

Sovereign wealth funds

The rapidly evolving landscape

Illustration: Getty Images

Michael Doran,
Olivier Prost, Richard Pogrel and Hugues Parmentier of Gide Loyrette Nouel examine the rise of sovereign wealth funds and the European and international efforts to establish an acceptable global operating framework.



The rise of sovereign wealth funds (SWFs) has been inexorable and their importance is now unquestioned (*see box "What is a sovereign wealth fund?"*). SWFs sit firmly, but somewhat unhappily, at the crossroads where financial markets, foreign direct investment, international economics and geopolitical relations meet.

SWFs represent an important source of capital in today's global markets. They tend to have longer investment horizons without being constrained by the

shorter-term "exit-strategy" of, for example, a private equity fund. SWFs also have deep pockets, meaning that they can move swiftly without the need for (now very scarce) bank credit.

High profile examples in the UK of SWF activity include: the purchase by Dubai Ports World of P&O; the attempt by Qatari-backed Delta Two to acquire J Sainsbury; the presence of two SWFs in the three-party consortium that ac-

quired the landmark Metropole Building in London from the Crown Estate in March 2008; Dubai International Capital's approach to buy Liverpool football club; Abu Dhabi's 20% investment in the £2.5 billion London Array offshore wind project; and, most recently, the involvement of the Qatar Investment Authority in the £7.3 billion capital increase by Barclays Bank plc, resulting in approximately one third of Barclays now being owned by Gulf SWFs.

The debate surrounding SWFs is varied and complex. To some, SWFs are an economic Trojan horse: an undisguised threat to national economic sovereignty and strategic national assets. To others, they are one of the few remaining sources of stable investment that is desperately needed in a faltering global economy.

The recent worldwide turmoil in the financial sector has resulted in unprecedented and previously unimaginable state intervention in the private sector. What began as a series of pragmatic ad hoc responses by central banks and governments to the financial crisis now appears to be recasting the balance in the economy between government and the private sector. The credit crisis has seen the return of state capitalism and has triggered calls for a mix of economic protectionism and economic nationalism.

Against this backdrop, a considerable amount of work has been carried out to establish an appropriate global regulatory and operating architecture for SWFs. This article looks at:

- The rise of SWFs.
- The European response and the existing EU legal regime applicable to SWFs.
- The international response and efforts by the *Organisation for Economic Co-operation and Development (OECD)* (see *Glossary*) and the *International Monetary Fund (IMF)* to establish an acceptable global operating framework.
- Convertible securities: the recent investment instrument of choice for SWFs investing in financial institutions.

THE RISE OF SWFs

There are a number of reasons for the extraordinary rise of the profile of SWFs:

- There has been a deliberate shift in investment strategy and diversification

What is a sovereign wealth fund?

The International Monetary Fund has defined sovereign wealth funds (SWFs) as:

“Special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments, surpluses, official foreign currency operations, the proceeds of privatisations, fiscal surpluses, and/or receipts resulting from commodity exports.”

of SWF’s vast portfolios. Rather than maintaining a conservative investment policy by simply continuing to buy US treasuries or other low yielding government debt, or even asset backed securities and real estate, an increasing number of SWFs decided to become active (and sometimes aggressive), yield-hungry investors, expanding into equities and taking large stakes in companies (see box “*SWF purchases of convertible securities in banks*”).

- In September 2007, China’s announcement of the creation of its state investment agency, China Investment Corporation, and its initial capitalisation of US\$200 billion, catalysed interest in SWFs and increased the need for serious analysis (see *News brief, “Sovereign wealth funds: the heirs apparent”, www.practicallaw.com/1-380-9442*).
- In 2007, commentators concluded that SWFs held US\$2.5 trillion in assets. This was more than the hedge fund and private equity industries combined and, even with recent downward revisions to forecasts, is still estimated to rise to US\$10 trillion by 2015 (“*SWFs: Growth Tempered – US\$10 Trillion by 2015*”, 10 November 2008, by Stephen Jen and Spyros Andreopoulos of Morgan Stanley London, www.morganstanley.com/views/gefl/archive/2008/20081110-Mon.html#anchor7146). Although currently still dwarfed in size by worldwide assets managed by insurance companies, mutual funds and pension funds, the investment power

of SWFs is hugely significant and will only grow in influence.

