



# Sovereign Wealth Funds: Background and Policy Issues for Congress

**Martin A. Weiss**

Analyst in International Trade and Finance

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## Summary

Sovereign wealth funds (SWFs) are investment funds owned and managed by national governments. Such funds currently manage between \$1.9 and \$2.9 trillion and are expected to grow to over \$10 trillion by 2015. This is due to the rapid growth of commodity prices and large trade surpluses in several emerging market economies. Beginning in 2007, interest in SWFs increased as Asian and Middle Eastern SWFs, fueled by surging foreign exchange reserves, invested large sums of capital in U.S. and other Western companies.

Policy makers in the United States have raised two broad policy concerns about SWFs: (1) their lack of transparency and (2) their possible misuse for political or other non-commercial goals. Hearings have been held by several congressional committees including the House Financial Services Committee and the Senate Foreign Relations and Senate Banking Committees.

SWFs pose a complex challenge for policy makers. On one hand, SWFs are long-term investment vehicles looking beyond quarterly results and therefore serve as stable funding sources during financial turbulence. On the other hand, however, there are operational concerns stemming from government control (i.e., lack of transparency and possible non-commercial investment goals). Without transparency, it is difficult to attain a clear picture of SWF investment activity. A lack of SWF transparency can also obscure governance and risk-management problems within SWFs. Many are also concerned that countries will use SWFs to support what one analyst has called “state capitalism,” using government-controlled assets to secure stakes around the world in strategic areas such as telecommunications, energy and mineral resources, and financial services, among other sectors.

In response to these concerns, many analysts and policy makers are evaluating the operations of existing SWFs and are looking to the international financial institutions such as the International Monetary Fund, World Bank, and the Organization for Economic Cooperation and Development to establish guidelines for SWF operations. All of these institutions are currently developing proposals that will be deliberated during 2008. This report will be updated as events warrant.

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## Introduction

Sovereign Wealth Funds (SWFs) are investment funds owned and managed by national governments. Originally created in the 1950s by oil and resource-producing countries to help stabilize their economies against fluctuating commodity prices, and to provide a source of wealth for future generations, they have proliferated considerably in recent years. Although their lack of transparency makes estimating SWF investment levels difficult, it is estimated that they currently manage between \$1.9 and \$2.9 trillion.<sup>1</sup> Estimates of their growth over the next several years vary, with the consensus hovering around Morgan Stanley's projection of \$10 trillion by 2015.<sup>2</sup> Early estimates were higher, but it appears that the global financial crisis has led SWF growth to slow due to losses by SWFs on the value of their existing portfolios, lower commodity prices, and the likelihood that some developing countries will tap into their SWF resources for domestic purposes.

SWFs can be funded through a variety of means, including profits from the sale of commodities (such as oil) or a current account surplus. SWFs can be established to serve several different objectives. These may include diversifying national assets, stabilizing the domestic economy against volatile commodity prices, saving for future generations, getting a better return on investment than traditional foreign exchange reserves, and promoting political or strategic interests.

The dramatic recent increase in SWF activity has raised concerns about this relatively unexamined class of international investors. This report provides background on SWFs, including what countries operate SWFs and the size of the SWF market, and discusses two broad areas of concern to Members of Congress and the international financial community:

- governance and transparency-related issues, and
- possible non-commercial investment goals, including the potential use of government-controlled investment vehicles to attain global strategic and political goals.

Some U.S. policy makers stress that their concerns about SWFs are not meant to undermine the U.S. commitment to open investment. They maintain that the United States is one of the most open economies in the world and note that foreign investment in the United States provides many benefits, including lower interest rates, increased employment, productivity, and access to capital for American enterprise. Indeed, for countries such as the United States, which have both a high national budget deficit and historically low levels of public savings, foreign investment has been crucial.<sup>3</sup>

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<sup>1</sup> All figures are in U.S. dollars.

<sup>2</sup> Stephen Jen, "SWFs' Growth Tempered: US\$10 Trillion by 2015," *Morgan Stanley Research Global*, October 30, 2008.

<sup>3</sup> For more information on foreign investment in the U.S. economy, see CRS Report RS21857, *Foreign Direct Investment in the United States: An Economic Analysis*, by James K. Jackson.

## Background

The rising profile of SWFs is a direct consequence of the massive accumulation of global foreign reserve assets over the past decade. While reserve accumulation has occurred in many emerging market economies, it has been especially sharp among oil producers and Asian countries that have large trade-surpluses with the United States and other developed countries. In these countries, reserves have swelled to levels far in excess of the amount needed for balance of payments support, thus presenting an opportunity for foreign exchange reserve managers to maximize returns.

Foreign exchange reserves are traditionally invested in low-risk assets such as U.S. Treasury bills, but their recent growth has seen an increasing shift of excess reserves to higher-risk, higher-return investments. In contrast to traditional foreign exchange reserves, SWFs invest in a much broader array of assets, including stocks, bonds, fixed assets, commodities, derivatives, and alternative investments such as real estate and hedge funds. Like private hedge funds and government pension funds, SWFs often rely on outside expertise and professional fund managers.<sup>4</sup>

Two key forces drove congressional interest in SWFs during the 110<sup>th</sup> Congress: (1) the introduction of new funds and (2) major acquisitions by existing SWFs following large losses by Western financial institutions from the U.S. sub-prime mortgage crisis. Many point to the September 29, 2007, launch of the new China Investment Corporation, Ltd. (CIC), with \$200 billion of capital as a catalyst of the initial Western interest in SWFs.<sup>5</sup>

While SWFs represent a small percentage of all investment classes globally, their rapid and projected growth could increase demand for riskier assets, including equities and bonds. Deutsche Bank estimates that future SWF asset allocation could lead to a gross capital inflow of over \$1 trillion into global equity markets and \$1.5 trillion into global debt markets over the coming five years.<sup>6</sup> Merrill Lynch, using more aggressive assumptions, estimates that \$3.1 to \$6 trillion is likely to be invested in riskier assets by SWFs in the next five years.<sup>7</sup> While SWF investments peaked during the financial crisis in 2007-8, with many foreign SWFs taking large stakes in Western financial institutions, it appears that the pace of investments has tailed off.

## What Are Sovereign Wealth Funds (SWFs)?

While the term “Sovereign Wealth Fund” was coined only recently, SWFs have a more than 50-year history, with the first fund established by Kuwait in 1953.<sup>8</sup> There is no universally agreed upon definition of SWFs. The U.S. Treasury Department narrowly defines SWFs as “a

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<sup>4</sup> Stephen Jen, “Economics: How Much Assets Could SWFs Farm Out?” *Morgan Stanley Global Research*, January 10, 2008.

