, CIC Capital formed a consortium with the state-owned Chinese shipping company COSCO and the majority state-owned conglomerate China Merchants Holdings (International) to acquire a 65 per cent stake in Kumport, the third largest container port in Turkey, via a jointly established special purpose company (CIC, 2015).

The focus on co-investment with – or investment in – local Chinese companies for the purpose of overseas expansion seems to have a direct geopolitical edge, with an explicit intent to support Chinese businesses that wish to expand globally. This could either take the form of co-investment with Chinese companies seeking to acquire international subsidiaries or injecting capital into Chinese companies themselves. This directly links CIC to the more general history of outward direct investment by Chinese SOEs. This topic is further explored in the following section.

7.2 The CIC in the context of China's outward foreign direct investment

In 1999, the Chinese government initiated its 'Go Out' policy – also referred to as the 'Going Global' strategy – in an attempt to stimulate outward investment from the country. Prior to this, authorities had mainly focused on steering inward investment. Controls had mostly been lifted on inward investment but remained on capital and money market transactions and external borrowing. However, as part of its accession to the WTO in 2001, China made a series of commitments to substantially liberalise its trade and investment regimes (Branstetter & Lardy, 2006).

7.2.1 Drivers of China's ODI

Cai (1999) outlines the destinations of China's outward investment from the beginning of the reform era to the early 1990s. Between 1979 and 1993, Hong Kong and Macau were the largest recipients of direct investment, accounting for 61 per cent, followed by North America (15 per cent), Oceania (8 per cent), Asia Pacific excluding Hong Kong and Macau (5 per cent), Central and Eastern Europe (5 per cent) and Africa, Latin America, and Western Europe (2 per cent). Certainly, China's political relations with Hong Kong and Macau are linked to the early investment in those countries, but these places are also culturally similar, have similar business conditions and low trading costs, all of which are typically offered as explanations for China's investments there.

In terms of sectoral investment, investment in the services sector accounted for over 60 per cent of total outward investment and was mostly related to trading, reflecting the fact that Chinese ODI was principally used to support commodity exports. The natural resources sector accounted for approximately 25 per cent of total ODI up to 1994. The companies in which Chinese enterprises in this sector have invested are fewer in number but much larger in scale (Jiang & Zou, 1996). Manufacturing accounted for only 15 per cent of ODI and was focused on small-scale manufacture of low-value-added goods such as textile and clothing or simple electrical appliances. These early investment relationships reflected the comparatively early stage of China's development, which did not allow it to invest in technology-oriented projects or production processes adding high amounts of value.

Teasing out trends in outward investment have been complicated because one adverse consequence of the Chinese authorities' encouragement of inward investment is that it has created certain economic distortions that muddy the data. In a process referred to as 'round-tripping', local Chinese investors move money to an offshore jurisdiction – for example, to Hong Kong – and then bring it back into China disguised as inward foreign investment to take advantage of generous government incentives for ODI. This distorts the data for both outward and inward investment. Nevertheless, despite this complication, important recent trends can be identified from the available data:

i. There has been a considerable increase in Chinese ODI in advanced economies (Garcia-Herrero, 2015).
ii. ODI is also widely dispersed and administered in small amounts. The Ministry of Commerce statistics shows that, as of 2009, there were Chinese overseas investments in 177 countries, many less than 10 million USD (Salidjanova, 2011).
iii. More recent analyses of Chinese outward investment highlight the fact that China's outward investment activity has continued to expand, despite the global contraction in outward investment caused by the 2008 financial crisis. Salidjanova (2011) documents that in 2008, while global ODI fell by 15 per cent in the wake of the financial crisis, Chinese ODI flows more than doubled. In 2009, when global ODI fell by 43 per cent, government financial support facilitated a growth of 1 per cent in Chinese ODI.
iv. A relatively large proportion of China's investments appears to have been in offshore centres like the British Virgin Islands, although they were in fact

held in these jurisdictions to avoid certain tax obligations. The British Virgin Islands, Cayman Islands, and Hong Kong together accounted for 79 per cent of Chinese ODI.

v. According to the Ministry of Commerce, China's US-bound investment for the first nine months of 2010 grew by 530 per cent from a year earlier, which contrasted with 10.4 per cent during the same period for China's total ODI. Given the relatively risk- free status of the American Government securities, this probably comes as a response to various global sources of economic uncertainty, including the debt struggles of the Euro area and the weak performance of the emerging economies as a group.

vi. The percentage of outward investment flow into services has fallen since the 1990s but is still significant. In 2009, 30 per cent was accounted for by business services and 19 per cent by financial services, which suggests that ODI is still largely used to serve and promote the export of Chinese commodities. However, contrary to the focus of media accounts regarding China's investment patterns and their motivations, the flow of investment in natural resource extraction dropped to less than 16 per cent in 2009.

One recurrent claim is that, because of the state involvement, Chinese investments are more likely to be driven by non-commercial motives. In popular commentary, there is often an implicit consensus that emerging economies have a different approach to foreign investment than do developed nations. This is echoed by some experts who maintain that the traditional theories of foreign investment behavior cannot fully be applied to developing countries. The conventional expectation is that while companies from developed nations will seek out jurisdictions with highly developed legal and financial institutions when they expand overseas, emerging country companies often appear comfortable in jurisdictions with questionable political stability and weaker investment protection. A large empirical body of literature has been built up attempting to isolate the true determinants of Chinese outward investment.

The distinctive features of China's foreign investment are captured in the study of Buckley et al. (2007). The study investigates the determinants of Chinese FDI in order to build up a more diverse theory of the multinational company. The authors found that Chinese ODI is positively associated with cultural similarity and high levels of political risk in host countries, as well as host market size, geographic proximity, and resource endowments. The significance of political risk is consistent with the concerns of some Western authorities regarding the Chinese state's geopolitical objectives. The conclusion that cultural similarity and geographic proximity are statistically significant factors corresponds with the intuitive point that investment is more likely to occur in places that investors are 'used to', rather than places that are alien. The influence of more traditional 'economic' factors, such as market size, should not be overlooked. The drive to gain assets in large advanced markets abroad is consistent with the increasingly competitive forces that economic reforms have introduced into China's economy.

The identification of political risk as an attribute associated with direct investment from China represents a major departure from earlier empirical results from FDI, which focused principally on analysis of data from mature developed economies, and which suggested that FDI was attracted to countries with strong institutions (see, for example, Globerman & Shapiro, 2002). Results from Kolstad & Wiig (2012) suggest that the presence of natural resources has been a driver of Chinese investment, suggesting Chinese investments are motivated by the nation's need to acquire commodities. Among countries that provide natural resources, Chinese direct investment appears attracted to countries that have unstable institutional environments.

At first glance, this might be attributed to China being a latecomer to foreign investment, meaning it may only have underdeveloped and relatively undesirable 'leftovers' available to it. However, this observation holds even when controls on the level of exploitation of resources by the host country have been imposed. There are several theories attempting to account for this finding, for example, by arguing that investment in such countries is due to similarities in institutions between China and the host country. Habib & Zurawicki (2002) state that the greater the difference in corruption levels between the host countries and China, the less the tendency for bilateral trade between the two. In the light of this finding, Kolstad & Wiig's (2012) conclusions could be reformulated as indicating that Chinese companies will invest more in a resource-rich country if that country has a similar level of corruption to that which exists in China, although implicit in this is the assumption that Chinese domestic institutions are relatively corrupt.

Chinese companies have indeed been characterised as having a competitive advantage in dealing with difficult or less transparent regulatory environments. According to this view, Chinese companies can benefit from experience in dealing with networks of professional and institutional favours in relatively opaque business environments (Yeung & Liu, 2008) or working around burdensome regulations and political constraints (Morck, Yeung & Zhao, (2008).

Kang & Jiang (2012) offer a further study to explain institutional attributes of host countries that attract direct investment from Chinese enterprises. They have accomplished this using panel data on China's ODI in eight different countries in East Asia and Southeast Asia over a thirteen-year period, and they find that institutional factors are more important than economic factors in explaining the patterns of investment in this region. This includes normative institutions, which regulate social behavior and the perception of legitimacy, and cognitive institutions, which arise when a particular activity is repeated frequently by multiple parties and thus establishes certain accepted routines. Kang & Jiang's (2012) regression results find support for the following hypotheses:

i. The choice of a Chinese company's FDI location is negatively associated with the labour cost in the host economy.
ii. The choice of a Chinese company's FDI location is negatively associated with the degree of difference in political and legal regimes between China and the host economy.
iii. The choice of a Chinese company's FDI location is positively associated with the degree of difference in FDI restriction between China and the host economy.
iv. The choice of a Chinese company's FDI location is negatively associated with the cultural distance between China and the host economy.
v. The choice of a Chinese company's FDI location is positively associated with the depth and frequency of business transactions between companies of the host and home economies.

Taken together, the institutional hypotheses above suggest that whereas Chinese firms prefer political, legal, and cultural environments that are similar to those found domestically, they also prefer jurisdictions that have a more liberal attitude towards direct investment. This analysis, however, is restricted to a particular geographical region, and it could be argued that while institutional factors are more significant than economic factors when considering China's relationship with East Asia and Southeast Asia, further investigation is required before its finding can be extended to host countries in other regions.

However, to gain more insight into China's ODI patterns, we need to consider a split between the public sector – which ought to account for a large proportion of capital outflows due to controls on China's capital account – and the smaller amount administered by the private sector, which may be invested on the basis of completely different motives. This is the approach taken by Ramasamy, Leung, & Laforet (2012), who consider a range of economic and institutional explanatory variables, but who also consider the effect of the ownership of the enterprise, for example, whether or not there is government representation on the company's board. Their dataset contains the international location decisions made by publicly listed Chinese firms during the period 2006-2008 and finds that it is the location choice among state-controlled Chinese firms that is inconsistent with traditional theories on FDI, rather than those of the private sector.

Based on regressions that use the full dataset, the results indicate that: i) the ownership of natural resources, ii) the importance of the host country to China's exports, iii) its proximity to China, iv) its average level of income, v) the level of technology exports, and, vi) the size of Chinese population in the host country, are all significant explanatory factors. The number of patents registered in the host country – which is a proxy for the strength of institutions protecting intellectual property rights – is also significant, but actually seems to have a negative effect on investment.

The data were then divided according to each firm's ownership type in order to identify differences in the strategies of state owners compared with private owners. For private companies, the appetite for political risk is found to be less than that of state-owned firms, as state-controlled firms have a higher likelihood of investing in politically risky countries. In the case of SOE, it may be that their familiarity with the politicised business environment at home provides a competitive advantage over other global investors in politically risky countries. Alternatively, this finding might provide support for the thesis that investments in these regions are driven by motivations that are not financial and are influenced by the political interests of the Chinese government.

In conclusion, the literature demonstrates that Chinese ODI is driven by the level of, and interaction between, a number of key factors:

- Host country GDP.
- Host country institutions and political risk.
- Natural resource holdings.

- The ownership structure of the Chinese firm doing the investing.

In the light of these results, and considering Chinese foreign investment history, there are strong reasons for anticipating continued evolution of the composition of China's ODI as the government lifts restrictions on the economy's capital account. Private enterprises, for example, show a greater preference for investments in countries with more stable political environments and liberal attitudes towards international investment compared with enterprises with government involvement. It is, therefore, reasonable to expect that more developed economies will receive a higher proportion of China's ODI.