- SWFs played a critical role in helping to recapitalise major financial institutions in the early stages of the credit crunch, which attracted much attention (see box “*SWF purchases of convertible securities in banks*”). Their unanticipated arrival on the global stage, combined with their obvious financial clout, immediately provoked hurried analysis of their real investment purposes, the relationship between SWFs and their government owners/sponsors and their potential use as an arm of foreign or domestic policy execution. SWFs represent a new approach to economic diplomacy.
- In an environment of depressed mergers and acquisitions activity and tight liquidity there is, unsurprisingly, an increased focus on SWFs with their ready supply of capital.

As a result of the raised profile of SWFs, an international regulatory response has been developed at several levels. While some governments made unhappy noises, a division of labour between certain supranational entities was quickly agreed, courtesy of the G7. The OECD was asked to address the issue of establishing common guidelines to be followed or implemented by home or “recipient” countries, that is, those countries into which the SWFs were investing (see “*OECD report*” below). The IMF was charged with entering into a direct dialogue with the SWFs to persuade them of the merits of agreeing a volun-

tary code of conduct of best practices for their investment activities (see “*The Santiago Principles*” below). Meanwhile, the EU and other major economies and trading blocs have considered their own policy approach.

THE EUROPEAN RESPONSE

In February 2008, the European Commission (the Commission) formally stepped into the then feverish debate on SWFs and set out some policy parameters in a communication on SWFs (the Commission’s communication) (www.practicallaw.com/8-381-0908). The Commission:

- Reaffirmed its commitment to ensuring that EU markets remain open for investment, including from SWFs.
- Tried, in a balanced and poised manner, to lower the temperature and rationalise the tenor of the debate in Europe surrounding SWFs.
- Emphasised the benefits to all (including the SWFs) of increased transparency, predictability and coherence.
- Supported the ongoing IMF efforts that seek the adoption of a global voluntary code of conduct for SWFs based on the twin pillars of governance and transparency.
- Reminded EU member states that investments by SWFs constitute a form of economic investment to which a comprehensive body of rules already applies within the EU (see “*Existing EU regime*” below).

European political leaders endorsed these parameters at a European Council meeting on 13 and 14 March 2008 (see box “*Sovereign wealth funds: key dates*”). However, the Commission’s communication did not address, or reserved its position on, some key issues, including:

- The scope of national protectionist measures that member states can legitimately take under existing EU law (see box “*Protective measures by EU member states: ECJ jurisprudence*”).

SWF purchases of convertible securities in banks

November 2007	Citigroup’s US\$7.5 billion capital raising through the sale of equity units (with mandatory conversion into common shares) in a private placement to the Abu Dhabi Investment Authority.
December 2007	UBS’s CHF13 billion (about US\$11.71 billion) capital raising through the sale of mandatory convertible notes to the Government of Singapore Investment Corporation (GSIC) and the Saudi Arabia Monetary Agency.
January 2008	Citigroup’s US\$12.5 billion capital raising through the sale of convertible preferred securities in a private offering to investors, including the GSIC and the Kuwait Investment Authority.
	Merrill Lynch’s US\$6.6 billion capital raising through the sale of 66,000 shares (9%) of non-voting, mandatory convertible, non-cumulative preferred stock in private placements to investors, including the Korea Investment Corporation and Kuwait Investment Authority.
Winter 2008	Barclays Bank’s £7.3 billion capital increase via the issue of £4.3 billion mandatorily convertible notes and £3 billion of reserve capital instruments and warrants agreed with Middle East investors, including the Qatar Investment Authority (so avoiding the terms of the UK government’s recapitalisation of the banking sector).