<sup>5</sup> See CRS Report RL34337, *China’s Sovereign Wealth Fund*, by Michael F. Martin.

<sup>6</sup> Steffen Kern, “Sovereign Wealth Funds - State Investments on the Rise,” *Deutsche Bank Research*, September 10, 2007.

<sup>7</sup> Alex Patelis, “The Overflowing Bathtub, the running tap and SWFs,” *Merrill Lynch Economic Analysis*, October 6, 2007.

<sup>8</sup> For the first use of the term Sovereign Wealth Fund, see Andrew Rozanov, “Who Holds the Wealth of Nations,” *State Street Global Advisors*, August 2005, at [http://www.ssga.com/library/esps/Who\\_Holds\\_Wealth\\_of\\_Nations\\_Andrew\\_Rozanov\\_8.15.05REVCCRI1145995576.pdf](http://www.ssga.com/library/esps/Who_Holds_Wealth_of_Nations_Andrew_Rozanov_8.15.05REVCCRI1145995576.pdf).

government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities (the Central Bank and reserve-related functions of the Finance Ministry).”<sup>9</sup> The U.S. Treasury Department’s definition is meant primarily to distinguish SWF investment from official reserves managed by a country’s central bank. Because the primary goals of official foreign reserves are liquidity and security, the investment horizon for these for reserves is short.

Some observers provide a more detailed definition of SWFs. Stephen Jen, a currency analyst at Morgan Stanley, expands on the Treasury definition to provide a broader understanding of SWFs and how they differ from official foreign reserves and other government-sponsored funds. According to Jen, there are five key traits of SWFs. They are (1) sovereign government entities with (2) high foreign currency exposures, (3) no explicit liabilities (such as a national state pension fund), (4) high-risk tolerances, and (5) long investment horizons.<sup>10</sup>

The IMF divides SWFs into several categories based on their stated goals. In practice, however, many SWFs combine elements of the following three categories. The three primary types of SWFs, according to the IMF, are as follows:

**(1) Stabilization funds**—Volatile international market prices are a primary concern for resource- and commodity-intensive economies. Some commodities face price fluctuations of an average of 20%-25% per year. To mitigate this volatility, several countries have established funds to sterilize capital inflows<sup>11</sup> and stabilize fiscal revenues. Because stabilization funds serve a more immediate function than long-term savings funds, they tend to be more conservative in their investment decisions, focusing on fixed income rather than equity investments.<sup>12</sup> Examples include Russia’s Stabilization Fund of the Russian Federation and Kazakhstan’s National Oil Fund.

**(2) Savings funds**—Savings funds are intended to share wealth across generations. For countries rich in natural resources, savings funds convert non-renewable natural resources into a diversified portfolio of international financial assets to provide for future generations or other long-term objectives. According to the IMF, while newer oil funds predominantly focus on stabilization objectives, the recent increase in oil prices has allowed SWFs to emphasize savings objectives. Because savings funds have longer investment horizons than pure stabilization funds, they invest in a broader range of assets, including bonds and equities, as well as other forms of alternative investments, such as real estate, private equity, hedge funds, and commodities. Examples include the Abu Dhabi Investment Authority, Kuwait Investment Authority, Singapore’s Government Investment Corporation, and the China Investment Corporation.

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<sup>9</sup> “Report to Congress on International Economic and Exchange Rate Policies,” Department of the Treasury, December 2007, at <http://www.treas.gov/offices/international-affairs/economic-exchange-rates/>.

<sup>10</sup> Stephen Jen, “Currencies: The Definition of a Sovereign Wealth Fund,” *Morgan Stanley Research*, October 25, 2007.

<sup>11</sup> Currency sterilization is a form of monetary action in which a country’s central bank attempts to insulate itself from the foreign exchange market to counteract the effects of a changing monetary base by selling or buying the domestic currency in the foreign exchange market to stabilize the value of the domestic currency. For more information, see Jang-Yung Lee, “Sterilizing Capital Inflows,” International Monetary Fund, 199, at <http://www.imf.org/external/pubs/ft/issues7/issue7.pdf>.

<sup>12</sup> Rachel Ziemba, “Responses to Sovereign Wealth Funds: Are ‘Draconian’ Measures on the Way?,” *RGE Monitor*, November 2007.

**(3) Reserve investment corporations**—Reserve investment corporations are funds established to reduce the opportunity cost of holding excess foreign reserves or to pursue investment policies with higher returns. Reserve investment corporations adapt more aggressive investment strategies, including taking direct equity stakes. These funds typically seek higher returns than other SWFs and use leverage (i.e., debt) in their investments. Historically, these vehicles tend to be more secretive than other SWFs that are primarily portfolio investors.<sup>13</sup> Examples of such funds are Singapore’s Temasek, Qatar’s Investment Authority, and Abu Dhabi’s Mubadala.<sup>14</sup>

Among funds, there are substantial differences in risk-return profiles, investment horizons, asset allocation, eligible instruments, risk tolerances, and constraints.<sup>15</sup> Because each fund is different and has varying goals and objectives, it is difficult to generalize about the investment strategies of SWFs as a class. For example, an oil-exporting economy may initially establish a SWF for stabilization purposes. However, if the assets under management by the SWF grow to exceed the levels needed for stabilization, the country may either change the priorities and investment strategy of the fund or establish a separate fund with a more aggressive investment approach. Thus, several countries have multiple sovereign wealth funds. For example, the United Arab Emirates’s primary fund, the Abu Dhabi Investment Authority (ADIA), was established in 1974 to invest surplus cash in assets that provide steady gains and returns over a long time-horizon using a portfolio investment strategy. In 2002, the United Arab Emirates established Mubadala Development to pursue direct investment projects targeted at higher returns.

## What Countries Operate SWFs?

The first SWF was established by Kuwait in 1953 as a means to help stabilize the economy from fluctuating oil prices.<sup>16</sup> In 1956 the Gilbert Islands (now Kiribati) established the Revenue Equalization Reserve Fund to manage profits from phosphate mining. Following Kuwait and Kiribati, the next major SWFs were created in the 1970s in the wake of the oil shock. The most recent wave began in the 1990s with the Norway Government Pension Fund-Global in 1990 and continues to this day. In the last five years, funds have been established by China, Iran, Russia, Qatar, and the United Arab Emirates.