7.2.2 ODI in the EU

Clegg & Voss (2012) note that the emerging trend of Chinese investments in EU targets – which was apparent at the end of the 1990s – continued until the beginning of the 2008 financial crisis. The EU saw an increase in Chinese inward investment from 0.3 to 4.5 billion EUR between 2003 and 2009 so that the stock of Chinese investment in the EU grew at a faster rate than China's total global stock of ODI over this period. However, these commitments were unwound as the EU economy began to struggle, and the solvency of its governments was called into question. The investments were also heavily concentrated in a small number of EU Member States, with France, Germany, and the UK attracting a collective average of 36.8 per cent of annual Chinese investment in the EU between 2003 and 2009. The authors assert that the significant country-level variations in Chinese FDI are related to the size of the Member State economies, supporting the view that the EU internal market is still segmented to a significant extent. Clegg & Voss (2012) thus argue in favour of an integrated FDI policy created via an investment agreement with China at the EU level. Establishing a more homogenous framework for Chinese-EU FDI activity may establish the EU member state grouping as a more attractive overall target for Chinese FDI.

7.2.3 Geopolitics of ODI

Some commentators assert that Chinese ODI decisions form part of a plan to gain control of strategic industries in foreign countries, which can subsequently be used to exert geopolitical influence. Navarro (2008) has been vocal in warning against the strategic dangers of China's possible desire to influence critical US sectors, including telecommunications, energy, and defence. The focus on Chinese activity parallels widespread and increasing interest in the implications of China's emergence as a global power (Cognato, 2008).

In addition to security concerns, Nolan (2012) outlines various sources of apprehension among Western business leaders and governmental bodies regarding China's changing role in the world economy. These include:

- The export of jobs from Western economies to China.
- A negative impact on the real wages of Western workers resulting from the import of Chinese goods into Western domestic markets – cheap imports can render local industries uncompetitive, impacting jobs and wages.
- Increasing urbanisation and industrial activity in China resulting in the exacerbation of environmental problems.
- China's perceived non-compliance with the core ethical and political values of Western nations.
- The acquisition of Western companies and raw material reserves either by China's firms, or its SWFs or by the utilisation of its massive foreign exchange reserves.

Despite concerns about China's increasing involvement in Western economies, relatively few Chinese takeovers of Western companies have warranted significant attention. Those that have, including Lenovo's acquisition of IBM's personal computer division and Geely's takeover of Volvo, were of minimally profitable or even loss-making entities. Nolan (2012) argues that Chinese companies have become increasingly reluctant to attempt takeovers of US companies because previous attempts have been blocked on the grounds of national security.

Alarmist commentary in the Western media regarding the nature of and motivations for, China's outward investment often has weak empirical support. For example, the scale of this investment activity is exaggerated, with China still accounting only for a small proportion of global ODI.

7.3 CIC as an aid to SOEs

CIC is an investment fund with a strong link to government, and it would be naïve to assume that there is no government influence in its investments. It is also naïve, however, to assume that this process works in a straightforward or uniform way, or that it necessarily leads to commercially imprudent investments. In this context, it is helpful to split out three elements of CIC:

i. Its foreign portfolio investment – it appears likely that this is largely 'non-political'.
ii. Its direct investment activities via CIC Capital.
iii. Its broader role in supporting Chinese SOEs via CIC Capital and Central Huijin.

CIC has been specifically mandated with increasing the financial returns that China earns on its foreign exchange reserves, and its articles of association explicitly distance – or perhaps exempt – it from considering non-financial concerns of state. Furthermore, a significant proportion of its money is put into foreign portfolio investment – such as public equities – where only minority stakes are acquired in companies. CIC employs external managers to oversee over 65 per cent of its portfolio, who are not subject to the same structures of government influence that might dictate the behavior of managers of SOEs.

If the political lens is to be applied to CIC, it must be holistic, taking in CIC's position within the broader political landscape of China. SOEs other than CIC are better placed to further the nation's foreign policy objectives; the introduction of CIC funding might only serve to complicate policy execution (Friedberg, 2006). Unlike in CIC's case, China's SOE managers are appointed as state civil servants and answer directly to State-owned Assets Supervision and Administration Commission of the State Council (SASAC), which receives neither the widespread attention nor the mandates to which CIC is subject. Thus, insofar as China does seek geopolitical influence, it is more likely that it seeks it through the action of SOEs rather than through CIC (Martin, 2008).

There are two channels through which CIC exerts potential influence over the SOEs. First, through the aforementioned CIC Capital, which engages in strategic co-investment activities with them. Second, through the state-owned banking sector.

7.4 Interview results

It is against the backdrop of the secondary research discussed in the beginning of this chapter that primary research was conducted in the form of interviews with policymakers, fund managers, lawyers, consultants, and academics. The following three themes emerged:

7.4.1 The nature of China as a player in global markets

It is generally recognised that CIC takes an active and opportunistic stance in global markets, rather than just generically investing passively in low-risk endeavors. An academic spoke about Chinese SWFs as aggressive outward investors, prepared to take high risks for high returns:

> "The Chinese are completely different, again, they use something called SAFE (State Administrative Foreign Exchange) which manages them. They also have a flagship investment with CIC (Chinese Investment Corp) – both entities have been investing overseas very aggressively. They also have their own enterprises; if you look at the Chinese government website they have a list of 100 state owned enterprises." (I4C2 Academics)

A legal adviser speaking on Chinese SWFs reiterated this active stance:

> "These are all companies that abide by a policy called Go Out and they were urged to go abroad and buy companies. I used to represent a lot of Chinese clients going to buy companies in Latin America. They are more operational investors, they would invest in the companies and they would operate them as well. So it's very different to the traditional sovereign wealth fund." (I3C9 Advisers/Lawyers)

An adviser to the Chinese SWF discussed what the investment interests and priorities for the funds have been:

> "Chinese SWFs started investing in deals in the USA and bonds in Europe. Then real estate, toll roads or hospitals, which are also perceived as safe investments. Then usually into private equities, and in the stock exchange. Then at the end into hedge funds, that is usually the end of what they invest in." (I3C9 Advisers/Lawyers)

Nevertheless, the Chinese fund has faced resistance on political grounds. An employee from a legal department noted how geopolitics gets in the way of doing business.

> "There are several transactions in the States which have been declined because they are coming from China which makes it political." (I2C12 Regulators)

A Chinese official, however, talked about the need for foreign investment in countries like the UK, and how a mutually beneficial relationship exists between SWFs and the UK domestic economy:

> "Take the UK for example, there's very little in the UK that's owned by the UK. Most of the major companies and assets are owned by companies that aren't UK companies." (I2C10 Regulators)

The question of whether CIC is a 'political' investor was rebuffed by a legal adviser:

> "All sovereign wealth funds are only worried about returns. It is the capital preservation and the maximisation. They only worry about keeping their money safe and making more money. I think all the rest is secondary." (I3C6 Advisers/Lawyers)

All four groups interviewed suggested that China is as an opportunistic global investor. Whether or not this is a fair representation, China has been described as a 'vulture' looking for deals in the right places at any cost. Academics agree that China might be a geopolitical investor, as opposed to one driven purely by profit, although there is not yet research-based evidence to prove this.

During one of our interviews, a Chinese SWF official tellingly quoted Chairman Lou of CIC: *"We have to be in everything, because you never know what is going to happen in the world."*

That statement sums up sentiment about China, but does little to put the minds of interviewees participating in our research at rest about their strategic rationale. Our data suggests that regulators and government officials are suspicious of the reasons behind global investments by the Chinese SWF. However, when the group was questioned on the reasons for such thinking, it turned out that a good proportion of them were shaped by the negative public image that developed in the aftermath of the 2008 financial crisis. Academic interviewees confirmed that based on the sheer size of the Chinese SWF and its investments, CIC is a force to be reckoned with. It is similarly recognised in the global financial markets, as a sizable investor and a driving force for significant investments in the future.

Advisers and lawyers touched on the topic of China becoming a driver of innovation, and education with a willingness to support development in foreign states that, because of a lack of democratic values, are unable to access Western investment. This point can be interpreted in two ways. It might mean that China fosters disrespect for democracy and accountability by investing in states that have a poor track record on these issues. However, it could also be interpreted that such investments enabled China to lend a supporting hand to independent states, regardless of their internal politics, in the name of profit. Taken together the implication is that China is not a geopolitically strategic investor but rather a profit driven one, albeit not always in an ethical manner.

7.4.2 Should the CIC be subject to greater regulation?

While it is generally acknowledged that CIC is an active outward investor subject to political concerns, views were mixed as to whether it should come under more international regulatory oversight. A legal adviser representing the Chinese SWF spoke about the benefits of relaxed regulation, suggesting that the Santiago Principles are enough and that no extra regulation is needed:

> "There is an argument that the sovereign wealth fund coming in is a good thing, since they do not have enough people to take over operations. They are almost like a passive investor. They are less likely to harm your economy than other multi-national industries around the world." (I3C3 Advisers/Lawyers)

A partner in a law firm specialising in SWF transactions talked about the fact that there is a cap on what percentage of a certain asset can be owned by a foreign corporation before having to report it, and that the funds play with that:

> "It depends what the regulation is for. Is it just to stop people spending too much money because China has a lot of money? Socially responsible is interesting because they (SWFs) won't be if they don't have to be. If you're a passive investor, it depends what you are investing in also. The Chinese have bought a stake in a FTSE 100 company which is just below the reporting requirements." (I3C10 Advisers/Lawyers)

An academic noted that SWFs are not unique in being opaque and that it is up to individual countries to set up their own standards about inward and outward investment. He suggested that there will always be countries that are willing to accept money from states with very poor transparency records and that we cannot really do much about this:

> "Social responsibility tends to be dependent on country, it depends which country you are in and how do you impose international regulations. When you take countries like Uganda and the Congo; they are in need of investment, so they would accept investment regardless of transparency issues." (I4C4 Academics)

The data gathered and analysed for this research suggests that most interviewees did not oppose regulation as a concept. However, in the eyes of most interviewees, more regulation seemed an implausible solution to the issues SWFs face in the eyes of the public, the most prominent being transparency, and accountability. Most participants stand by the concept of less regulation, but would prefer a more tailored and concrete set of standards and regulations for SWFs. With the reference to CIC, academics highlighted particularly that SWFs have already made great strides, both publicly on their web pages and through opening up discussions with the media via their PR teams, in discussing their current investments and some future projects, as well as the benefits they can bring to a community.

While regulator/government officials interviewees questioned this type of 'selective' transparency, they raised the valid question that even though, on the surface attempts are made to appear responsible, engaging and to an extent transparent, at least online and in the media campaigns, much is done in response to reputation management issues and the need for public rebranding. For example, CIC wants to stand tall among international investors of its calibre as it becomes more and more powerful and sophisticated as an international investor. From data analysed we note that the lawyers/advisers believe that this newfound focus on image should and will come at the cost of willingness to accept stricter regulation and audit.