- The issue of reciprocity, that is, reciprocal openness to inward investment by EU companies.
- The “Gazprom question”, that is, the commercial activities of state-owned entities that are not SWFs and would not be caught by the proposed global voluntary code of conduct regime (see box “*The ‘Gazprom question’*”).
- The inherent monitoring, governance and transparency problems where SWFs invest via intermediaries, such as private equity funds or hedge funds.
- The possible establishment of an EU-wide equivalent of the *Committee on Foreign Investment in the United States (CFIUS)*.

The Commission emphasised that SWFs do not operate in a law-free vacuum in the EU. Like any other investor, SWFs are subject to the existing rules on foreign investment and merger control.

Existing EU regime

Although there is currently no EU legislation that is aimed specifically at SWFs, EU legislation governing restrictions on the free movement of capital and the rules on merger control and state aid do apply to SWFs.

Free movement of capital. Article 56 of the EC Treaty establishes the principle of free movement of capital among member states and between member states and third countries, without distinguishing between public and private investors. Therefore, in principle, all restrictions on capital movements among member states and between member states and third countries are prohibited, including investments made by SWFs.

However, member states may introduce restrictions in certain circumstances. Article 58 of the EC Treaty provides that national regulation may restrict the exercise of the free movement of capital, particularly through investment control, if it is

Sovereign wealth funds: key dates

1953

Kuwait Investment Authority, the oldest sovereign wealth fund (SWF) in the world, is established.

1967

Norway's Government Pension Fund established.

1974

Singapore's Temasek established.

1976

Abu Dhabi Investment Authority established.

1987

UK Prime Minister Margaret Thatcher forces the Kuwait Investment Authority to relinquish most of a stake in British Petroleum.

2006

Acquisition by Dubai Ports World (an entity controlled by the government of Dubai) (DPW) of certain US port operations from the British port operator P&O. Following substantial pressure by the national media, as well as labour unions, DPW agreed to sell the US ports to AG Global Investment Group. This event led to a stricter review of foreign investments by the Committee on Foreign Investment in the United States.

2007

3 May In "How Big Could SWFs be by 2015?" Morgan Stanley estimates assets of SWFs to be US\$1.5 billion and possibly rising to US\$12 billion by 2015.
 29 September Official launch of China Investment Corporation with a capitalisation of US\$200 billion.
 15 October Publication of "State Capitalism: The rise of sovereign wealth funds" by Standard Chartered Bank.
 12 December UBS's US\$11.71 billion capital raising via Singapore GIC and the Saudi Monetary Agency.

2008

30 January Russia's Globalisation Fund is split into two separate SWFs, The Reserve Fund and The National Wellbeing Fund.
 17 February Australia announces its updated foreign investment screening process based on six core principles.
 23 February Japan reveals that it is considering the establishment of a SWF by tapping into the nation's huge pension monies and FX reserves (Japan's FX reserves are the world's second largest after China).
 13/14 March European Council meeting of EU leaders in Brussels. Approval of European Commission Communication "A common European approach to Sovereign Wealth Funds".
 4 April OECD Investment Committee Report "Sovereign Wealth Funds and Recipient Country Policies".
 11 October Publication by the International Working Group of Sovereign Wealth Funds of the "Santiago Principles - Generally Accepted Principles and Practices for Sovereign Wealth Funds".
 21 October Italy establishes a National Interest Committee to establish rules on the behaviour of SWFs and proposes a 5% ceiling on shareholdings.
 21/23 October President Sarkozy of France announces the establishment of a French SWF and urges other EU member states to set up their own national SWFs.
 3 November UK government announces the establishment of UK Financial Investments Limited to manage its investments in RBS, Lloyds TSB, HBOS and, eventually, Northern Rock and Bradford & Bingley on an "arm's-length" basis.

justified on grounds of public order or public security or on overriding reasons of public interest. Whatever the nature of the measure, the restriction is justified only if it meets the following conditions:

- It must remain proportionate to the interest protected, that is, it must be necessary to protect the interest in-

involved and less restrictive measures must not be available.