As noted previously, the recent growth of SWFs is a consequence of rapid growth in emerging market reserves driven by (1) the impact of rising oil prices for Middle Eastern economies and (2) large trade surpluses, net foreign direct investment flows, and high savings rates among Asian economies. Reserve accumulation has been especially sharp in the case of China, where there has been extensive intervention in the foreign exchange markets to limit the yuan’s appreciation against the dollar.<sup>17</sup>

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<sup>13</sup> Similar entities to SWFs that raise many of the same concerns are state-backed companies engaged in foreign acquisitions. For example, in 2005 an attempt by the China National Offshore Oil Cooperation (CNOOC) to purchase the U.S. energy company Unocal raised substantial congressional concerns and was eventually abandoned. For more information on the CNOOC case, see CRS Report RL33093, *China and the CNOOC Bid for Unocal: Issues for Congress*, by Dick K. Nanto et al.

<sup>14</sup> “Global Financial Stability Report: September 2007,” *International Monetary Fund*, September 2007.

<sup>15</sup> For more information on the challenges of establishing a SWF, see Andrew Rozanov, “Sovereign Wealth Funds: Defining Liabilities,” *State Street Global Advisors*, May 2007.

<sup>16</sup> The first Kuwaiti SWF was called the Kuwait Investment Board. It was later acquired by a separate fund, the Kuwait Investment Authority, which was founded in 1960.

<sup>17</sup> CRS Report RL32165, *China’s Currency: Economic Issues and Options for U.S. Trade Policy*, by Wayne M. (continued...)

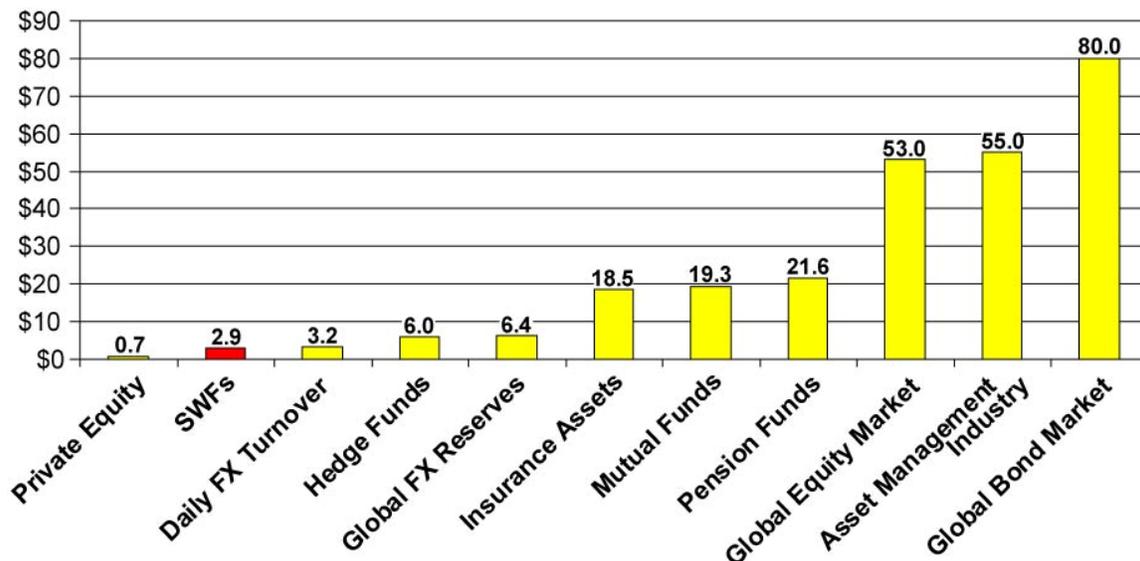
Analysts estimate that foreign assets held by sovereign nations currently exceed \$5 trillion and are, as the growing U.S. current account imbalance would indicate, increasing at a significantly more rapid rate in emerging market countries with high savings rates than in the industrialized countries.

## The Size of SWFs

It is difficult to accurately measure the amount of assets under management by SWFs because many funds do not disclose much information about their operations and assets. The funds believed to be the largest do not disclose their size, investment strategies, or current holdings. Estimates for the size of the largest fund, the United Arab Emirates' ADIA, for example, range widely between \$500 and \$900 billion. Reportedly, ADIA has achieved a 20% rate of return for many years and rarely considers deals less than \$100 million.<sup>18</sup>

Official and private sector analysts estimate that there is between \$1.9 and \$2.9 trillion under management by SWFs. This is significantly smaller than other investment classes (**Figure 1**).

**Figure 1. Segments of the Global Capital Market, USD Trillion, 2007**



Source: Norges Bank

However, analysts expect that if oil prices remain, and there no immediate correction of current global imbalances, SWFs will grow rapidly over the next few years. Morgan Stanley estimates that if foreign reserves continue to increase at a current pace, they could grow to \$12 trillion by 2015.<sup>19</sup> Several factors could weaken these growth projections, including a cyclical economic downturn, a reduction in oil prices, or a weakening of competitiveness in Asian exporting economies. On the contrary, given the rapid increase in emerging market foreign exchange

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Morrison and Marc Labonte.

<sup>18</sup> Henny Sender, Live at Apollo (Management): Plan to Cash In, Limit Scrutiny, *Wall Street Journal*, July 17, 2007.

<sup>19</sup> Stephen Jen, "Currencies: How Big Can Sovereign Wealth Funds Be by 2015," *Morgan Stanley Global Research*, May 3, 2007.

reserves, if countries decide to increase transfers from official reserves to SWFs, projected figures could be substantially higher. SWFs financed by oil and gas exports are estimated to account for around two thirds of SWFs by amount invested. Asian funds financed by current account surpluses make up the rest.<sup>20</sup> **Table 1** provides a list of the largest funds. **Figure 2** combines global foreign reserve growth with recent growth of Asian and oil SWFs.