7.4.3 Are the Santiago Principles effective?

A partner in a consulting firm who works with SWF clients, and deals with regulations relating to them, replied to the question of how China has implemented the Santiago Principles as follows:

> "If you look at the Santiago Principles they were a reaction to a perceived threat. Some funds have taken them on board completely, and some haven't as much. China follows them wholly, but Qatar picks and choose which principles suit them." (I3C7 Advisers/Lawyers)

A Chinese adviser added more on the Santiago Principles and the purpose behind them:

> "In 2008, they (the Working Group) created these principles, but mainly they were created to enhance their public image which it has. The financial crisis also helped because people needed equality and no one really cared about the politics behind it anymore." (I3C10 Advisers/Lawyers)

Currently, the Santiago Principles are the only universal set of regulations, albeit non-binding, affecting SWFs. A regulator spoke about the reliability of transparency – measuring methods overall, saying that the Linaburg-Maduell and Truman tables that measure accountability are not very reliable:

> "They have come a long way already; there are a few – Linaburg-Maduell and Truman – that tell you how they perceive their funds. But none of them are reliable." (I2C1 Regulators)

An academic backed this up by noting that the reliability of the measuring methods is compromised by the fact that it is based on self-reporting that cannot be monitored and checked:

> "I think it's getting closer, but I think it's very difficult to assess their transparency." (I4C2 Academics)

A regulator noted that no fund reports in a perfect manner:

> "It's very subjective, the opinion of transparency we have, but none of them are perfect, they all have flaws." (I2C7 Regulators)

Revisiting the background and the objectives of our research, we found that the analysis of our results also revealed that our interview subjects are content to adhere to the Santiago Principles and are supportive of them in their existence as a reference point, and in some cases are signatory members of the principles themselves. However, they do not seem to believe that the Santiago Principles are a serious measure to encourage transparency, accountability and overall cooperation.

Amongst the lawyer/adviser group the results of interviews showed that the Santiago Principles are a positive PR box-check for a number of funds. Academics frequently highlighted that there is no realistic opportunity for thorough checking of the standards that are claimed to be met by the SWFs in order to develop an accurate understanding of the situation.

We feel that this research has been of sufficient scope to allow us to draw a reliable conclusion in relation to the views of the AIF community members with knowledge of how SWFs work with respect to voluntary regulation - in particular the Santiago Principles. They do not view voluntary regulation as an effective solution for bringing together and monitoring the SWF community. Nor do they believe the principles to be a means of creating universal and purposeful momentum towards a transparent and responsible SWF community.

However, the Santiago Principles are effective as a members' club, which work favourably as a tool to encourage the media to represent their members in a positive light.

Finally, we learned that there is a great opportunity for the Santiago Principles to be used as a foundation upon which substantial regulation, which is clear, far-reaching and effective, could be drafted.

7.5 Conclusion

The CIC illustrates the complexities of both how the internal political dynamics of a country get transposed into a SWF, and how the external foreign relations of a country impact it. In principle, the necessity for CIC emerged as a response to China's growing foreign exchange reserves, reflecting China's growing economic power in the world. On the other hand, the decision to create it as a unit under the control of the Ministry of Finance rather than the People's Bank of China reflects internal tensions. The situation is further complicated by the addition of Central Huijin under the banner of CIC. Like the Russian NWF, then, the CIC appears to be an entity operating with multiple – even conflicting – logics.

All of this must then be situated in the context of the geopolitical relations between the US and China. The fixation upon the foreign political aspirations of the fund perhaps reflects the shift from a Cold War fixation upon Russia to a new focus on the growing power of China. Even in apparently official and professional reports and analysis on CIC, one can detect tinges of 'moral panic' reminiscent of 'Yellow Peril' hysteria. Chinese CIC officials have been dismissive – and even exasperated – towards these concerns, pointing out the fickle nature of US policy towards the CIC. During the financial crisis it was viewed as a potential source of valuable capital in stabilising failing US banks, but as the crisis subsided the suspicion towards CIC was renewed.

CIC officials appear at least partly justified in suggesting that fears about their activities are unfounded. Much of their investment takes the form of passive portfolio investment characterised by minority stakes in many companies, just like any other traditional large institutional investor. That said, the fund has attempted to make aggressive large direct investments in potentially strategic industries in the past. The creation of CIC Capital (not to be confused with CIC Capital Ltd) as a separate subsidiary for specialist direct investment is an acknowledgement that the fund has at least two separate faces. One face is a passive, diversified investor, while the other is an active private equity style investor. The third face of CIC – arguably – is Central Huijin, which appears to be an entirely separate entity shoehorned into the overall structure.

CIC Capital is an interesting focal point for further research. It is not only the potential focus of the most politicised direct investments – thus making it a potential source of suspicion to nation states – but out of that geopolitical context it is also the type of entity that would stand to gain advantages in the context of generic AIMFD regulation applied to private equity funds and hedge funds. This begs the question of what the deep purpose of CIC Capital is. Does it exist to back Chinese enterprises in their overseas ventures, or does it perceive itself as a normal private equity investor backing a range of ventures irrespective of their affiliation to Chinese national interests?

This highlights a core difficulty in any future attempts to create SWF regulation. Unlike normal funds – which are assumed to be motivated by straightforward objectives like profit maximisation relative to risk minimisation – any analysis of SWFs and their subsidiary entities needs to treat them as being subject to a spectrum of motivational dynamics. A SWF has to be seen as a potential blend of geopolitical aspirations and pure financial profit-maximising aspirations. Assuming that they will behave strictly according to one motivation or the other is bound to lead to poorly fitting or irrelevant regulation. Complaints by private equity fund managers about being disadvantaged relative to the direct investment arms of SWFs is – in part – predicated on an underlying assumption that SWF direct investment is motivated by the same dynamics that drive normal private equity investment.

The CIC has different dynamics to the Russian NWF in that China appears less subject to fluctuations in single commodity prices. The objective of CIC is to boost earnings on foreign reserves that would otherwise lie dormant in US government bonds. This may contribute to a more active stance. Whereas the Russian NWF appears conservative, with a ‘macroeconomic hedging’ mentality, the CIC appears more opportunistic, risk-taking and potentially more prone to speculation. Their reputation for a more active stance is one reason why they encounter more political resistance, but there is also always a risk of this stance being overstated. Arguably, the same activities undertaken by a nation perceived to be more 'respectable' or less alien in Western eyes – like Norway – may be subject to much less scrutiny.

It is apparent that Chinese officials are aware of these dynamics, and seem keen to maintain face and appear respectable. They produce publicly available annual reports, have public relations outreach, have a public-facing website, and their directors appear in video interviews on mainstream financial television. This is in contrast to the behavior of Russian fund officials, who seem less concerned about projecting an image of their activities to the Western public or US and European officials. This difference may also be reflected in attempts to adhere to official standards like the Santiago Principles. CIC officials appear to be more 'forward-looking', displaying at least superficial transparency and making investments in progressive industries like renewable energy. This behavior can be read in two broad ways.

The results of this China case study, together with those of the Russian Case Study, and also the more general evidence that has emerged, lead to a series of conclusions that are set out and discussed in the following, and final, chapter of this thesis.

Chapter 8: Discussion and Conclusion

The objective of this thesis has been to investigate the regulatory environment that surrounds SWFs, and whether it is both appropriate and proportionate. A key dimension of this is the question of whether SWFs' exemption from the AIFMD gives them an unfair competitive advantage in their activities, and particularly in the direct investment activities that bear resemblance to the activities of private equity fund managers. These regulatory debates must be seen within the broader geopolitical context, with national security concerns about the objectives of funds like the CIC mixing with questions about how such funds impact global financial stability.

In short, the evolution of the activities of SWFs in recent decades, and thrown into relief by the 2008 financial crisis, has brought to the fore the issue of their regulation. Whether it should be mandatory or voluntary, in whole or in part, has yet to be agreed upon by the industry and the role SWFs played by investing at that time. We conducted forty-three in-depth interviews of those involved with regulation, those involved with SWF's, their legislation and research. Our groups were divided as follows; SWF and PEF managers (twelve interviewees), government officials/regulators (twelve interviewees), advisers/lawyers (eleven interviewees), and academics (seven interviewees). The comprehensive review that resulted is set out in chapters five, six and seven of this thesis. At the beginning of each interview we set out to understand what issues SWFs face in relation to regulation, and how these issues might be approached in the future. The interview process was directed towards assessing and evaluating the following suggestions, about which there has been continued debate:

i. that SWFs are under-regulated and that there would be significant scope for further regulation, with various alternatives to current requirements
ii. the proposal that the best outcome would be to achieve a balanced regulatory model, treating SWF investors equally and fairly
iii. part of the solution would be to find options which would take into account the 'special' background and particulars of sovereign money

The empirical nature of the interviews, the materials gathered and the research undertaken, were of great benefit in helping us to form fair and objective views. SWFs are investors with certain differences, but some similar characteristics, to other AIFs. They share the same aims and investment approaches; also they are run by experienced professionals, and their ultimate objective is to achieve profit and stability in their investments.

The purpose of the forty-three interviews was, amongst other things, to assess whether the behavior of SWFs should give rise to concern, and if so, whether this would suggest the need for further regulation, mandatory, or voluntary.

SWFs are not a unified group. They have varying structures, investment strategies, and end objectives. What, however, does unify them is the fact that they have the backing of a particular nation state, which in turn gives them a potentially politicised nature that other investment funds are not considered to have. They are thus categorised differently to other fund management groups that may engage in similar investment strategies.

Part of the regulatory complexity emerges from the fact that a large SWF is a diversified long-term investor with a wide asset allocation requiring many forms of more specialist investment management expertise. Many of these specialist areas are 'non-threatening', such as building a diversified portfolio of emerging market corporate bonds. Likewise, their more passive and indirect portfolio investment in generic blue-chip company shares is not likely to be seen as a threat, provided they maintain minority stakes.

Yet political scrutiny of SWF activity becomes acute when more concentrated or large-scale holdings are acquired. The most politically controversial element of SWF activity involves a fund accumulating significant stakes in a public company – a stake that would allow it a significant shareholder voice in the direction of the company – or when they undertake large direct investments in public or private companies seen to be strategically important. This may include, for example, a large privately placed loan, or a private equity buyout of a company in which management control is completely ceded to the SWF.

Many large SWFs do set aside a section of their asset allocation to 'alternatives', including PE, HF, infrastructure, property and commodity investments. The regulatory complexity is accentuated by the fact that a SWF can either mandate external fund managers to run these parts of its portfolio, or it can undertake that management 'in-house' with an internal team. If the regulatory treatment of an external manager differs from that of an internal team, anomalies may arise. For example, should the US government view a US-based private equity fund manager mandated by the CIC as an extension of the CIC, subject to greater oversight than a normal PE fund? Our research has shown, that there is support, in particular from regulators and academics, for greater transparency, stemming from the fact that more regulated mandatory disclosure of investment interests and the investment process itself would allow for greater information sharing between the investing SWFs and recipient governments and their regulators. This would allow them to ask the questions necessary to avoid opaque, geopolitical investment. Alternatively, should the EU be content with tolerating lower transparency from a buyout deal orchestrated by the CIC's internal direct investments group, simply because SWFs are not currently covered by the AIMFD? We noticed that an increasingly popular view amongst our interviewees was that low transparency levels are not good for business. Information should be available, but a line ought to be drawn defining what is available for the public knowledge, and what is only for the record of participants involved in the deal, including regulators. This was supported by the idea that companies receiving investment, are increasingly becoming more conscious of appearances, and thus more socially responsible when it comes to partnering up with investors.