- The restriction cannot be used to protect purely economic interests.

The EC Treaty also allows restrictions on free movement of capital in special circumstances related to:

- Difficulties in the operation of the Economic and Monetary Union (*Article 59, EC Treaty*).
- Security or foreign policy issues (*Article 60, EC Treaty*).
- Arms trade issues (*Article 296, EC Treaty*).

The aim of the EC Treaty and the analysis of the European Court of Justice (ECJ) (see box “Protective measures by EU member states: ECJ jurisprudence”) are quite clear about the mechanisms that member states are entitled to set up for the purpose of controlling foreign investments; member states must maintain a balance between protecting strategic interests and ensuring clarity and certainty for investors.

Although the theoretical aim of the EU regime is clear, it lacks consistency. As there is no harmonisation on what is a necessary and proportionate restriction to an overriding public interest, member states retain a significant discretion in implementing restrictive measures. The controls by the Commission and the ECJ are, by their nature, retrospective. There have been numerous instances of member states attempting to introduce restrictions that are outside of the spirit of the EU legislation and, in the current environment, there is a very real possibility of further instances of such protectionism.

Merger control. Since 1990, changes of control in companies exceeding certain turnover thresholds must, pursuant to the EC Merger Regulation and national legislation of each member state, be notified to the Commission or to one or more of the national competition authorities. In most jurisdictions, such deals must be authorised before they can be implemented.

Incremental acquisitions of shares do not avoid the legislative requirements. When two or more transactions between the same parties occur within a two-year period and the combined transactions exceed the mandatory notification threshold, they are considered to be a single transaction that must be notified to the relevant authority. Merger control also applies to acquisitions made by financial institutions, except where the acquisition is made for the purpose of reselling within one year and the financial institution has had no real involvement in the business.

As stated in the Commission’s consolidated jurisdictional notice under the EC

Protective measures by EU member states: ECJ jurisprudence

The European Court of Justice (ECJ) has examined on several occasions the compatibility of national regulations that limit the ability of investors to take stakes in sectors deemed to be “strategic” with Articles 56 and 58 of the EC Treaty. Such national regulations have included submitting the acquisition to a prior authorisation, or establishing a specific share (known as a “golden share”) allowing a member state to retain a veto over changes in the capital structure and activities of certain companies in strategic sectors.

On 17 July 2008, the ECJ held that the Spanish system of prior approval for any purchase of stakes in companies in certain regulated activities in the energy sector did not comply with the EC Treaty (*Commission v Spain, case C-207/07*). This system of prior authorisation was considered to be disproportionate to the aim pursued (safeguarding energy supply). According to the ECJ, the mere acquisition of a stake in a company cannot in principle be regarded as a genuine and sufficiently serious threat to the security of energy supplies. The ECJ also stated that the mere public nature of the investor may not in itself constitute a danger to the energy supply of a member state.

Another case examined the compatibility of a Belgium decree establishing a “golden share” for the state in relation to the national oil pipeline company (www.practicallaw.com/7-101-7529). The ECJ held that the objective in this case, namely to ensure security of energy supply in case of crisis, was indeed a legitimate interest (*Commission v Belgium, case C-503/99*).

In 2005 in France, a decree was passed that regulated financial relations with foreign investors (*Decree No. 2005-1739, 30 December 2005*). It introduced a compulsory prior authorisation from French authorities for foreign investors intending to take control or acquire a blocking minority of 33.33% in companies active in eleven different “sensitive” industries. In April 2006, the EU Commission initiated infringement proceedings against France and, on 12 October 2006, issued a reasoned opinion, which is the second stage of the infringement procedure (*case no. 2006/2110*). On 11 December 2006, the French government responded. To date, no further action has been taken and the Commission has not referred the matter to the ECJ.

Merger Regulation, merger control applies to all public bodies, including the member states themselves, and therefore to SWFs, regardless of their country of origin (www.practicallaw.com/0-374-0995).