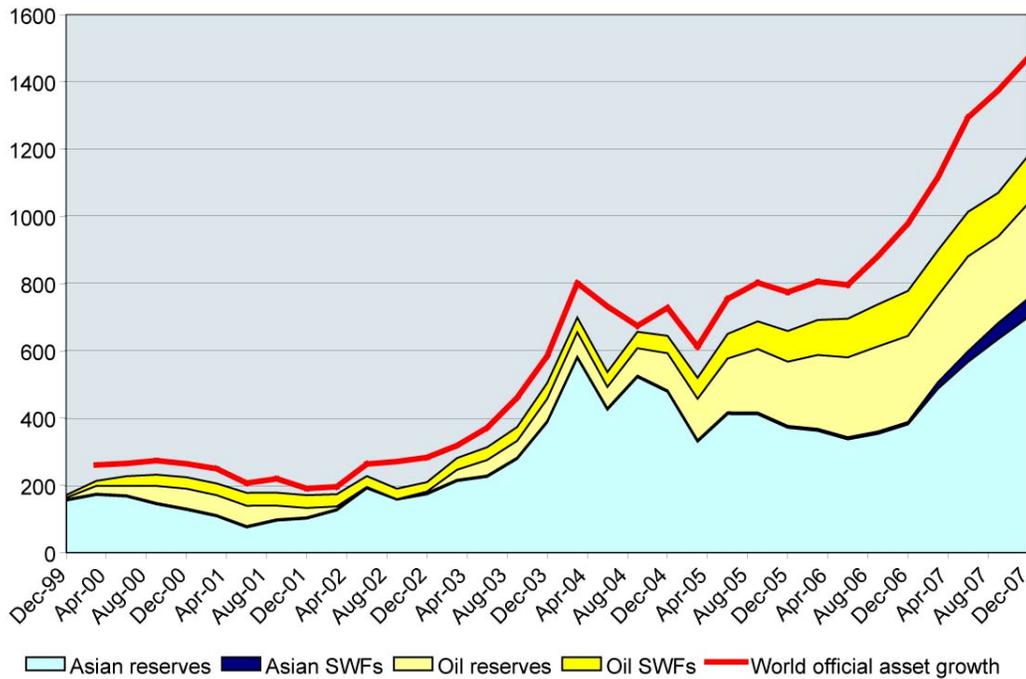
**Table 1. Large Sovereign Wealth Funds**

Country	Name	Date Est.	Current Size (\$ billions)	Source of Funds
<b>United Arab Emirates</b>	Abu Dhabi Investment Authority and Corporation	1976	500-875	Oil
	Mubadala Development Company	2002	10	Oil
<b>Norway</b>	Isithmar	2003	4	Oil
	Government Pension Fund—Global	1990	329	Oil
<b>Singapore</b>	Government of Singapore Investment Corporation	1981	100-330	Other
	Temasek Holding	1974	108	Other
<b>Kuwait</b>	Kuwait Investment Authority	1960	213	Oil
<b>Russia</b>	Stabilization Fund of the Russian Federation	2004	141	Oil
<b>China</b>	China Investment Corporation	2007	200	Other
<b>Qatar</b>	Qatar Investment Authority	2005	50	Oil
<b>Australia</b>	Future Fund	2006	49	Other
<b>Algeria</b>	Revenue Regulation Fund	2000	43	Oil
<b>United States</b>	Alaska Permanent Fund	1976	40	Oil
<b>Brunei</b>	Brunei Investment Agency	1983	30	Oil
<b>Korea</b>	Korea Investment Corporation	2005	20	Other
<b>Kazakhstan</b>	National Oil Fund	2000	19	Oil, Gas
<b>Malaysia</b>	Khazanah Nasional	1993	18	Other
<b>Venezuela</b>	National Development Fund	2005	15	Oil
	Macroeconomic Stabilization Fund	1998	1	Oil
<b>Canada</b>	Alberta Heritage Savings Trust Fund	1976	15	Oil
<b>Chile</b>	Economic and Social Stabilization Fund	2006	10	Other
<b>New Zealand</b>	Superannuation Fund	2001	10	Other
<b>Iran</b>	Oil Stabilization Fund	2000	9	Oil

**Source:** Peterson Institute for International Economics

<sup>20</sup> Stephen Jen, “How Big Could Sovereign Wealth Funds Be by 2015,” *Morgan Stanley Perspectives*, May 3, 2007.

**Figure 2. Global Reserve Growth and SWFs**  
(USD Billion, rolling 4<sup>th</sup> quarter sums)



Source: RGE Monitor

## Policy Issues for Congress

The magnitude of financial impact combined with the lack of transparency and possibly political investment motivations of non-commercial entities has sparked concern among some analysts and Members of Congress about the rapidly growing wealth of emerging market countries and how this wealth is being invested in the United States. Hearings on SWFs have been held in several congressional committees including the Senate Banking Committee, Senate Foreign Relations Committee, House Financial Services, House Foreign Affairs Committee, and the Joint Economic Committee.<sup>21</sup> In addition to hearings, Senator Richard Shelby (AL) has requested a study from the Government Accountability Office (GAO) to ensure that SWFs are “effectively monitored.”<sup>22</sup>

<sup>21</sup> Congressional hearings on SWFs include:

1. Senate Committee on Banking, Housing, and Urban Affairs hearing, “Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the U.S.: Assessing the Economic and National Security Implications,” November 14, 2007;
2. Joint Economic Committee hearing, “Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?,” February 13, 2008;
3. House Financial Services Subcommittee on Domestic and International Monetary Policy, Trade and Technology, and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises hearing, “Foreign Government Investment in the U.S. Economy and Financial Sector,” March 5, 2008;
4. Senate Banking Committee hearing, “Turmoil in U.S. Credit Markets: Examining the U.S. Regulatory Framework for Assessing Sovereign Investments,” March 24, 2008;
5. House Foreign Affairs Committee hearing, “The Rise of Sovereign Wealth Funds: Impacts on U.S. Foreign Policy and Economic Interests,” May 21, 2008; and

(continued...)

In his opening remarks at the first congressional SWF hearing, before the Senate Banking Committee on November 13, 2007, Senator Evan Bayh (IN) neatly summarized the two primary concerns about SWF activity in the United States and the challenge they present:

A lack of transparency that characterizes many sovereign wealth funds undermines the theory of efficient markets at the heart of our economic system. In addition, unlike private investors, pension funds and mutual funds, government owned-entities may have interests that will take precedence over profit maximization. Just as the United States has geopolitical interests in addition to financial ones, so do other countries. Just as we value some things more than money, so do they. Why should we assume that other nations are driven purely by financial interests when we are not?<sup>23</sup>

The political challenges facing U.S. leaders are aptly summarized by Senator Charles Schumer (NY):

Right now, the U.S. finds itself in a difficult position. Some of our financial institutions have made mistakes and need capital. So we're short of capital because of the credit crunch, and in the longer run because of our own habits. We import more than we export; we consume more than we save. The best choice would be that financial institutions could raise capital within the U.S. But we don't have that choice. So they raise capital from where it exists, and sovereign wealth funds are the most available form of capital right now. Or [financial institutions] can dramatically shrink, and we can lose thousands and thousands of jobs. The choice is a simple one, and the issue with sovereign wealth funds can be defined in a single sentence: Because they are government-owned, noneconomic factors may influence their decision-making and the pressure they put on companies that they own a piece of.<sup>24</sup>