The view of SWFs as potentially threatening or aggressive investors contrasts with the view of SWFs as a source of stable, long-term and reliable investment capital. The 2008 financial crisis saw SWFs being courted for emergency capital, which shorter-term, and often more risk-averse investors did not want to risk. A long-term investor is more able to ignore the shorter-term volatility of markets. Having SWFs present in the global investment ecosystem, therefore, could be a force for financial stability.

Furthermore, even in the case where a SWF obtains a significant stake in a company, the corporate governance impact of having a majority shareholder with a long-term outlook may be positive. In recent years, there has been criticism of the short-termism of corporate managers who engage in a 'quarterly capitalism', focusing on boosting short-term performance in order to deliver positive quarterly earnings reports for investors, thereby to boost share prices. This short-termism may deliver short bursts of good company performance and associated share prices, but is unlikely to provide a solid basis upon which company management can build businesses that are sustainable, resilient and future-looking (Ownership Commission, 2012). Long-term capital from SWFs may thus not only be a force for stability for the markets, but also a force for fostering the long-term growth potential of companies that otherwise might be encouraged to artificially inflate their share prices. Overall, we believe that SWFs are solid, long-term investors, and that SWFs are keen to be welcomed and seen as trustworthy international business partners. They are particularly valuable partners when it comes to availability of capital for projects at times of crisis, especially where urgent funding is required. When other funds are nervous of investmenting, SWFs remained stable investors, and in the times of crisis did not sell out, but were in a position to wait for the market to correct itself. This of course highlights the belief that SWFs did not contribute to the 2008 financial crisis and were in fact a balancing tool at the time of economic need for many western corporations.

8.1 The political imperatives of SWFs

SWF investment is often said to be 'politically motivated'. It is difficult to unpack this phrase, because by its nature a government is a 'political' structure, and therefore in that sense a government-backed fund is inevitably political. The real question seems to be whether or not the funds use mainstream forms of investment analysis – such as modern portfolio theory or monetary risk-return calculations – in order to make investment decisions, or whether their final decisions on where to invest are informed by the desire to create political power through the process of investing.

The 'politics' in this scenario could come into play at various points. First, the decision to back a particular company is a vote in favour of that company, and a decision to support its management. This gives rise to the possibility that SWFs may back a company because the company management has political ties to the government. There is significant evidence of this in the case of the Russian NWF, which has clearly supported SOEs with connections to the government.

Second, politicised investment might take the form of decisions to invest in one country rather than another, as a way of rewarding a client state with patronage, or alternatively as a way of ignoring a state that is out of favour with a particular government. This type of activity has long been a feature of, for example, US foreign aid financing to friendly client states, but it could also be carried via a SWF.

Third, politicised investment could take the form of investment aimed at 'taking control' of strategic assets in a country with which the fund's government has frosty or ambiguous relationships, as a way to assert power within that country. This is how the CIC's attempts to obtain assets in America may be perceived; likewise with the Russian NWS's acquisition of Ukrainian sovereign bonds.

Nevertheless, in certain cases, the 'politics' may be less in the investment process itself – which may be characterised by arms-length 'rational' investment – and more in the use of the returns. The case of the Russian funds was ambiguous as to how the state could draw upon the funds: for example, money ostensibly earmarked for the national pension system could be drawn upon to cover short-term budget deficits. We found that in general, SWFs do not invest for geopolitical reasons. A good number of our interviewees agreed that there was not enough evidence in their experience to accuse Russian or Chinese funds of strategic investments based on political needs. It was rather an image created by the media to paint a mysterious foreign investor in the form of a sovereign state, working its way to overtake businesses and infrastructure in the West. Overall, our research has shown that SWFs are seen as reliable business partners.

When considering these 'political' uses of SWFs, it is worth noting that the negative views of SWFs from some commentators are, at least in part, linked to questionable popular narratives about foreign countries. There are no comprehensive studies to this effect, but it is not implausible that the Western fear of the Chinese CIC can at least in part be attributed to the hangover of anti-Chinese 'Yellow Peril' ethnocentrism. Likewise, scepticism towards the Russian funds bears the hallmark of Cold War fear of the Soviet Union.

The other side of the coin might be manifest in the general lack of concern about Norway's SWF. It is seen as a fund from a 'normal' and 'advanced' nation that can be trusted, and therefore need not be subject to particular scrutiny.

This is not to say that there are no reasons for commentators to be concerned, and indeed, the funds looked at in this thesis's case studies do show real weaknesses of governance. Rather, the point is that Western commentators are hyper-sensitive to recognising these weaknesses in funds from 'alien' places – like China – whilst not checking for them to the same extent when the SWF is from other, more familiar, places like Norway.

International regulation seems ill-equipped to deal with political concerns. First, it is difficult to prove that an investment is 'politicised', and second, if it were, why that might be wrong. The principle of state sovereignty still reigns supreme in global geopolitics, and while individual states might decide to block investment from the SWF of a particular state – as in the case of the US scrutinising investments from the Chinese CIC – it would be difficult for generalised and internationally-binding regulation to be placed on such activities.

It is something that those nation states have to deal with themselves, as is the problem of how the parent nations of SWFs use the income the SWFs generate, which can not properly be within the remit of international regulators.

8.2 The opaque politics of SWFs

One inescapable conclusion of this thesis is that, at heart, the political objectives of some SWFs are ambiguous. Media and political commentators often wish to project a single story about SWFs, as if they are characterised primarily by commonalities rather than differences. However, it is crucial to note that the actual effect of a fund in any one country cannot be generalised. Rather, we need to consider the specific history and dynamics under which it was set up, and also the dynamics of the fund relative to other – potentially competing – political forces within its home country.

The CIC, for example, emerged from competition between the People's Bank of China and the MOF. It is important to realise that there is no single 'political will' in a country that expresses itself through a unified set of state institutions. Rather, there may be multiple, conflicting, political wills jostling for power through different state institutions. This complicates any attempt to cast SWFs as straightforward instruments of a coherent state with a coherent political objective. Rather SWFs might be set up to achieve the objectives of particular factions within a state, and find themselves as sites of power struggles between different groups. Certainly in the case of the Russian NWF there appear to be different interest groups that seek access to funding and influence.

In this context, we must be aware of the potential for such funds to end up being a force for reconciling the interests of different political factions, or standing apart from them entirely. In respect of the latter, one prospect that is not popularly entertained in much literature or media is the potential for SWF managers to develop idiosyncratic or 'rogue' tendencies in the context of blurred lines of power in a state. Much mainstream debate simply assumes that the state either influences or directs the SWF, or that the SWF is sufficiently independent to follow international norms of 'proper investment'. An alternative possibility is for a SWF to follow neither the objectives of a nation state nor 'international norms', but rather to be driven by idiosyncratic internal dynamics such as charismatic managers, or governance structures that allow managers to pursue their own interests.

Unfortunately, one weakness in the SWF literature is a lack of robust ethnographic studies of their internal dynamics. This is probably due in large part to a lack of access by ethnographers to SWFs, or – if they do get access – their inability to publish without the consent of the fund directors. What 'colour' we get about the internal dynamics of SWFs tends to come from interviews, journalistic reports, anecdotal accounts, and personal experiences reported on public sites. In-depth ethnographies would address the weaknesses of statistical studies of SWFs, which suffer from the fact that the sample size is small. SWFs are not numerous or widespread entities, and cannot easily be generalised or modelled. They have some common characteristics, but they – like governments – have idiosyncrasies and historical backgrounds that are not really comparable.

This complicates any attempt to generalise about problems in the funds, and furthermore, to generalise about the regulation of any such issues. For example, the idea of what constitutes 'corruption' is not perceived uniformly in different nations, and neither is it subject to a 'one-size-fits-all' solution to combat it. A set of best practices forged in one national or regional context does not necessarily translate into another. Furthermore, when pushed into a different context, such measures can seem shallow or formulaic.

In the Russian political context, the mere act of telling the Russian funds to be more transparent might be naïve, insufficient, or even disingenuous. Russian politicians are no less 'conscious' than Western European ones, and they are not somehow unable to understand the problem. It is just that they find themselves in a different and complex historical and institutional setting, and cannot just reverse the existing set-up, or pretend that constraints are not there. The case of China is similar: the CIC directors do understand Western concerns about the fund, but their thinking is colored by the fact that they believe that Western opinion is based on a poor understanding of the Chinese culture. In short, we concluded that the statement on just how opaque politics of SWFs are depended entirely on the current political climate amongst the states in question. For example, the topic of western sanctions against Russia, led to a discussion on just how careful and sensitive companies have to be when accepting SWF investments due to the impact of such deals and agreements upon their reputation in the media, a driver of perception of their transparency and accountability by the public.

8.3 SWFs within the geopolitics of natural resources, trade, and currency

When considering the politics of SWFs, it is important to place them within the context of natural resource geopolitics. The Middle Eastern funds exist to manage their states' large accumulation of US dollars from the sale of oil and gas. Likewise, the Russian funds exist to manage the Russian state's vulnerability to a downturn in oil and gas prices, or volatility in those prices.

One of the governance concerns around such SWFs stems from the potential link between oil revenues and poor state governance: the so-called 'resource curse'. If large endowments of natural resources do indeed have a material link to poor governance at a state level, then government funds set up to manage the financial surpluses derived from those resources might replicate that poor governance within the funds themselves. The contrasting view might be that SWFs may actually serve as a buffer between a government and its natural resource-derived financial surpluses. By 'locking away' the funds and mandating them to a quasi-independent body with a long-term horizon, any incoming government within a resource-rich state may find it more difficult to raid or abuse those funds.

SWFs also need to be seen in the context of global currency dynamics. The Chinese CIC, for example, was set up in part to diversify the Chinese state's exposure to US dollar denominated securities, amassed as a result of the current account surplus it has run relative to the US since the opening of Chinese trade to the world. As such, it finds itself as one player in the management of broader tensions around Chinese international trade with the US.

This, in turn, needs to be set within the context of broader shifts in global economic power. The paramount position of the United States and Europe is under threat and the gatekeeper institutions of the economic status quo – like the IMF, World Bank, Bank for International Settlements (BIS), and OECD – are not as influential as they used to be. Whether China feels pressure to conform in order to be 'let into' the club of advanced industrial nations is debatable. The Chinese CIC, for example, makes a show of being diplomatic and respectful towards the concerns of the USA, but behind closed doors, the story might be different. This was precisely the tension highlighted during the 2008 financial crisis, when the CIC was called upon to help bail out failing US financial institutions, after which the US political mood towards Chinese investment hardened again.

8.4 SWFs as a possible cause of systemic risk

SWFs must also be included in the agenda for addressing the paramount need for global financial stability. This is related to, but nevertheless conceptually different from, the more overtly 'political' concerns expressed about SWFs. The CIC's takeover of a strategically important US port would be an issue that concerns the US Department of State, but it is not necessarily something that the IMF will seek to resolve, because it poses little systemic financial risk at a global level. The potential for SWFs to create systemic risk stems rather from the sheer amount of money they manage, and their potential to become opaquely entangled with other financial institutions.