State aid control. EU state aid rules prohibit any aid granted by a member state or through state resources in any form that distorts, or threatens to distort, competition by favouring certain firms or the production of certain goods and that affects trade between member states (*Article 87, EC Treaty*) (*Article 87*). The Commission must be informed of any plans to grant or alter aid (*Article 88(3), EC Treaty*). The aid is prohibited unless it falls in one of the exempted cat-

egories listed in Article 87 or is covered by one of the block exemption regulations.

Public enterprises’ resources may be considered as state resources under Article 87. Where a state is able, through its influence on public enterprises, to guide the use of its resources to finance specific benefits for other companies, this may constitute state aid and be subject to authorisation. Entities from non-member states are not subject to such control. Some commentators have challenged the EU state aid regime because of the need to take into account industrial policies of non-member states that include subsidies to competitors of EU undertakings. The criticism is of the apparently uneven

The “Gazprom question”

A wide range of state-owned entities already operate in the international markets as banks, insurance companies, shipbuilders, airlines, energy suppliers, oil companies and so on. Should regulation of SWFs apply to all such operational state-owned entities? If not, sovereign states could simply “park” investments in other state-owned entities to avoid scrutiny or compliance with SWF codes of conduct, in which case effective and even-handed regulation would seem an unachievable aim. The controversial and often quoted example is Gazprom, the Russian energy supplier. However, the “Gazprom question” is symbolic of a broader, and so far little debated but closely linked, issue.

State-controlled entities such as Gazprom are clearly not SWFs (see box “*What is a sovereign wealth fund?*”) and so will not be subject to the voluntary code of conduct embodied in the Santiago Principles. If countries are concerned about the geopolitical implications of state-owned companies being used to help execute foreign policy or anything other than bona fide commercial interests, then the IMF appears to be leaving a major issue unresolved. Similarly, the EU Commission has not commented on this issue. However, at least for the time being, EU law applies equally to all investors.

In this context it is also interesting to note that several major UK high street banks are now effectively state-owned, notwithstanding recent statements as to the intended government policy of “hands-off” involvement via the introduction of UK Financial Investments Limited as an arm’s-length company to manage the UK government’s investments in UK banks. Following the financial meltdown in late 2008 and the unprecedented state intervention that followed, the lines between state involvement and private enterprise are now more blurred than ever.

playing field created by, for example, aid being granted by the US government to Boeing or to US carmakers, while the Commission has closely scrutinised alleged state aid granted to Airbus or to European car manufacturers.

The state aid rules may also be used to regulate the activities of SWFs, although they would not apply to investments made by non-European SWFs. For example, in 2003, France took a share in Alstom, which was comparable to a SWF investment. The Commission approved the restructuring aid that formed part of the investment package, on the condition that Alstom adopted so-called compensatory measures, such as selling off businesses in various sectors of the group’s activities. These compensatory measures were necessary to ensure that the restructuring aid would not cause substantial harm to competitors operating without state aid and to restore fair competition in the transport and energy sectors. But, if a non-member state SWF invested in Alstom in the same manner, rules on state

aid would not have been applicable and such measures would not have been applied.

What next for the EU?

There remains considerable uncertainty about the approach that the EU and individual member states will take towards regulation of SWFs.

The weaknesses with the current approach lie in the lack of clarity and consistency of the existing law and the possible willingness of some member states to push the boundaries of what it means to have an open investment environment (one of the five principles proposed in the Commission’s communication). For example, Italy recently stated that SWFs wishing to acquire shares in Italian companies should, “in principle”, control not more than 5% of their capital.

It is implicit in the Commission’s communication that member states should not impose piecemeal domestic protectionist measures beyond what is proportionate and within existing EU law. Any

unilateral action could prove counter-productive and possibly conflict with existing EU laws. Conversely, it could also result in competitive bidding among member states seeking SWF investment.