Given these concerns, Congressional attention on SWFs has focused on two broad areas, namely (1) the lack of SWF transparency and (2) the potential use of SWF capital for strategic or political (i.e., non-commercial) purposes. These concerns as applied to specific SWFs are mapped in **Figure 3**. The X axis illustrates fund transparency, or levels of disclosure. The Y axis measures the active, or strategic, nature of their stated (or perceived) investment philosophy. For example, the funds of Norway, Alaska, and Alberta, Canada, are conventionally invested in a wide range of investments and are highly transparent. Malaysia's SWF and Singapore's Temasek, while also highly transparent, pursue a more strategic approach to their investments, targeting various industries that are of interest to their respective governments. The funds in the upper-left quadrant are of most concern to Western policy makers. These are the funds that disclose the least information about their funds and are the most strategic in their investment philosophy. A third issue that has sparked some congressional interest is how the United States taxes gains on investments in the United States made by SWFs.

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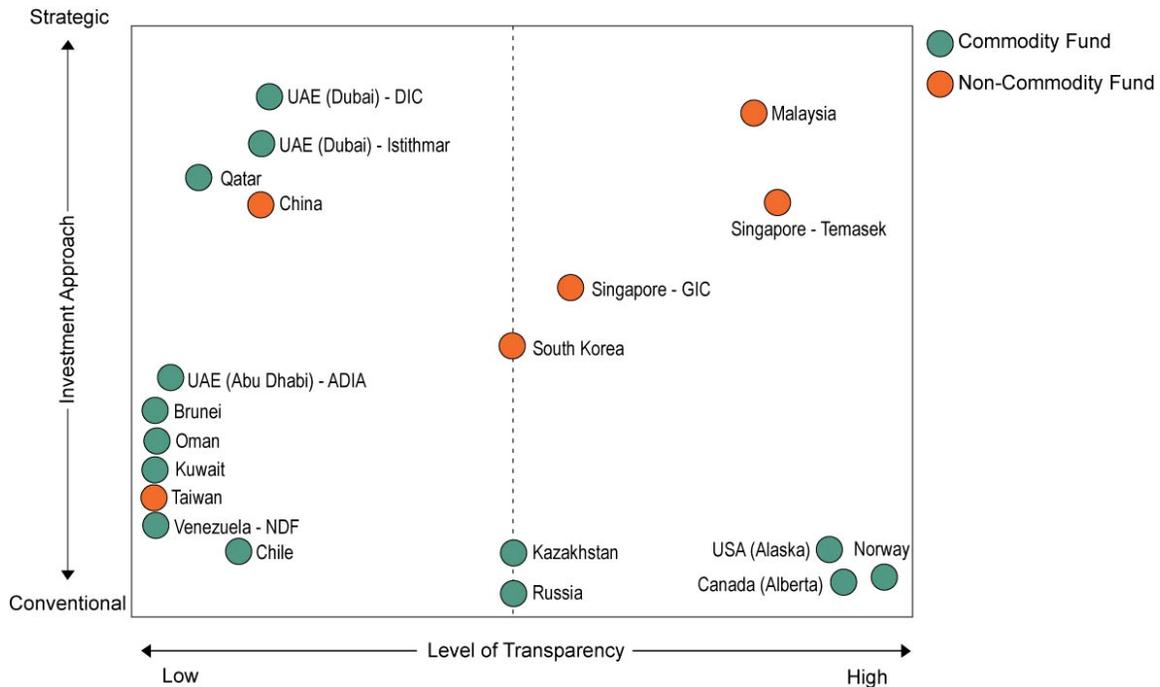
6. Senate Foreign Relations Committee hearing, "Sovereign Wealth Funds: Foreign Policy Consequences in an Era of New Money," June 11, 2008.

<sup>22</sup> Christopher S. Rugaber, "Agency Investigates Sovereign Funds," Associated Press, January 11, 2008. Available at <http://www.forbes.com/feeds/ap/2008/01/11/ap4522903.html>.

<sup>23</sup> Senate Banking, Housing and Urban Affairs Committee Hearing on Foreign Government Investment in the United States, November 14, 2007.

<sup>24</sup> Maria Bartiromo, "Chuck Schumer on the Rise of Sovereign Wealth Funds," BusinessWeek, March 6, 2008.

**Figure 3. Standard Chartered Ranking of SWFs, by Investment Approach and Transparency**



Source: Standard Chartered and Oxford Analytica

## Transparency and Governance-Related Concerns

Given the recent and projected growth of SWFs, many analysts stress the need for increased transparency of SWF activity. There are no supra-national regulations or disclosure requirements for the size of SWFs, their investment strategies, or their current holdings. Unlike privately owned, nationally regulated funds, SWFs are not required to provide information to stock-holders and stake-holders. “In terms of disclosure on fund performance, investment strategy, or even basic philosophy, many [SWFs] rank below the most secretive hedge fund,” according to Gary Kleiman, a senior partner at Kleiman International Consultants, an emerging financial markets consulting group.<sup>25</sup> Of the existing national funds, only Norway’s fund is universally considered to be transparent and publically accountable.

Minimal SWF transparency masks SWF investment activity and can obscure governance and risk-management problems within the funds. This can have distressing consequences for policy makers. First, without insight into SWF activity, it is difficult to assess systemic risks or to determine whether SWFs are in fact pursuing strategic, non-commercial investment strategies (see next section). Second, limited disclosure makes it difficult to assess the management and governance of the funds and therefore difficult to identify mismanagement or corruption by fund managers. Conflating this problem, many of these SWFs are established in countries that currently lack the underpinnings for good SWF governance or SWF oversight. This is of concern to policy makers, because sizable failures due to poor management, particularly if concentrated within certain sectors, could affect national or global markets.

<sup>25</sup> Tony Tassell and Joanna Chung, “The \$2,500 Question,” *Financial Times*, May 25, 2007.

Some analysts have tried to empirically measure the lack of SWF transparency. The Peterson Institute of International Economics (PIIE) has tabulated a SWF scorecard, that among other variables, looks at transparency and accountability.<sup>26</sup> For its transparency and accountability figure, PIIE scored several questions, including the following:

- Do regular reports on the investments by the SWF include the size of the fund? Information on the returns it earns?
- Do reports provide information on the types of investments? Information on the geographic location of investments? Information on the specific investments, for example, which instruments, countries, and companies? Information on the currency composition of investments?
- Is the SWF subjected to a regular audit? Is the audit published? Is the audit independent?