In our interviews we discovered that overall there is currently little evidence that SWFs have a negative impact on financial stability. Indeed, the consensus seems to point in the other direction. Highly-leveraged and interconnected banks with misaligned incentives and a tangled web of shadow-banking operations seem to pose more serious problems than do large SWFs. And even if the funds are opaque, their investment behavior appears to be relatively predictable and reasonably conservative. Further, we note that, even if a fund invests imprudently and suffers large losses, it appears relatively 'contained', not connected via masses of derivative contracts to other institutions and less likely to create knock-on effects around the financial sector. We believe that the systemic risk posed by SWFs appears lower than that created by the more complex operations of commercial and investment banks.

This is not to say that SWFs have no future financial stability implications. For example, if the CIC were to engage in grossly imprudent management of its delegated portion of China's foreign exchange reserves, there could be a range of economic and political consequences. It is in everyone's interest to see SWFs adopt a prudent and sustainable long-term approach to investment. This is one reason why the Santiago Principles emphasise that fund governance should be robust and that investments should be apolitical, which in one sense means making decisions according to financially prudent criteria (although this is of course somewhat complicated by the events of 2008, where many apolitical and rational financial institutions suffered huge losses).

One area that is currently very under-researched is the potential for unintended rogue behavior in SWFs that are not subject to proper oversight and governance. We are used to cases of rogue traders in normal financial institutions – such as Nick Leeson bringing down Barings Bank – but we have not yet seen any high-profile cases of a rogue SWF manager becoming overexposed to complex speculative instruments, such as derivatives-laced structured products.

Further research should also be undertaken into the extent to which SWFs are involved in 'shadow-banking' activities. The shadow-banking sector remains of concern to regulators and is likely to continue to come under regulatory pressure. For example, in the context of more stringent bank capital adequacy regulations imposing greater capital requirements for higher risk-weighted assets, SWFs might find it attractive to begin offering privately placed loans or lines of credit to riskier companies seeking debt financing. So far, it appears that many SWFs retain fairly high portfolio allocations to public equities, sovereign bonds, and higher-rated corporate bonds, but it is certainly possible for them to develop innovative and opportunistic forms of bank-like credit investment. Indeed, if governance is loose, and their mandate is open to interpretation, such funds could, theoretically at least, become hives of innovation, in the way that Enron was a largely unregulated site of questionable innovation in the 1990s.

8.5 The current state of SWF regulation

Unified SWF regulation remains imperative, and sustained effort from regulators is necessary to ensure systematic methods of investment that will prove efficient in the long run. More relevant rules like the Santiago Principles are needed to guide SWF managers and governments. The Santiago Principles remain the only set of rules tailor-made for the governance of SWF, although managers continue to rely on other rules relevant to investment sectors by following corresponding codes implemented by working committees of the IMF, the OECD, and by ISO standards. These regulations owe their importance to the work of SWFs as they offer flexibility of implementation on a voluntary basis.

Thus we found that the absence of a binding set of international guidelines means that it is a difficult task for fund managers – who are responsible for constantly following the extensive literature and legislation – to find clauses that are relevant to the operation of their SWF in a particular territory and business sphere. A working committee established by regulatory authorities related to the SWFs would be beneficial, as it would prepare relevant literature and guidelines from each ruling to guide the SWF managers through issues of importance in various jurisdictions. SWF managers should be free to consult the broader ruling in a condensed form as relevant to the activities of SWF. This is a valuable and beneficial way to educate and train SWF managers on an ongoing basis internationally.

From our research we found that one of the ways to guide host countries is by recommending institutions that rank SWFs for transparency. One such institution is Sovereign Wealth Fund Institute (SWFI), which actively participates in defining transparency ratings for large scale global SWFs. Amid the debates on voluntary regulations versus mandatory, perhaps one answer towards finding a reasonably unified solution is the creation and establishment of bodies like the SWFs Institute. It rates SWFs based on the transparency index, which offers easy to use league tables to assess the viability of cooperation between regulators and individual SWFs, as it relates to concerns about risk management, national security, and corporate social responsibility. SWFs are free to make their own decisions as to which standards they are prepared to accept, but a lack of transparency on their part is likely to lead to mistrust by the international investment and the business community. The question going forward concerns whether it is preferable to rely upon voluntary frameworks such as Santiago Principles, or whether to bring SWFs into more binding mandatory regimes.

Several host governments are currently consulting SWFI ratings to establish how they want to best deal with transparency issues originating from individual SWFs. In addition, the legal structure of SWFs at the domestic level also requires consideration. Governments must clearly define the legal status of SWFs to hold the decision-maker accountable. Within the SWF industry, there remains the concern that several prominent SWFs report to the state president directly or require permission from a political review committee before making investments abroad. Such requirements make it hard to improve transparency.

On the whole we believe that there are consistent and ongoing attempts by the international community as a whole to regulate investment decisions made by financial institutions, inclusive of SWFs, it is also notable that the financial crisis of 2008 prompted prominent regulators to take action to regulate financial institutions so that they would keep up with adverse financial risks. We found evidence of efforts of by the international community taking notice of how big of an issue SWF regulation really is, and attempting to regulate and clean up the investment world. This can be seen in the emergence of an array of rules and guidelines. Amongst other documents work is being done on the Santiago Principles and the Solvency II Directive, and most recently the emergence of the binding AIFMD, which although does not cover SWFs, regulates most AIFs, and is seen as an example of the type of regulation that SWFs could be facing at in the future. Regulators, academics, politicians, fund managers, advisors, and others are coming together to ensure the development of a united set of regulations, which would permit governments and investors worldwide to comprehend, analyse, and address paramount issues in a fast and effective manner. Our thesis shows that the group of professionals (academics, regulators, politicians, fund managers and advisors), which do not always work together, and did not cooperate in detail to create previous regulation, are now truly eager to come together and draft a suitable regulation. Whilst, taking in to account, amongst other things, the issues and questions discussed in this thesis on the theme of transparency, accountability and in itself the need for change in regulation.

8.6 The risk of financial instability from different degrees of regulation

One of the major problems for the authorities stems from imposing different standards of regulation, part of the difficulty for regulators is the issue of categorisation. A PE fund that takes money from external investors is clearly a different entity to a large national fund set up exclusively to serve a nation state. Yet, a SWF has a wide scope for 'sub-activities' that are very similar in nature to a private PE, HF, or property investment company. All these diverse activities will be covered by its umbrella categorisation as 'SWF', a category that remains largely unregulated. This can create a regulatory pressure gradient that might see, first, the internalisation of business within a SWF that might have otherwise been delegated to external managers, and second, the establishment of SWFs as a hotbed of new, risky investment activities that cannot be implemented in other types of funds.

The possibility of SWFs becoming sites of unmonitored financial experimentation currently appears fairly remote, but it is important to place SWFs more generally within the cat-and-mouse game of financial regulation. The job of regulators is to bring more and more previously unmonitored financial spaces into the realm of oversight and monitoring, but they can only do that in stages. In doing this, regulators face a delicate balancing act in that their attempt to place restrictions or oversight on one type of institution can lead to black markets forming for the same activities in unregulated institutions.

Alternatively, imposing such restrictions may simply confer advantages to the unregulated institutions. For example, as regulators seek to bring institutions like PE funds within more closely monitored bounds, the potential, however remote, does exist that SWFs could, in certain cases, find their capital favoured by those seeking funding. For example, CIC investment in Chinese companies is generally interpreted as being initiated by the CIC for political reasons, but it is equally likely that Chinese entrepreneurs, who are faced with a range of potential investors, might prefer investment from a body like the CIC, and therefore, actively court it. The CIC may place lower demands on them, partly due to the fact that it faces lower regulatory oversight and therefore requires less from the companies it invests in. This is currently an understudied issue that requires further investigation.

One suggestion would be to create separate multilateral guidelines for SWFs wanting to invest in other states. Such guidelines would ensure that foreign SWFs have an obligation to disclose their investment objectives, and are held accountable for their governance structure, and also for ensuring transparent reporting and administration of the fund. There are, of course, specific international rules for the activities of SWFs, but the introduction of multilateral guidelines would add transparency and ease to the process. Guidelines must address paramount issues such as the role of administrators and their responsibilities towards the affairs of the host country.

Some industry professionals believe that multilateral constraints would be welcome. To them, it is discriminatory to ask the investing SWF to abide by all the laws of host nations, suggesting instead that host nations should lift constraints, thereby allowing international SWFs to bid for lucrative contracts even if of national importance.

8.7 Possible alternative shapes of regulation

Among other things, SWF regulation has to take into account, and eliminate, conflicts of interest between SWFs and connected government bodies. For example, it is understood that some SWFs are in a position to access funding from central banks, potentially distorting the optimal allocation of financial resources, sometimes at the expense of deserving commercial recipients.

International regulation of investment funds can take various forms. It can include governance requirements, reporting and transparency requirements, and limitations on investment size and scope. The AIMFD, for example, has sought to bring investment institutions that were previously outside EU regulations into a regulatory framework. In particular, it affects various AIF managers, such as PE fund managers, adding new reporting and transparency requirements.

Two key questions arising for further future research in this prominent and growing area around potential future SWF regulation would be, first, which body would seek to create binding international rules around SWF investment and, second, on what grounds? The banking sector is subject to an elaborate set of national and international rules. For example, the Basel Committee on Banking Supervision set standards and targets for banks that national legislators could then pass into law. The Basel Committee was formed by the Group of Ten countries to create convergence and consensus on banking regulations, and having support from these core advanced economies allowed it to establish these standards as de facto or near-compulsory standards in the world more generally. Likewise, EU directives like Markets in Financial Instruments Directive (MiFID), UCITS, and AIMFD have the power to dictate national financial regulations around a range of financial institutions.

We noted that, to date, however, there is no body equivalent to the Basel Committee that focuses on investment funds, and core multilateral financial institutions like the IMF have limited scope to affect SWF behavior beyond voluntary efforts. Insofar as new SWF regulation will be formed, it must come either from, first, individual nation states, who might already impose specific requirements on particular foreign funds; or, second, from regional bodies like the EU, who have the power to impose regulation that impacts SWF operations across an entire region; or, third, from a multilateral international body with power to compel disparate nation states to accept binding consensus around the operation of their SWFs, or on their national regulations on how to treat foreign SWFs. Finally, such new regulation could come from an industry-led effort among SWFs themselves to set standards.

The Santiago Principles are the closest to any form of 'international regulation' of SWFs, and were formed by a coalition of SWFs – the International Working Group of Sovereign Wealth Funds – alongside the IMF. The Principles might be understood as a pro-active attempt to boost international standards on SWF investment behavior, governance, disclosure and transparency. Alternatively, they may be seen as a pre-emptive strike against potentially stricter regulation that may have emerged in the absence of a voluntary agreement. Thus, they have the potential to be viewed either as a temporary stopgap framework preparing the way for more stringent, comprehensive and binding regulations, or as a final, comprehensive set of rules.

Likewise, the position of the IMF and the SWFs in the creation of the Santiago Principles is of interest. The combination gives rise to different scenarios in the minds of different observers. Some may perceive it as a good faith collaboration between a respected multilateral financial institution and a set of concerned funds who wish to improve their standards. Others may perceive it as the IMF taking the lead and 'twisting the arm' of otherwise unwilling SWFs to force them to be more proactive in regards to regulation. Alternatively, it could be seen as the IMF being used by SWFs to give weight and credibility to rules that are sufficiently stringent temporarily to allay fears about SWFs, but sufficiently loose to allow leeway for the funds. Finally, it could be perceived as a cynical collaboration between the IMF and SWFs to produce a watered-down illusion of SWF accountability.

