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Sovereign Wealth Funds and the Problem of Asymmetric Information: The Santiago Principles and International Regulations

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INTRODUCTION

In 2008 and 2009, Sovereign Wealth Funds ("SWF") appeared almost daily in financial news and had risen in significance in international capital markets and policy circles. Having grown in number and size, SWFs are now the second largest class of investors in the international capital market.¹ In general terms, SWFs are private equity funds run by governments to manage their excess foreign reserves. They are among a range of investment vehicles that governments can employ to manage excess revenues or foreign reserves.² One of the key differences between SWFs and other investment vehicles is that SWFs typically have higher risk preferences and return expectations.³

SWFs, however, are not a new phenomenon in the international capital market. One of the oldest SWFs dates back to 1953, when Kuwait established the Kuwait Investment Authority ("KIA"),⁴ and, as Dr. Lyons⁵


². Gilson & Milhaupt, supra note 1, at 1354 (“Sovereign wealth funds belong to a continuum of sovereign investment vehicles. At one end of the spectrum are central banks. At the other end are state-owned enterprises such as Russia’s Gazprom or China’s National Offshore Oil Corp. In between are sovereign stabilization funds, sovereign saving funds, and government investment corporations. Thus one way to define sovereign wealth funds is by exclusion: SWFs are sovereign investment vehicles that are not central banks, monetary authorities in charge of foreign reserves, or national pension funds, unless they are financed by commodities exports.”); Edward F. Greene & Brian A. Yeager, Sovereign Wealth Funds—A Measured Assessment, 3 CAPITAL MARKETS L.J. 247, 249 (2008). See also Citigroup Global Markets Inc., Sovereign Wealth Funds: A Growing Global Force 11 (2008).


⁴. Kimmitt, supra note 3, at 120. See also GERARD LYONS, STANDARD CHARTERED BANK, STATE CAPITALISM: THE RISE OF SOVEREIGN WEALTH FUNDS 5, 22 (2007); Testimony Before the Comm. on Foreign Affairs, U.S. H.R.: The Rise of Sovereign Wealth Funds: Impacts on US Foreign Policy and Economic Interests, at 8 (May 21, 2008) (tes-
noted, “Of the twenty two largest SWFs . . . seven were in existence before 1990, six started in the 90s and nine since the millennium.”

Despite the number of years SWFs have existed, their sheer number and size have recently raised a number of concerns. Among these are that “SWFs are a threat to the sovereignty of the nations in whose corporation they invest” and that “the nations whose corporations are targets of investments are said to be threatened with becoming ‘sharecropper’ states if ownership of industry moves to foreign-government absentee holders.” The biggest concern, however, is that SWFs will make decisions for political or strategic reasons rather than economic and commercial ones. In fact, the increasing number of SWFs and the ownership stakes they are taking have led to an outcry for regulatory control and for opposition to SWF investment in recipient countries.

In this Note, I will discuss the various concerns surrounding SWFs, the need for international regulation, and possible solutions to some of the problems SWFs raise. The focus of this discussion is on the problem of asymmetric information. Asymmetric information occurs when one party has better information than the counterparty. SWFs are not in the same position as typical private parties in business relationships, which might have superior information. First, unlike private parties, SWFs might have interests that are not economic or commercial in nature. Second, SWFs...
introduce state capitalism to the market. The problem of asymmetric information is the source of the problems surrounding SWFs and that any regulation of SWFs must address this issue.

Part I will provide a background discussion on SWFs. Particularly, I will focus on their significance to the global capital market, the current global market’s effect on SWFs, and how the United States currently regulates SWF investments. Part II discusses the need for regulations, while Part III addresses why SWFs must be regulated internationally. Part IV discusses the newly adopted Santiago Principles created by the International Monetary Fund (“IMF”) to govern SWF conducts.

I. BACKGROUND ON SWFS

A. What Are SWFs?

As the Acting Under Secretary for International Affairs in the U.S. Treasury Department, Clay Lowery, noted in his remarks concerning SWFs, “There is no universal, agreed definition [of SWFs].” However, because SWFs are only one of several ways a government can manage and invest in the global capital market, “[d]ifferentiation between different types of sovereign-controlled entities is integral to identifying policy issues raised by their activities, and in crafting appropriate policies to address such issues.”

The definitions offered by the U.S. Treasury Department (“Treasury Department”) and the IMF are helpful for discussion purposes. The Treasury Department defines an SWF as “a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from official reserves.” The IMF adopted a similar definition: a “government-owned investment [fund], set up for a variety of macroeconomic purposes. They are commonly funded by the transfer of foreign exchange assets that are invested long term, overseas.”

15. Kimmitt, supra note 3, at 120. See also Lyons, supra note 5, at 5.
16. Greene & Yeager, supra note 2, at 249. Even within the realm of SWFs, there are different ways to organize and structure an SWF. See INT’L WORKING GROUP OF SOVEREIGN WEALTH FUNDS, INT’L MONETARY FUND, SOVEREIGN WEALTH FUNDS: GENERALLY ACCEPTED PRINCIPLES AND PRACTICES “SANTIAGO PRINCIPLES” 11 (2008).
17. Lowery, supra note 14.
Dr. Lyons offers a slightly more specific and detailed definition. He limits it to four features: (i) the organization is owned by a sovereign nation state, but, as an exception, includes five subnational-level funds “that are financed by foreign exchange assets resulting from commodities exports, and that are large enough to rank within [the] top [twenty-two SWFs]”; (ii) the organization is “[n]ot a national pension fund, unless [it is] financed directly by foreign exchange assets generated by commodity exports”; (iii) the organization is “not [a] central bank[] or [authority] that perform[s] roles typical of a central bank”; and (iv) the organization is a “investment fund[] rather than producer[] of goods or services.”