Consistent with **Figure 2** above, the PIIE found that the largest funds (i.e., those owned by the United Arab Emirates, Qatar, Kuwait, and China) scored very low on the transparency and accountability rankings.

## Non-Commercial Investment Motives

While the ostensible goal of SWF investment is long-term value creation, government control could mean that a SWF may be motivated by non-commercial considerations in its investment decisions. Felix Rohatyn, a prominent investment banker and former U.S. official, has noted that for many funds, political and commercial objectives are closely intertwined. According to Mr. Rohatyn, “they are making investments that they probably think are O.K. but not spectacular.”<sup>27</sup> However, for these funds, “there has to be a political objective over and above the rate of return.”<sup>28</sup>

Many U.S. policy makers are concerned that countries will use SWFs to support what one analyst has called “state capitalism,” using government-controlled assets to secure strategic stakes around the world in areas such as telecommunications, energy resources, and financial services, among other sectors.<sup>29</sup> Recent deals in the energy and finance sector suggest that securing access to natural resources and developing domestic financial markets appear to be the two primary SWF strategic objectives.<sup>30</sup>

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<sup>26</sup> Edwin M. Truman, “Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications,” Testimony before the Committee on Banking, Housing, and Urban Affairs United States Senate, November 14, 2007. Testimony is available at <http://iie.com/publications/papers/truman1107.pdf>.

<sup>27</sup> Andrew Ross Sorkin, “What Money Can Buy: Influence,” *The New York Times*, January 22, 2008, at <http://www.nytimes.com/2008/01/22/business/22sorkin.html?dlbk>.

<sup>28</sup> Ibid.

<sup>29</sup> Gerald Lyons, “State Capitalism: The Rise of Sovereign Wealth Funds,” *Standard Chartered*, October 15, 2007. Document is available from the author.

<sup>30</sup> Richard Portes, “Sovereign Wealth Funds,” *VOXEU*, October 17, 2007, at <http://www.voxeu.org/index.php?q=node/636>. See also Huw Van Stenis, “Banks & Financials: Sovereign Wealth Funds—building stakes in financials,” *Morgan Stanley Research Europe*, September 24, 2007.

A report by Citigroup notes that “some sovereign wealth funds invest purely to achieve financial returns and portfolio diversification while others have a broader economic or social agenda.”<sup>31</sup> Such an agenda could be benign; many countries have expressed their interest in using investments in foreign financial institutions to acquire knowledge and technology to help build their own domestic financial institutions. On the other hand, many are concerned that countries may use their SWFs to gain access to other countries’ natural resource industries or other politically sensitive sectors. Such concern is not limited to Western countries. In January 2006, one of Singapore’s SWFs, Temasek, purchased from the family of then-Prime Minister Thaksin Shinawatra a controlling stake in the Thai telecom company Shin Corporation, which included taking control of space satellites used by the Thai military. This purchase sparked a political crisis in Thailand, which eventually led to the ousting of Thaksin’s government.

## **U.S. Taxation of SWFs**

Members have begun raising concerns about U.S. tax policy regarding investments in the United States by foreign SWFs, specifically a long-standing exemption from U.S. income tax that applies to certain passive investments made by SWFs and other investments made by foreign sovereigns. Under Section 892 of the U.S. Internal Revenue code, foreign governments are exempted from income tax on certain passive investments in the United States. Thus, a foreign government’s income from investments in the United States in stocks, bonds, and other domestic securities, financial instruments held in the execution of governmental fiscal or monetary policy, and interest on deposits in U.S. banks are exempt from US tax. Section 892 also carves an exception for income derived from a commercial activity by a foreign government, or a foreign-controlled commercial entity. The gains on passive investment, however, is not considered by the U.S. Internal Revenue Service (IRS) as a commercial activity.

In March 2008, Senators Max Baucus and Chuck Grassley, chairman and ranking member of the Senate Committee on Finance requested that the Joint Committee on Taxation (JTC), a nonpartisan House-Senate committee of the U.S. Congress, undertake a study to “analyze the history, current rules, and policy underpinnings of the U.S. tax rules applicable to U.S. investment by foreign governments, including investments made by Sovereign Wealth Funds.”<sup>32</sup> The JTC’s final report found that treatment as a foreign sovereign imparts limited but significant advantages to foreign governments over foreign private investors. According to the JTC’s final report,

In practice, some of the most important statutory U.S. income tax advantages that a foreign sovereign investor enjoys over a foreign private investor are: exemption from U.S. withholding tax on all U.S. source dividends paid by noncontrolled corporations; exemption from U.S. withholding tax on interest paid by a corporation where the foreign sovereign owns at least 10% (so the general “portfolio interest” exemption is not available) but less than 50% (so the payor is not “controlled” by the foreign sovereign) of the payor; and exemption from U.S. tax on certain gains from real estate transactions.<sup>33</sup>

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<sup>31</sup> The World Economic Forum ranks the United States first in its 2007 competitiveness report. *The Global Competitiveness Report 2007-2008*, World Economic Forum, at <http://www.gcr.weforum.org/>.

<sup>32</sup> “Baucus, Grassley Seek JCT Analysis of U.S. Taxation of Sovereign Wealth Funds,” United States Senate Committee on Finance, March 13, 2008.

<sup>33</sup> Joint Committee on Taxation, Economic and U.S. Income Tax Issues Raised by Sovereign Wealth Fund Investment in the United States (JCX-49-08), June 17, 2008.

Some analysts propose revising the U.S. tax code to tax SWFs the same as foreign private investors are. Victor Fleischer, a law professor at the University of Illinois, has proposed that the baseline tax rate on any SWF investment in the United States could be raised to equal the flat 30% rate on income from passive investment levied on foreign individuals or corporations. According to Prof. Fleischer, “This approach would raise significant amounts of tax revenue, and it would give the U.S. a new policy lever to achieve nontax objectives, such as encouraging SWFs to comply with best practices of transparency, disclosure, and accountability.”<sup>34</sup> To date, no legislation has been introduced that would move to remove the tax exemption granted foreign SWFs.

## **Existing legislation on foreign investment**

Congress has broad powers regulating foreign investment in the United States. While there is no express constitutional provision permitting the regulation of foreign investment in the United States, justification for congressional legislation regulating foreign investment includes federal powers over immigration and naturalisation, the federal power to regulate interstate and foreign commerce, and the power to provide for the national defense.<sup>35</sup> Of course there are already some restrictions on foreign investment in the United States, but existing legislation is transaction-specific and not entity-specific. Thus, there is no legislation that specifically regulates sovereign wealth funds as a unique class of investors. However, certain sectors of the American economy, such as the financial sector, telecommunications, energy, among others, have statutory limitations on the types and amounts of investments in which non-American individuals and entities can participate. In addition, the United States has legislation that allows the president to block any investment which may impact national security.