The reality is likely to be a combination of these. Some funds sincerely wish to improve their standards, seeking to display their mastery of international best practices and to show themselves to be responsible members of an international community. Others may participate in name only, paying little heed to the spirit of the Santiago Principles, and facing little consequence if they are found to be ignoring them.

It is this lack of consequence that leads to the Principles being viewed by some as cosmetic or insufficient. The point of regulation is to enforce clear standards and longer-term predictability to situations that would otherwise be characterised by multiple unclear standards and no long-term predictability. While voluntary standards might be adhered to when it suits a SWF, the voluntary nature gives much scope for flexibility and a reduction of standards when it suits a fund.

During qualitative reflection on the forty-three interviews it was apparent that a large majority of the people interviewed – who were significant players in the SWF industry – did not believe that further regulation was either needed or possible. This bias was especially prevalent among the fund managers, who had a strong tendency to see the negative sides of mandatory regulation. This was set against the backdrop of their sense of frustration that SWFs were unnecessarily demonised by the press, and that their positive role relative to other financial institutions was insufficiently recognised. In regards to any future increased compliance burden implemented via the AIMFD, they speculated that SWFs might begin to focus on investments in developing markets, outside the EU. Whether that would in practice be likely to occur, or whether it is just posturing, would be hard to judge without further study. The EU remains an important market for high-quality investment in a relatively stable political environment. While increased regulatory requirements would increase costs, and therefore reduce returns, the risk-reward trade-off would not necessarily be significantly altered by changes in regulation.

Regulators who were interviewed were not unsympathetic to some of the concerns of fund managers, but they generally expressed a more positive view on mandatory regulation. Fund managers might see elements of strict mandatory regulation as being ‘out of touch with reality’, but it must be acknowledged that the reality experienced by a fund manager may be characterised by different pressures to the reality experienced by regulators. Regulators must in theory, respond to concerns beyond the immediate commercial interests of SWFs. While realising that the 'one-size-fits-all' nature of regulation can be a problem, in their eyes that did not make mandatory local regulation any less important, suggesting that, in the long run, SWFs would benefit from being brought into line with best practice standards on transparency.

That view, with some variations, was also generally shared by advisers, lawyers, and academics, most of whom suggested that in theory mandatory regulation was preferable to unenforceable voluntary regulation. To some extent this belief is based upon an underlying concern that, although SWFs have not previously been implicated in contributing to global financial crises, they do have the potential to cause instability in the future.

A key motif among fund managers is to point to the costs of regulation. Inevitably such costs are short-term and subjective. For example, in the short-term it is individually costly for fund managers to have to increase their monitoring and reporting. Such costs, however, might not be large when compared to the generalised long-term costs faced by broader society because of a lack of regulation of a particular industry. The political game is inevitably one of, first, individual industry players lobbying privately against regulation, and aligning themselves ideologically against the concept of regulation, while at the same time reluctantly or willingly supressing their individual interests in favour of broader industry interests in the context of industry-level groups like the International Working Group of Sovereign Wealth Funds. Second, of using both individual lobbying and industry-level negotiations to seek diplomatic accommodation with the mandates of regulatory bodies whose concerns, interests and stakeholders differ from those of SWFs.

It is also worth noting that a major part of the rationale for the creation of the EU was to create infrastructure for markets and to streamline markets between countries. In this sense it is questionable to think of EU regulation as originating in an anti-market mind-set, notwithstanding the opinions of individualist libertarians among investment bank traders or PE deal-makers. The EU is comparatively distant from the class politics of individual nation states, and its mandate – at least in principle – is to create high-level co-operation between states that otherwise might resort to protectionist policies or tit-for-tat regulatory retaliations. Therefore EU policies involve forms of compromise between nation states, and their respective industry groupings, but the theoretical objective is to bring to life coherent markets that might otherwise remain fragmented. In this context, individual interest-groups fight to have their interests prioritised over others, or – if the policies do not go their way – to reduce the stringency of the measures that do not directly work in their interests.

It appears that in the future there will be scope for fund managers to collaborate with regulators in developing more nuanced regulation. Several parties suggested that more specific regulatory guidelines should be developed for SWFs in particular, to break the 'one-size-fits-all' criticism. This is a welcome development for all parties. One fruitful area of research might be how to develop guidelines for productive collaboration between such parties, ones that take into account the different interests in a balanced manner.

Thus, we found that, the AIMFD looms as a threat to SWFs. It is a new body of regulation that does not currently apply to them, but that could be expanded in scope to see them being incorporated. This creates a potential tension between SWFs and alternative fund managers, who are subject to AIMFD. This tension may be a driving factor in any future attempts to increase the scope of the AIMFD to incorporate SWFs. There is also a possibility of a new regulation focusing solely on SWFs in the future. If PE fund managers, and other alternative investment fund managers, begin to perceive themselves as being unfairly disadvantaged by the regulation, they may lobby for SWFs to be included too. This would reduce any 'regulatory gap' between the activities of regulated private PE managers, and the internal, unregulated direct investment teams within SWFs.

Whether such a PE lobby would form really depends on the losses faced by PE fund managers relative to SWFs. First, is the cost of the AIMFD regulation really that high, and second, are the direct investment activities of a SWF really competing against those of a PE fund manager?

To answer these questions, the nature of competition in PE type investment needs to be explored. Certainly, there is competition for clients, or, more specifically, investors. SWFs have no external investors, which is one of the reasons why they are exempt from the AIMFD. On the whole, they exclusively serve one client – the nation state – and we found that in this sense an internal direct investment group within a SWF does not, at least superficially, represent a threat to a private PE manager. We can report that they are not out in the open market competing with PE funds to win mandates from, for example, high net-worth individuals.

The nuance emerges when we realise that while the SWF as a whole serves one client in the nation state, we might choose to characterise each SWF investment department as separate organisation ‘competing’ for the parent organisation’s money. In this sense, the internal PE team of a SWF is not only competing for a greater asset allocation relative to, for example, the corporate bond team, but it is also competing with external fund managers who might obtain outsourced mandates from the SWF to run parts of the portfolio. This is perhaps a somewhat abstract characterisation, but for a PE fund manager the decision by a SWF to set up an internal team to run its direct investment portfolio represents a type of loss of potential business.

The second form of competition is for staff. There is no comprehensive research on the extent to which a fund like the CIC poaches staff from alternative investment managers in order to set up internal direct investment teams. Anecdotal evidence, such as browsing the LinkedIn profiles of CIC staff, suggests that staff often have a background in large private sector financial institutions and were probably poached. In the context of the financial industry, in which the headhunting of specialist staff is a norm, this is unsurprising.

The third type of competition is for deals, and this is perhaps the most interesting element. While PE investors are often seen as aggressive and proactive deal-makers, they are numerous, and the companies they target might have a choice in whom they accept investment from. This is certainly the case at the venture capital end of direct investment, where startup or growth companies can solicit equity financing from a range of sources, and might be particular about whom they take money from.

If indeed the AIMFD does increase the costs of external PE fund managers in any meaningful way, it may make them relatively less attractive to high-level asset allocators and investment strategists within a SWF. This in turn opens up the scenario of SWFs seeking to internalise PE portfolios which were previously outsourced to external managers. This would not only represent a loss of clients for PE fund managers, but the creation of a hidden tier of internally-run PE operations within SWFs that could compete for deals and staff.

For this situation to make sense, the loss of competitiveness experienced by external PE managers would have to be so high as to override the cost of setting up and running an internal PE team. On the other hand, large funds like the CIC already have their own in-house direct investments teams. It is thus possible, but we would judge doubtful, that PE fund managers would lose business to SWFs who might otherwise be using them to manage their alternative investment portfolios.

Finally, we believe that mandatory regulation like the AIFMD, with all its complexities and requirements, does not allow for a "level playing field" for all AIFs; however, we would also argue that a similar regulation, consisting of equally stringent measures, would not benefit SWFs as a whole, and would encourage them to invest elsewhere. As a community, we want to encourage investment and support collaboration between investors and growing businesses; but we can only do so successfully, by listening, working together and paying close attention to the data available to us, in order to determine how best to create a path that is functional and desirable whilst minimising potential negative effects on the economy.

8.8 The need for proactive self-regulation

The opportunity now exists to consider several alternative possible systems of regulation. The Santiago Principles could continue to be the major global guidelines for SWF investment activity, and on a global level might form a bulwark against further attempts to regulate SWFs. In this context, individual countries and supranational bodies like the EU could attempt to respond to the lack of broader binding international regulation on SWFs by implementing more stringent localised laws on SWF investment.

The ebbs and flows of regulation are linked to many factors. In the context of a recessionary global environment, where demand for foreign capital might be higher, the pressure may be for individual regulators to reduce regulations that restrict the movement of capital into their respective jurisdictions. Conversely, in boom times, states have more room to place higher requirements on investors who are seeking opportunities.

The lessons of recent history are ambiguous. The 2008 financial crisis was followed by recessionary pressures alongside demands for the increased regulation and limitation of financial institutions which were seen to have caused the recessionary environment. And now that the recessionary pressures have been reduced – at least for the time being – the political will to push new regulation has diminished, or at least lost its previous intensity.

In this context, SWFs are uniquely placed. They have been exempted from responsibility for the 2008 financial crisis, and thus are in a position to present themselves as providers of long-term responsible capital. On the other hand, the lack of regulatory focus on them, and the focus of regulator efforts on previously irresponsible institutions, could lead to SWFs being the new unmonitored zones of questionable financial innovation. Forward-looking regulators – who are aware of their previous failures to monitor the institutions responsible for the last financial crisis – may be aware of this, and may push pre-emptively for increased oversight of SWFs.

In this context, forward-looking SWF managers need to be politically aware. The Santiago Principles do not currently satisfy many regulators, and reactively rejecting regulators' concerns is not likely to reduce pressure for regulation. SWFs need to show proactively that not only were they a force for stability during the last crisis, but that they continue to be a force for stability. To this end bodies like the International Working Group of Sovereign Wealth Funds should demand more of those members who do not proactively contribute to improving the image of SWFs. Quite how they could do this is unclear, but it is a topic that deserves further investigation. Do SWFs have enough in common to form a coherent political voice? Can they proactively work together in a meaningful sense? What lessons are there from other financial industry groupings that might provide a model for how SWFs could co-operate?

Most industry groups work best in a national context. The British Bankers' Association (BBA), for example, is a lobby group of UK-based banks and financial institutions. Their senior management tends to have cultural similarities – for example, speaking English at a first-language level – and have a fairly coherent set of interests. Such associations operate a particular type of commercial operation, with a particular end goal, and do so in a particular political context. They compete against each other, but recognise their common interests and struggles fairly easily.

A group of SWFs, on the other hand, faces a myriad of complexities in reaching a consensus. Their managers come from different cultural backgrounds with diverse languages, business practices, norms, religions, and histories. They operate funds that may seem similar superficially, and that are categorised together, and that yet contain significant differences in structure, size, and investment philosophy. On the surface they appear to have a coherent set of interests, yet they not only represent nation states that have divergent interests, but they may be faced with fragmented and divergent interests within their own country. Furthermore, they operate in quite different geopolitical contexts. Thus, the pressures placed on the CIC are very different from those placed on the Norwegian fund.