The risk of a protectionist use of national and EU regulation would be diffused in an environment envisaged by the *Santiago Principles* (see “*The Santiago Principles*” below), resulting in increased transparency of SWFs and what is hoped will be less suspicion and more trust in their investment objectives. But achieving the goals of the Santiago Principles may be some way in the future, and member states may not be so patient.

A CFIUS-style body? The Commission has previously dismissed the possibility of an EU committee on foreign investments or an EU-wide screening mechanism similar in nature to CFIUS in the US. The Commission has said that this would run the risk of sending a misleading signal that the EU is stepping back from its commitment to an open investment regime. The Commission has also pointed out the possible conflict with EU law and international obligations. Whether this is the end of the debate is yet to be seen.

More decisive action? On 25 February 2008, José Manuel Barroso, the president of the Commission, emphasised the Commission’s preference for an unregulated “consensual” approach but said that, although it would not propose EU legislation, it reserved the right to do so if transparency could not be achieved through voluntary means.

In response to pressure from member states, the European Parliament and public opinion, EU regulatory activity in the financial sector is set to escalate in 2009. There is an increasing possibility of the introduction of new legislation to catch perceived gaps in the oversight and transparency of institutions in the capital markets, which could catch SWFs.

Greater co-ordination at the EU level and clarity and guidance of what actions by member states are permissible, would be a welcome development. This is espe-

cially the case when one considers the shortcomings of the Santiago Principles (see “*The Santiago Principles*” below). The Commission should take the opportunity at this stage of global economic diplomacy to establish from the outset clear principles applicable to all member states, as well as making the rules of the game clear to the SWFs.

THE INTERNATIONAL RESPONSE

The international reaction to the rise in profile of SWFs was spearheaded by the G7 (see “*The rise of SWFs*” above). The resulting publication of the OECD report and the agreement of the Santiago Principles have gone some way to encouraging a co-ordinated international response, however there remain significant obstacles to achieving a harmonised and universally applicable regulatory regime.

OECD report

At the request of the G7 finance ministers, the OECD began the process of developing guidance for its recipient countries’ policies towards SWF investment. The OECD approached this task in the context of its ongoing project on freedom of investment and national security; a project launched due to a perceived rise in investment protectionism.

The OECD report, published in June 2008, concluded that existing OECD investment instruments are suitable for developing guidance for countries receiving SWF investment (www.oecd.org/dataoecd/34/9/40408735.pdf) (see box “*OECD investment instruments*”).

Under the auspices of its broader freedom of investment project, the OECD report suggested that the use of the national security exemption to block inward direct investment was to be exercised with restraint and that the following core principles should be applied:

- Transparency.
- Predictability.
- Proportionality.
- Accountability.

OECD investment instruments

The OECD report provides the following explanation of the OECD investment instruments:

The key OECD investment instruments are the OECD Code of Liberalisation of Capital Movements, adopted in 1961, and the OECD Declaration on International Investment and Multinational Enterprises of 1976, as revised in 2000. They have procedures for notification and multilateral surveillance under the broad oversight of the OECD’s governing Council to ensure their observance. The instruments embody the following principles:

Non-discrimination. Foreign investors are to be treated not less favourably than domestic investors in like situations. While the OECD instruments protect directly the investment freedoms of those SWFs established in OECD member countries, they also commit members to using their best endeavours to extend the benefits of liberalisation to all members of the International Monetary Fund. Experience has shown that, in practice, OECD governments nearly always adopt liberalisation measures without discriminating against non-OECD countries – investors from non-members countries reap the same benefits of free market access as OECD residents. Outright discrimination against non-OECD based investors would be a major departure from OECD tradition.

Transparency. Information on restrictions on foreign investment should be comprehensive and accessible to everyone.

Progressive liberalisation. Members commit to the gradual elimination of restrictions on capital movements across their countries.

“Standstill”. Members commit to not introducing new restrictions.

Unilateral liberalisation. Members also commit to allowing all other members to benefit from the liberalisation measures they take and not to condition them on liberalisation measures taken by other countries. Avoidance of reciprocity is an important OECD policy tradition. The OECD instruments are based on the philosophy that liberalisation is beneficial to all, especially the country which undertakes the liberalisation.