## **Banking**

The relevant statute regarding investments by sovereign wealth funds in the American banking sector is the Bank Holding Company Act, which regulates a “bank holding company” – that is, any company that controls an American bank, meaning any bank chartered by the federal or state government to do business in the United States. It is important to distinguish between bank holding companies from foreign banks, which are chartered in their home countries, but do business in the United States.

The Bank Holding Company Act defines “control” of a bank or bank holding company as follows: the acquisition of a 25% share or more of any class of voting securities; controlling the election of a majority of the directors or trustees; or having been determined by the Federal Reserve to be exercising a controlling interest over the management or policies of the entity. The law presumes that “any company which owns, controls, or has power to vote less than 5% of any class of voting securities of a given bank or [bank holding] company does not have control over that bank or company.”

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<sup>34</sup> Victor Fleischer, “Taxing Sovereign Wealth Funds,” *The Conglomerate*, March 4, 2008. Available at <http://www.theconglomerate.org/2008/03/taxing-sovereig.html>. See also Victor Fleischer, “A Theory of Taxing Sovereign Wealth,” University of Illinois Law & Economics Research Paper Series, LE08-030, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1234410](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1234410).

<sup>35</sup> . See CRS Report RL33103, *Foreign Investment in the United States: Major Federal Statutory Restrictions*, by Michael V. Seitzinger.

Foreign companies are subject to the Bank Holding Company Act unless: they are organized as a banking holding company under foreign law and are principally engaged in the banking business outside the United States; they control less than 5% of the outstanding shares of a class of voting stock; the Federal Reserve determines that an exemption would “not be substantially at variance with the purposes of the [Bank Holding Company Act] and would be in the public interest.”

## **Securities**

Added as part of the Foreign Corrupt Practices Act of 1977, the Domestic and Foreign Investment Improved Disclosure Act of 1977 requires that any entity acquiring 5% or more of the equity securities of a company registered with the Securities Exchange Commission must disclose certain specified information including their citizenship and residence. According to one legal expert, “The 5% threshold ... explains the levels of investment of sovereign wealth funds, which have been and will almost certainly continue to be in amounts below the 5% level.

## **National security**

American law also provides statutory authority for the Committee on Foreign Investment in the United States (CFIUS), a multi-Cabinet member board led by the Secretary of the Treasury, to review certain foreign investment and determine whether such investment raises a national security threat to the United States and then make a recommendation to the president whether or not to prohibit the transaction.<sup>36</sup> By law, CFIUS can review “covered transactions,” which includes any merger, acquisition, or takeover by any foreign person, which could result in foreign control of any person engaged in interstate commerce in the United States.

The statutory limitation on “mergers, acquisitions, and/or takeovers” appears to lead to the conclusion that CFIUS is not legally required to review the types of transactions that sovereign wealth funds have invested in to date. However, if sovereign wealth funds were to begin assuming ownership stakes of American companies in critical sectors, there may be a larger role for CFIUS in reviewing their transactions in the future.

## **The Global Response to SWFs**

At the G7 Finance Ministers meeting in October 2007, ministers discussed SWFs for the first time, noting that they are “increasingly important participants in the international financial system and that our economies can benefit from openness to SWF investment flows.” The final G7 communique for the meeting stated that the IMF, World Bank, and the OECD should explore best practices for SWFs in key areas such as institutional structure, risk management, transparency, and accountability.<sup>37</sup> Secretary of the Treasury Henry Paulson further elaborated on this in his remarks to the International Monetary and Finance Committee of the IMF:

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<sup>36</sup> For more information on CFIUS, see CRS Report RL33312, *The Exon-Florio National Security Test for Foreign Investment*, by James K. Jackson; CRS Report RL33388, *The Committee on Foreign Investment in the United States (CFIUS)*, by James K. Jackson; and Edward M. Graham and David M. Marchick, U.S. National Security and Foreign Direct Investment, Peterson Institute for International Economics, May 2006.

<sup>37</sup> Statement of G-7 Finance Ministers and Central Bank Governors, October 19, 2007, at <http://treas.gov/press/releases/hp625.htm>.

The United States believes a multilateral approach to SWFs that maintains open investment policies is in the best interest of countries that have these funds, and countries in which they invest. The IMF is uniquely positioned to identify best practices for SWFs, building on the existing Guidelines for Foreign Exchange Reserve Management. Best practices would provide multilateral guidance to new funds on how to make sound decisions on how to structure themselves, mitigate any potential systemic risk, and help demonstrate to critics that SWFs can be constructive, responsible participants in the international financial system. Recipient countries of SWF investment also have a responsibility to maintain openness to investment and should work through the OECD to develop best practices for inward government-controlled investment.<sup>38</sup>

To address concerns related to the lack of SWF transparency, some have called for an international body, such as the IMF, to establish guidelines and monitor countries' compliance with transparency efforts. Proponents maintain that increased transparency would limit the potential negative impact of greater SWF investment by allowing financial markets to better observe SWF activity and exercise any necessary market discipline. Edwin Truman, of the Peterson Institute for International Economics, argued during November 2007 Senate Banking Committee hearings on SWFs that

[t]he development of a set of best practices for sovereign wealth funds, and similar understandings covering other cross-border government investments, offers the most promising way to increase the accountability of these activities, which are likely to increase in relative importance over the next decade. The associated increase in transparency, which is a means to the end of greater accountability, would help to reduce the mysteries and misunderstandings surrounding these governmental activities. At the same time, the environment for them would become more stable and predictable.<sup>39</sup>

During the October 20, 2007 G7 finance ministers meeting, U.S. Treasury Secretary Henry Paulson hosted an outreach dinner with top SWF managers from around the world to begin the process of negotiating increased levels of SWF transparency. There appears to be some positive reception from leading SWFs. According to Dr. Tony Tan, Executive Director of Singapore's GIC:

We believe there is a case for further disclosure on the part of sovereign wealth funds in the interest of transparency. Such disclosure can include clarity on the relationship between the funds and the respective governments, their investment objectives and general strategies, and their internal governance and risk management practices.... Any guidelines on sovereign wealth funds should encourage them to operate according to commercial principles with a long-term orientation, free from political motivations. Singapore will participate in formulating a set of principles and best practices for sovereign wealth funds.<sup>40</sup>

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<sup>38</sup> Statement by Henry M. Paulson, Jr. Secretary of the U.S. Treasury before the International Monetary and Finance Committee, International Monetary Fund, October 20, 2007, at <http://www.imf.org/external/am/2007/imfc/statement/eng/usa.pdf>.