8.9 Staying ahead of new regulatory concerns: responsible investment

It is generally accepted that the underlying objectives of regulations applicable to financial institutions include investor protection, anti-financial crime measures, and the paramount requirement for financial stability. SWFs, however, find themselves exempt from scrutiny around investor protection, but only at the cost of being scrutinised for the political nature of their major investor. SWF managers may have gained experience at the existing regulatory game, but they need to stay abreast of new, previously unrecognised, regulatory drivers.

These include the evolving global perspectives of responsible investment. It is still acceptable for investors to ignore issues like climate change, ecological degradation, and global inequality, but it is not apparent that such acceptability will continue in future. In the realm of climate change, in particular, it is becoming harder for investors to ignore their role in supporting large fossil fuel companies and other carbon-intensive industries. In this sense, several of the world’s largest SWFs find themselves in a conflicted position. The Norwegian fund, for example, is an oil fund that is seeking to be a world leader in sustainable investment, a seemingly positive stance and yet at the same time highly contradictory. Other oil and gas funds, like Russia’s funds, seem to have little or no engagement with sustainable investment concerns at all.

Groups like CarbonTracker have popularised the concept of the ‘carbon bubble’, the idea that the shares of publically-listed oil and gas companies are fundamentally overvalued as a result of our failure to take account of the fact that we simply will not be able to allow them in future to extract all their reported reserves for burning. It is a slightly abstract concept, because, at the moment, all oil companies believe that they individually will be able to extract the oil for burning, but collectively, if they all do it, and if predictions around climate change are fulfilled, the effect would be disastrous and thus, politically not feasible. The ‘carbon bubble’ concept, along with related concepts like ‘stranded assets’, is starting to be noticed by national authorities. Furthermore, it is becoming perceived as a potential financial stability concern, something that prudential regulators might wish to address.

This raises the possibility of future regulation on the carbon intensity of portfolios, or punitive taxes upon the returns from such portfolios. Proactive investors should be considering how to position themselves for this: it ties deeply into the aforementioned politics of natural resources. For example, it could be argued that nation states that currently depend on oil and gas for revenues should be using their SWFs to diversify, ‘hedging’ themselves by investing heavily into renewable energies and clean technology. Such a progressive and proactive stance is very difficult to undertake, however, when influential opinion in those countries remains very much with the oil and gas industry.

Interviewees generally suggested that SWFs were ‘responsible’, but this was often narrowly interpreted as being ‘not individually reckless’, rather than ‘not investing in industries that are collectively detrimental to the world in the long-term’. The interviews posed a unique challenge in that interviewees had self-awareness about the potential use of the research and that therefore they ought to develop strategies for how they ‘should’ present themselves. There is always a potential for the interviewees to censor themselves in answering, or to present the interviewer with a ‘standard line’ on a particular topic; this is particularly the case when they work in a high-pressure industry and do not have extensive time to answer research questions for an external researcher. What we can read into many of the answers is a focus upon shorter-term, day-to-day experiences; in that context, questions of whether funds will be regulated according to carbon intensity appear distant and far-fetched. Thus, they can be vague about such matters, or dismissive.

8.10 The complexity of the institutional challenge

SWFs operate in a very varied, and at times complex and changeable global financial environment. They have to be seen in the light of geopolitics, the competitive jostling between states mediated via different routes, from diplomacy to outright conflict. This makes them unique, in particular, they need to be seen within the natural resource geopolitics of the oil and gas industry, and within the international trade geopolitics of China and the USA, both of which relate to the changing economic power of emerging market nations, which threaten to destabilise the economic status quo. They need to be seen in the light of global currency dynamics and in the context of the widespread concerns about global financial stability. They must negotiate the councils, committees and institutions tasked with establishing common rules and best practices for disparate nation states with disparate national regulatory systems in a globalised, financialised economy. Finally, they must be positioned to respond to new concerns around issues like climate change, an issue that is globally recognised but that still struggles to be dealt with in any coherent way.

It is within these contexts that proposals for regulations, and lobbying against regulations, take place. It is not merely a struggle between SWFs and regulators. It is a situation in which numerous different classes of financial institutions seek the best possible deal for themselves.

In recent years, the regulatory hammer has fallen hardest on the banking sector, but there is little reason to suggest that there will be no calls to put SWFs under greater regulatory scrutiny. Practically implementing this is difficult for any regulator, but the SWF industry needs to do two things: first, to find ways of efficiently coordinating itself with one coherent voice, and, second, proactively to rise above and beyond its lacklustre adherence to the Santiago Principles. SWF managers do not want to feel the heavy hand of mandatory regulation, but in order to avoid it they need to dispel the notion that voluntary regulation is ineffective.

They need to present themselves as a force for long-term financial stability, and authentically to develop investment strategies that support it. To do that they must take a proactive stance on global issues like climate change, showing themselves to be exemplars of a future sustainable financial system. This will require both greater transparency and an investment philosophy that actively backs industries that will contribute to greater future social well-being, rather than continuing with an atmosphere in which industries merely serve current entrenched interests. The grand challenge, though, is how to get such disparate funds to work together in a coherent manner. It requires inspired leadership, and for funds to be prepared to forgo their immediate self-interest in favour of a collective effort that secures their interests in the longer term. This appears to require them to distance themselves to some extent from their respective nation states: a task that seems enormous. Without some form of autonomous space where SWF managers can gain a nominal independence from the states they represent, they will struggle to form even a basic consensus on their common interests. To this end, the International Working Group of Sovereign Wealth Funds needs to be reformed and strengthened. It needs effective tools of collaborative decision-making, and the ability to censure those members who do not co-operate, while, rewarding those who do. This seems like a tall order. And it is. It is also a recommendation of this thesis. Although it will no doubt be difficult, we would argue that it is an important reform to seek to achieve.

The alternative is for the world's SWFs to continue to operate in a fragmented fashion in a fragmented regulatory space, a space in which they will often be left to their own devices. Unfortunately, financial history shows us that when some parts of the financial system are regulated and others not, the tendency is for 'shadow' activities to form in the unregulated spaces. Just like the shadow-banking sector formed as a response to banking regulations, so too could a shadow-fund management sector flourish in response to attempts to regulate only some parts of the fund management industry. Currently, SWFs are subject to political scrutiny for geopolitical reasons, but remain relatively free from suspicion of causing financial instability. There is little chance that they will shake off the geopolitical suspicions, but it would be prudent for them to maintain a good image in the eyes of financial stability authorities.

8.11 Implications for further research

In the course of our research, we have uncovered a number of areas that warrant further investigation:

i. The extent to which the position of SWFs, as sovereign investors backed by states with internal divisions and interest groups, can lead to a lack of internal oversight that could allow unintended 'rogue' behavior to occur within SWFs. To date SWFs, are viewed – more or less – as long-term investors that may promote financial stability; but does their ambiguous position as quasi-state market participants create internal environments where oversight is more lax than that of private sector financial institutions?
ii. The extent to which SWFs are – or could become – involved in 'shadow-banking' activities in the context of more stringent regulation of banks and regulated fund managers. If there is market demand for unregulated financial services in the context of increasing regulation, attractive opportunities could open up for unregulated fund managers. This is especially the case if the mandates of SWFs are flexible and opportunistic.
iii. Whether or not unequal regulation makes receiving investment from SWFs attractive to potential entrepreneurs and businesses, giving SWFs an edge in making investment deals. Does a Chinese company prefer investment from the CIC rather than an EU-based venture capital fund? Does the lack of regulation in SWFs translate into lower demands on the companies it invests in? Or, conversely, do greater regulatory demands on regulated alternative investment managers translate into greater demands placed on companies they invest in?
iv. If regulation by the AIMFD was extended to SWFs, would they be deterred from investing in the EU, and become inclined to invest elsewhere? Is the regulatory cost of the AIMFD really so high as potentially to deter an investor from entering a highly important market? Likewise, is the lack of current EU regulation concerning SWFs 'encouraging' them to enter the EU?

v. Is it possible for financial institutions that represent nation states to form an ‘industry group’ that collectively seeks to boost proactively the standards of its members proactively? Groups like the International Working Group of Sovereign Wealth Funds seem paradoxical: they represent SWFs within nationally and internationally regulated markets, while they are a forum for disparate nation states that disagree with each other. And yet they do – on the whole – represent a particular group of rising or ‘developing’ nation states that are often viewed suspiciously by the first wave of global economic powers. In a world where investment has traditionally flowed from advanced industrial nations to emerging markets, do such groups represent a change in polarity, promoting foreign investment by emerging market countries into advanced industrial nations?

8.12 Implications for policy

It seems from the groups we interviewed there is the emergence of an idea of a ‘desirable’ mode of regulation, which would be a blend between the current voluntary reporting standards and a mandatory set of regulations relevant to the state that the investment is being made in, along with a ‘minimum’ level of transparency reporting. That minimum level would be greater than that prevailing today and would be presented in a simple format, which would be clear and user friendly, not just for the funds reporting, but also for knowledgeable financial commentators.

In considering the AIMFD, this thesis has pointed out the pitfalls of formulating regulations that are not applied consistently; such inconsistency may take the form of variations between different geographic regions, or it may lead to discrimination between financial institutions offering in all relevant respects the same services. For example, the AIMFD regulates the activities of PE funds within the EU, partly in order to apply to them the same scrutiny as is given to banks. However, that does not address the point that not all PE activities take place within PE funds: large SWFs sometimes set up internal ‘direct investment’ units that undertake PE investment. Such units escape the regulation of the AIFMD. This has three potential consequences: first, that SWFs that previously outsourced their private equity activities to PE fund managers might instead set up in-house; second, that such in-house and unregulated units might undertake questionable financial ‘innovation’; and third, that in contrast to regulated PE funds, they may have advantages which give them preferential access to deals. There is, therefore, a case for the AIMFD to be extended to cover such in-house activities of SWFs.

We have highlighted the strengths and weaknesses of the Santiago Principles; among the former is their flexibility, which allows funds to build best practice standards in their own time; however, in some respects they are weak, for example, allowing funds to ignore them without much fear of the consequences. The implication of this is twofold: either there must be established an international body with more stringent and mandatory principles, or, to pre-empt that, the SWF industry must collectively attempt to improve its own standards.

One underlying tension that the thesis unveils is the failure of regulators to distinguish the sovereignty of a wealth fund from that of a state itself. Control of privately held entities both domestically and abroad falls generally under the purview of economic regulation. However, where an entity is an investor on behalf of a state, regulation which impacts its operations, although primarily economic in purpose, may sometimes reflect foreign policy requirements. In such cases, the regulation of SWFs could be overruled by the needs of the state. However, such potential anomalies could reasonably be addressed by international bodies such as the BIS. In that sense, SWF regulation could be considered to be more akin to geopolitics than to the traditional regulation of private markets. SWFs thus live a dual life: one as a normal 'market participant' that theoretically should be subject to market regulations, and the other as a sovereign entity representing a sovereign state.