The OECD report recognised that SWFs:

- Are stabilising influences at a time of market volatility.
- Help recycle savings internationally.
- Have a good track record as long-term investors.
- Stimulate business activity and preserve and create jobs.

While the OECD report is commendable and in keeping with the OECD’s overarching policy goals, recent events illustrate the difficulty in stressful economic times of maintaining a cohesive

EU acceptance of the OECD report. Certain EU jurisdictions have broken ranks and begun to announce national measures on foreign investment, including SWFs. For example, in Germany, the Federal Ministry of Economics and Technology recently initiated changes to the German law on foreign trade to restrict acquisitions by foreign investors in certain circumstances. Simultaneously, Italy has established a “National Interest Committee” to establish rules on the behaviour of SWFs and has proposed a 5% ceiling on SWF shareholdings.

The Santiago Principles

The international working group of sovereign wealth funds (IWG) was estab-

lished in early 2008 (www.practicallaw.com/1-382-0114). It includes representatives from 25 IMF member countries and is co-chaired by a senior representative of the Abu Dhabi Investment Authority and the director of the IMF's monetary and capital markets department. On 11 October 2008, the IWG presented the Santiago Principles to the IMF's policy-guiding International Monetary and Financial Committee, where they were adopted (www.practicallaw.com/8-384-2400).

The IWG was conscious of the need for objective demonstration that SWFs are properly established and that investments are bona fide and made on a pure economic and financial rationale. Therefore, the Santiago Principles are underpinned by the following guiding objectives for SWFs:

- To help maintain a stable global financial system and free flow of capital and investment.
- To comply with all applicable regulatory and disclosure requirements in the countries in which they invest.
- To invest on the basis of economic and financial risk and return-related considerations.
- To have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability.

The Santiago principles cover three general areas:

- Principles 1-5 cover the legal framework, objective and coordination with macroeconomic policies.
- Principles 6-17 cover the institutional framework and governance structure.
- Principles 18-23 cover the investment and risk management framework.

Principle 24 calls for regular review of the implementation of the Santiago

Glossary

Committee on Foreign Investment in the United States (CFIUS). An inter-agency committee of the US government created in 1975 that reviews the national security implications of foreign investments in US companies or operations. It is chaired by the Secretary of the Treasury and includes representatives from nine US agencies, including the Defense, State Commerce and Homeland Security departments. The framework for review of foreign acquisitions by CFIUS was revised and made stricter by the Foreign Investment and National Security Act of 2007.

G7. The meeting of the finance ministries and central banks of seven industrialised nations: Canada, France, Germany, Italy, Japan, the UK and the US.

International Monetary Fund (IMF). An organisation of 185 countries established by the Bretton Woods (New Hampshire) conference in 1945. It works to foster global monetary co-operation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

Organisation for Economic Co-operation and Development (OECD). A forum where the governments of 30 market democracies work together to address the economic, social and governance challenges of globalisation as well as to exploit its opportunities.

Santiago Principles. The informal name given to the voluntary code of conduct called the "Generally Accepted Principles and Practices" published by the International Working Group of Sovereign Wealth Funds (IWG), the draft of which was agreed by the IWG at a meeting in Santiago, Chile in September 2008. The principles were adopted on 11 October 2008 (www.practicallaw.com/8-384-2400).

Principles, to be engaged in, by, or on behalf of, the SWFs.

Despite their commendable intentions, there are some notable weaknesses with the Santiago Principles. The most obvious is that they represent a voluntary code and have no binding effect. Also, the issue of reciprocal openness to inward investment by EU companies is not dealt with and may not appease the calls from some countries for clear principles governing the issue of reciprocity.

Arguably, the most significant shortcoming lies in the scope of the Santiago Principles and the types of arrangements or funds that they aim to catch. By not covering most state-owned enterprises, as well as many private funds that may be viewed by some as posing the same risk to national interests (such as the royally funded Gulf asset managers), it is questionable whether states will give sufficient weight to the Santiago Principles to hold back domestic political pressure in favour of imposing restrictions.