<sup>39</sup> Edwin M. Truman, "Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications," Testimony before the Committee on Banking, Housing, and Urban Affairs United States Senate, November 14, 2007. Prepared testimony is available at [http://banking.senate.gov/\\_files/111407\\_Truman.pdf](http://banking.senate.gov/_files/111407_Truman.pdf).

<sup>40</sup> Cited in Huw van Steenis and Huberty Lam, "Sovereign Wealth Funds and Chinese Financials," *Morgan Stanley Research*, January 15, 2008.

In November 2007, the IMF convened the first of a proposed annual roundtable of sovereign asset and reserve managers. At the meeting, delegates from 28 countries discussed how best to address the policy and operational issues faced by managers of growing reserves and sovereign assets.<sup>41</sup> The IMF's work agenda on SWFs was approved at a meeting of the IMF Executive Board, which includes representatives from both sovereign investors and recipients of sovereign wealth, on March 21, 2008.

## **The Santiago Principles**

In September 2008, following four months of negotiations and several international meetings, members of the newly formed International Working Group of Sovereign Wealth Funds agreed to a voluntary code of conduct at meetings in Santiago, Chile.<sup>42</sup> Although voluntary guidelines may likely help policy makers better understand the motives and methods of existing and emerging SWFs, it is unclear whether the voluntary guidelines will satisfy Western governments, which had sought more restrictive rules requiring greater SWF transparency. Reportedly, the debate of how much financial transparency SWFs should provide was one of the more contentious issues in the working group. While some countries agreed that greater transparency would allay concerns that SWFs may use their wealth for non-economic reasons and also reassure domestic constituents that the national wealth is being appropriately invested, many countries insisted that SWFs be allowed to maintain a high degree of secrecy regarding their operations.<sup>43</sup>

The chairman of the Australian Fund Board of Guardians, David Murray, chaired a subgroup of the IWG responsible for drafting the Principles. The group met three times in Oslo, Singapore and the final meeting in Singapore, where on September 2, 2008, the IWG agreed on a set of voluntary principles, the Generally Accepted Principles and Practices for Sovereign Wealth Funds (GAPP or Santiago Principles).

The Santiago Principles are comprised of 24 principles and additional sub-principles in three broad categories: (1) legal framework, objectives, and macroeconomic linkages; (2) institutional framework and governance; and (3) investment policies and risk management frameworks (see box). While country endorsement and adherence to the Santiago Principles is voluntary and must be ratified by authorities in each national country, by committing to financial objectives and guidelines for increased transparency and disclosure of investments, the creation of the Santiago Principles appears to be the beginning of the normalization of SWFs as global institutional investors.

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<sup>41</sup> IMF Convenes First Annual Roundtable of Sovereign Asset and Reserve Managers, IMF press release No. 07/267, November 16, 2007.

<sup>42</sup> Member countries of the SWF IMF working group are: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, and the United States. Oman, Saudi Arabia, Vietnam, the OECD, and the World Bank, participate as permanent observers. The IMF helped to facilitate and coordinate the work of the IWG by providing a secretariat for the IWG.

<sup>43</sup> Krishna Gura, "Sovereign funds back code," *Financial Times*, September 3, 2008.

## **Generally Accepted Principles and Practices (GAPP) on Sovereign Wealth Funds “Santiago Principles”**

### **A. Legal Framework, Objectives, and Coordination with Macroeconomic policies**

1. Sound legal framework with a clear delineation of responsibilities between the SWF and other government bodies.
2. Clearly defined and publicly disclosed policy purpose
3. Coordination with domestic fiscal and monetary authorities
4. Clear and publically disclosed policies, rules, procedures, or arrangements regarding an SWF's funding, withdrawal, and spending operations
5. Timely reporting of statistical data

### **B. Institutional Framework and Governance Structure**

6. Sound governance framework to facilitate accountability and operational independence
7. SWF owner should set the objectives, appoint members of the governing bodies, and exercise oversight
8. Governing bodies should have a clear mandate and adequate authorities.
9. Independent operational management with clearly defined responsibilities
10. Clearly defined accountability framework
11. Annual report and financial statements should be prepared in accordance with recognized international or national accounting standards.
12. Operations and financial statements should be audited annually in accordance with recognized international or national accounting standards.
13. Clearly defined professional and ethical standards
14. Third-party dealings regarding SWF management based on economic and financial grounds
15. Respecting and complying with all applicable host country rules, laws, and regulations
16. Public disclosure of governance framework and objectives, as well as the manner in which the SWF's management is operationally independent
17. Public disclosure of financial information to demonstrate its economic and financial orientation

### **C. Investment and Risk Management Framework**

18. Clear and consistent investment policy based on sound portfolio management principles
19. Investment decisions should aim to maximize risk adjusted financial returns or if investment decisions are subject to other than economic or financial considerations, these should be clearly set out and publically disclosed
20. No seeking advantages of privileged information or government's inappropriate influence
21. Exercising shareholder ownership rights in a manner consistent with its investment policy
22. Transparent and sound operational control and risk management systems
23. Accurate and consistent reporting of investments and investment performance
24. Regular review of GAPP implementation

**Source:** IMF

## **OECD Standards for Investment in Member Countries**

While the IMF is working to establish guidelines for the management and operations of sovereign wealth funds, the OECD has an ongoing work program to establish a set of best practices for recipients of investments from SWFs.<sup>44</sup> These guidelines would draw on the OECD's extensive work on the treatment of foreign investment in OECD economies. OECD work will also draw on the OECD Guidelines for Corporate Governance of State Owned Enterprises (the SOE Guidelines).<sup>45</sup> The Guidelines are applicable to both SWFs and SOEs.

## **Author Contact Information**

Martin A. Weiss  
Analyst in International Trade and Finance  
mweiss@crs.loc.gov, 7-5407

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<sup>44</sup> OECD Investment Newsletter, October 2007, Issue 5, at <http://www.oecd.org/dataoecd/0/57/39534401.pdf>.

<sup>45</sup> The OECD Guidelines on Corporate Governance of State-Owned Enterprises is available at [http://www.oecd.org/document/33/0,3343,en\\_2649\\_37439\\_34046561\\_1\\_1\\_1\\_37439,00.html](http://www.oecd.org/document/33/0,3343,en_2649_37439_34046561_1_1_1_37439,00.html).