It was clear from our interviews – not just with those working for SWFs, but also regulators and independent experts – that 'one size' would not necessarily fit all very effectively when it comes to SWFs. This is not only because there are such differences between them, but also because those differences are due to their links to sovereign states which in turn differ greatly. Thus to characterise SWFs as 'a sector' may be problematic given that each is, to some degree at least, an extension of a nation state. In this context, asking SWFs to work together may be akin to asking nation states to work together, with all the difficulties that would entail.

This suggests two alternative characterisations of these entities: one in which they represent a 'sector' with distinct characteristics, which can legitimately be thought to have certain interests in common; or the other, in which they do not have interests in common, but are extensions of the very same nation states that create the regulations for other private sector financial institutions. From this latter position, the coherent response to SWFs might be for individual nation states to decide for themselves how to treat foreign SWFs via the traditional bilateral politics of individual state diplomacy. However, this would undermine industry groups like the International Working Group of Sovereign Wealth Funds.

Finally, it is questionable whether it is in truth an *international* community seeking to regulate an *international* SWF sector. Rather, SWFs largely represent resource-rich emerging economies. There are few SWFs from traditional, advanced Western economies. What we are witnessing is a situation in which the economic forums dominated by advanced Western countries are attempting to agree on how to deal with the new financial strength of previously un-influential developing nations within the globalised economy. In this context, a group like the International Working Group of Sovereign Wealth Funds is not only representing SWFs as an institutional form; it also represents the common financial interests of nations that historically have been on a lower rung of the global economy. This may prove significant in terms of how new policy develops, and in terms of what the response to such policy developments might be.

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Appendices

A1: Interview questions for Sovereign Wealth Funds and private equity fund managers

1. What do Sovereign Wealth Funds [SWFs] invest in, and what are their perceived objectives?

2. To what extent do you believe that SWFs have had an impact in destabilising financial markets?

3. Are you actively following developments in the formulation and implementation of new financial regulations?

4. In your view are the motivations behind the introduction of the regulations principally economic or political?

5. What contribution, if any, did SWFs make to the structural imbalances that precipitated the 2008 financial crisis? How have SWFs responded to the new economic reality established in the wake of the 2008 financial crisis?

6. Should Sovereign Wealth Funds be more strictly regulated at an international level? If so, should there be a stringent set of mandatory regulations specifically for the monitoring and guidance of SWFs in their investments? Would you be keen to participate in drafting such regulations?

7. How do you evaluate the current policy / regulation, both mandatory and voluntary, established for the guidance of the work of SWFs today? I am specifically interested in the Santiago Principles. Are there specific elements of these regulations that are of particular concern to SWFs?

8. How do you evaluate the current policy / regulation, both mandatory and voluntary, established for the guidance of the work of SWFs today? I am specifically interested

in the Santiago Principles. Are there specific elements of these regulations that are of particular concern to SWFs?

9. How could AIFMD be appropriately reformulated to account for the positive contributions of funds to the European economic recovery? *(This establishes the interviewee's level of understanding of regulation and facilitates the prioritisation of subsequent areas for discussion.)*

10. Which part(s) of your business do you believe will be most significantly impacted by mandatory regulation (e.g. operations, governance, or relationships with investors)?

11. How do existing regulatory frameworks influence the transparency of the investments, activities and strategic positioning of your fund? To what extent do you believe that current discussions about the implementation of more stringent financial regulation like AIFMD are well focussed?

12. What are the overall strategic and financial objectives of your fund and how are they perceived by government and regulatory agencies?

13. How do you envisage new mandatory regulation changing the investment priorities or strategic positioning of SWFs? Are there specific elements of particular concern to SWFs, in particular to your own fund?

14. In the absence of the introduction of more regulation, would you consider that AIF activity in EU nations is likely to increase in the current financial market? *(In the existing economic milieu, it has been argued that any restriction of SWF inward investment would dampen the flow of capital into struggling economics and thereby delay economic recovery.)*

15. Does mandatory regulation reflect an attempt to limit the power of increasingly influential nations, such as Russia and China, in global financial markets? To what extent would an attempt to bring SWFs into line with existing 'best practice' regarding disclosure prove beneficial for international markets?

16. Do you consider your fund to be a socially responsible investor? Has your fund made specific plans to accommodate the requirements of new regulations for CSR and reporting transparency? Will requests for more transparency in investments have an impact on your fund's reporting practices?

17. Would you consider that the introduction of new regulations would establish an uneven playing field between large non-listed EU companies controlled by a private equity AIF and those where the party exercising control is a SWF?

18. With new regulations and amendments coming out on a regular basis, have you or your fund responded to relevant Discussion Papers, provided direct submissions to the EU Commission or contributed to EU Member State legislative evaluations? Is it your belief that routes for stakeholders to influence legislative formulation are clear and satisfactory?

19. Has your fund attempted to influence, directly or through submissions to third parties, the implementation of regulations relating to your business activities?

20. To what extent do you believe that SWFs (and your fund specifically) have been consulted as important stakeholders in the formation of regulation?

A2: Interview questions for government officials and regulators

1. What do Sovereign Wealth Funds [SWFs] invest in, and what are their perceived objectives?

2. To what extent do you believe that SWFs have had an impact on destabilising financial markets?

3. How efficient do you think mandatory regulation versus voluntary regulation is in regards to operational transparency?

4. What is your role in consulting/creating/commenting on regulation? What do you consider to have been the key driving force in the need to create a new financial regulation?

5. Should Sovereign Wealth Funds be more strictly regulated at an international level? If so, should there be a stringent set of mandatory regulations specifically for the monitoring and guidance of SWFs on their investments? Would you be keen to participate in drafting such regulation?

6. Have you/your team engaged practitioners from academia and/or fund managers when drafting new regulations? Does the potential introduction of new regulations reflect pre-existing discussions and concerns within the investment community?

7. How has SWF activity expanded during the 2000s? What contribution, if any, did SWF make to the structural imbalances precipitating the recession of 2008?

8. How do you evaluate the current policy/regulations, both mandatory and voluntary, guiding the work of SWF today? I am specifically interested in the Santiago Principles. Are there specific elements of these regulations that are of particular concern to SWF’s?

9. Which areas of investment business do you believe would be most significantly affected by new regulation (e.g. operations, governance, and/or relationships with investors)? How do you believe such effects would be manifest?

10. In the absence of the introduction of new regulations, would you consider that SWF activity in EU nations is likely to increase in the current financial climate?

11. Do you consider Russian and Chinese SWFs to be socially responsible investors? How are they perceived by legislative bodies and governmental organisations?

12. Does the possibility of new stringent regulations reflect an attempt to limit the power of increasingly influential nations, such as Russia and China, in global financial markets? To what extent would an attempt to bring SWFs into line with existing 'best practice' on disclosure prove beneficial for international markets?

13. Do you consider that new regulations would establish an uneven playing field between large non-listed EU companies controlled by a private equity AIF and those controlled by SWF?

14. Is it your belief that routes for stakeholders to influence legislative formulation are clear and satisfactory?

15. Are there any specific elements of potential new regulations of particular concern to you?

A3: Interview questions for advisers and lawyers

1. What do Sovereign Wealth Funds [SWFs] invest in, and what are their perceived objectives?

2. To what extent do you believe that SWFs have had an impact on destabilising financial markets?

3. Are you actively following developments in the formulation and/or implementation of new financial regulation?

4. How do you envisage potential new regulations changing the investment priorities or strategic positioning of SWFs?

5. Do you consider that new regulations would establish an uneven playing field between large non-listed EU companies controlled by a private equity AIF and those where the party exercising control is a SWF?

6. Should SWFs be more strictly regulated at an international level? If so, should there be a stringent set of mandatory regulations specifically for the monitoring and guidance of SWFs in their investments? Would you be keen to participate in drafting such regulation?

7. Do you believe that legal challenges to the statutory implementation of any new regulations would significantly shape the nature and extent of the influence of such legislation over SWF/PE activity?

8. How do you evaluate the current policy/regulation, both mandatory and voluntary, established to guide the work of SWFs today? I am specifically interested in the Santiago Principles. Are there specific elements of those that are of particular concern to SWFs?

9. In respect of operational transparency, how efficient do you consider mandatory, as opposed to voluntary, regulation to be?

10. How could the drafting of new regulation account for the positive contributions of SWFs to European economic recovery?

11. In the absence of the introduction of any new regulation, would you consider that AIF activity in EU nations would be likely to increase in the current financial market?

12. Does the potential introduction of new regulations usually reflect pre-existing discussions and concerns within the investment community?

13. Does the possibility of stringent new regulation reflect an attempt to limit the power of increasingly influential nations, such as Russia and China, in global financial markets? To what extent would an attempt to bring SWFs into line with existing 'best practice' on disclosure prove beneficial for international markets? Will requests for more transparency in investments affect SWFs' reporting practices?

14. Is it your belief that routes for stakeholders to influence legislative formulation are clear and satisfactory?

15. To what extent do you consider economic and political developments in the Eurozone to have influenced the formulation of regulatory measures?

16. Are there specific elements of potential new or stricter regulations which are of particular concern?

17. Have many AIFs asked for help in strategic positioning in order to minimise regulatory impact on their reporting practices?

A4: Interview questions for academics

1. What contribution, if any, did Sovereign Wealth Funds [SWFs] make to the structural imbalances precipitating the recession of 2008? How have SWFs responded to the subsequent new economic reality?

2. What do SWFs invest in, and what are their perceived objectives?

3. To what extent do you believe that SWFs have had an impact on destabilising financial markets?

4. Should Sovereign Wealth Funds be more strictly regulated at an international level? If so, should there be a stringent set of mandatory regulations specifically for the monitoring and guidance of SWFs in their investments? Would you be keen to participate in drafting such regulations?

5. How do you evaluate the current policy/regulations, both mandatory and voluntary, established to guide the work of SWFs today? I am particularly interested in the Santiago Principles. Are there specific elements of those that are of significant concern to SWFs?

6. How could the future drafting of regulations account for the positive contributions of SWFs to European economic recovery?

7. Which part(s) of your business do you believe will be most significantly affected by future regulation (e.g. operations, governance, and/or relationships with investors)? How do you believe such effects will be manifest?

8. How do existing regulatory frameworks influence the transparency of investments, activities and /or strategic positioning of SWFs?

9. In the absence of the introduction of further new regulations, would you consider it likely that AIF activity in EU nations would increase in the current financial market?

10. In respect of operational transparency, how efficient do you consider mandatory, as opposed to voluntary, regulation to be?

11. Do you consider that new regulations would establish an uneven playing field between large non-listed EU companies controlled by a private equity AIF and those controlled by SWFs?

12. Do you believe that legal challenges to the statutory implementation of any new regulations would significantly shape the nature and extent of the influence of such legislation over SWF/PE activity?

13. Is it your opinion that the motivations behind the introduction of regulation are principally economic or political?

14. Does the possible introduction of stringent new regulation reflect an attempt to limit the power of increasingly influential nations, such as Russia and China, in global financial markets? To what extent would an attempt to bring SWFs into line with existing 'best practice' on disclosure prove beneficial for international markets? Will requests for more transparency in investments affect their reporting practices?

15. To what extent do you believe that current discussions about implementing more stringent financial regulations are well focussed?

16. To what extent do you consider economic and political developments in the Eurozone to have influenced the formulation of regulatory measures?

17. To what extent is the academic community consulted in the formation of new regulation, both centrally and in its consideration by EU member state legislatures?