The Australian precedent

The Australian rules are worthy of note, as their approach to foreign investments is clear. Australian regulations regard all government-backed foreign investment as a single class and do not simply focus on investment vehicles labelled or identified as "SWFs". This approach deals squarely with the "Gazprom question".

On 17 February 2008, the Australian government announced guidelines setting out its approach to foreign government investment proposals; an issue that had attracted heightened public and commercial interest in Australia. The government is obliged to follow the Australian Foreign Acquisitions and Takeovers Act 1975 in determining whether foreign acquisitions are consistent with Australian national interests (for a summary of Australia's foreign investment policy see www.firb.gov.au/content/_downloads/General_Policy_Summary_April_2008.pdf). In the guidelines, the government listed the follow-

ing six issues as salient in its foreign investment screening process:

- An investor's operations are independent from the relevant foreign government (the so-called "arm's length test").
- An investor is subject to and adheres to the law and observes common standards of business behaviour.
- An investment may hinder competition or lead to undue concentration or control in the industry or sectors concerned.
- An investment may impact on Australian government revenue or other policies.
- An investment may impact on Australia's national security.
- An investment may impact on the operations and directions of an Australian business as well as its contribution to the Australian economy and broader community.

The "arm's length test" and the fact that all state controlled entities (and not just SWFs) will be assessed in the same way gives the Australian government some useful tools in regulating foreign investment.

CONVERTIBLE SECURITIES

Since the credit crisis began in late 2007, many major international banks have sought capital investment in a hurry, often turning to the world's wealthiest SWFs. Although different structures were used to effect the various investments, a common feature to many was the mandatory convertible nature of the product (*see box "SWF purchases of convertible securities in banks"*).

A mandatory convertible security is a type of convertible security that has mandatory conversion features. Either on or before a specified date, investors are required to convert their holdings of convertible securities into newly issued listed shares, irrespective of the price of the shares at that time. Mandatory convert-

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ible securities generally provide investors with higher yields (compared with "plain vanilla" convertible securities) to compensate holders for the mandatory conversion structure. It is implicit in the mandatory nature of these securities that there is no issuer call option.

Mandatory convertible securities have a number of attractive features from a prospective issuer's standpoint. The structure affords the opportunity to raise funds while protecting the issuer's credit rating. Cash flow is benefited by the removal of the requirement to cash fund the redemption of the securities. Automatic conversion into newly issued, underlying shares on a contractually agreed date also removes future refinancing risk and provides balance sheet advantages by the future equity increase. Accordingly, the rating agencies may treat mandatory convertible bonds like equity from an analytical perspective, excluding them from net debt calculations since they are due to convert to equity capital.

In normal market conditions, this type of funding invariably causes the share price to fall on issue. The future dilution of holdings is the price existing equity holders pay for the issuer's ability to raise relatively cheap capital in a hurry. Of course, in conditions where liquidity and funding is scarce, as has been the overwhelming feature of markets in recent times, the fact that investment has been secured can trigger a significant share price increase.

WHAT NEXT FOR SWFs?

The situation for SWFs is confused. The economic premise of an open investment environment that underpins the OECD report and the Santiago Principles has been superseded by events. Both the OECD and the IMF may have to reconsider their approach to reflect this reality or risk becoming marginalised as SWFs adapt to increasingly divisive policy approaches.

The quid pro quo for SWF compliance with the Santiago Principles was to be a coherent and predictable recipient country approach as sketched out by the OECD report. With that coherence clearly becoming fractured, the incentive for SWFs to follow both the spirit and the letter of the Santiago Principles will surely be undermined.

The Commission needs to play its part to ensure that, in Europe at least, this is not the road we go down. It is vital that the policy on SWFs is clear, consistent and effectively co-ordinated and policed. However, where the line is drawn in the sand remains the trillion dollar question.

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