Finally, in the recently published Santiago Principles, the IMF’s International Working Group of Sovereign Wealth Funds defined SWFs as “special-purpose investment funds or arrangements that are owned by the general government.” The term “general government” includes “both central government and subnational government.” The definition excludes, “inter alia, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises . . . in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals.”

While these definitions are useful in defining the limits of SWF, it is important to recognize that they are both over-inclusive and under-inclusive. However, this Note will be using the International Working Group’s definition for SWFs because it is sufficiently broad to include most of the entities affected by the Santiago Principles.

B. Who Has SWFs?

As of 2009, there are over twenty-two entities widely accepted as SWFs. The seven largest are known as the “Super Seven,” and each has

19. The five subnational-level funds large enough to be ranked with the top twenty-two SWFs are ADIA (Abu Dhabi), Istihmar (Dubai), Dubai International Capital, Alberta Heritage Savings Trust Fund (Canada), and Alaska’s Permanent Reserve Fund. Lyons, supra note 5, at 23–24.
20. Id.
22. See id. at 3 n.5.
23. See id. at 3 n.6.
24. See Lyons, supra note 5, at 23. For example, the IMF definition does not explicitly exclude noncommodity-based national pension funds. The Treasury definition does not include central banks that perform management functions for foreign investments such as the Saudi Arabia Monetary Authority.
25. Id. at 23.
The Super Seven includes Abu Dhabi Investment Authority, the Government of Singapore Investment Corporation, the Government Pension Fund of Norway, KIA, China Investment Corporation, Russia National Wealth Fund, and Temasek Holdings. Of the listed owners, United Arab Emirates’ Abu Dhabi Investment Authority possesses the largest SWF, with assets estimated to be somewhere between $250 billion and $1 trillion. Another player of note in this league of large SWFs is the China Investment Corporation (“CIC”), which has an initial endowment of $200 billion. While not as large as the Super Seven, the holdings of other SWFs are still quite substantial.

C. Why Create SWFs?

The goals of SWFs, unsurprisingly, depend on to whom they belong and the source of their endowments. Apart from potential political and strategic motivations, SWFs are typically created in order to achieve any combination of the following goals: macroeconomic stabilization, inter-generation transfers, higher returns, and domestic industrial developments.

Countries that establish SWFs for macroeconomic stabilization purposes are usually “highly dependent on commodity exports” because they are “exposed to swings in global prices.” For countries like Russia, the macroeconomic stabilization component functions (i) by supplementing government revenues when there is a decrease in global pric-
es, and (ii) by absorbing excess revenues when there is an increase in
global prices, thereby preventing inflation.35 An SWF with macroeco-
nomic stabilizing goals can help minimize “short- and medium-term
fluctuations.”36 Similarly, countries dependent on finite commodity re-
sources (e.g., oil and coal) may create SWFs to preserve the wealth of
these national resources for future generations by converting them into
financial resources.37 This wealth could be used to finance pension funds,
such as Norway’s Government Pension Fund,38 or be used as an “alterna-
tive to oil reserves for . . . future generations,” such as Kuwait’s KIA.39

Higher returns are also a common objective of SWFs.40 Traditionally,
foreign reserves are kept and maintained by the country’s central bank.41
Due to the goals42 and roles that central banks serve, their assets tend to
be held in lower risk and lower-yielding financial vehicles.43 With the
build up of reserves,44 these countries are motivated by the “opportunity
cost associated with funds being invested in risk free assets” to seek

35. Kimmitt, supra note 3, at 120; Y.V. Reddy, Governor, Reserve Bank of India,
Address at the Golden Jubilee Celebrations of the Foreign Exchange Dealers’ Associa-
tion of India, Mumbai: Forex Reserves, Stabilization Funds, and Sovereign Wealth
Funds: Indian Perspective 3 (Oct. 8, 2007).
36. Lyons, supra note 5, at 29.
37. Id.
38. Id. at 33.
39. Id. at 35.
40. Id. at 29.
41. Kimmitt, supra note 3, at 120.
42. The IMF lists six major objectives for central banks:
support and maintain confidence in the policies for monetary and exchange rate
management . . . ; limit external vulnerability by maintaining foreign currency
liquidity to absorb shocks during times of crisis or when access to borrowing is
curtailed . . . ; provide a level of confidence to markets that a country can meet
its external obligations; demonstrate the backing of domestic currency by ex-
ternal assets; assist the government in meeting its foreign exchange needs and
external debt obligations; and maintain a reserve for national disasters or emer-
gencies.

INT’L MONETARY FUND, GUIDELINES FOR FOREIGN EXCHANGE RESERVE MANAGEMENT
43. See John Nugée, Foreign Exchange Reserves Management, in CTR. FOR CENT.
BANKING STUDIES BANK OF ENG. 26–29 (Handbooks in Central Banking No. 19, 2000).
44. By 2006, Asian central banks, at $3.1 trillion, held over sixty percent of the global
foreign reserves. See MCKINSEY GLOBAL INST., THE NEW POWER BROKERS: HOW OIL,
ASIA, HEDGE FUNDS, AND PRIVATE EQUITY ARE SHAPING GLOBAL CAPITAL MARKETS 73
higher returns for their money. Finally, some countries utilize SWFs to “restructure and encourage domestic industries.”

D. Why Are SWFs Significant?

SWFs are significant for a variety of reasons. Primary among these are the size of their asset holdings and their investment strategies. Already holding an estimated $2–3 trillion in assets, SWFs are projected by various commentators to grow rapidly during the next decade and reach an estimated value of somewhere between $7 trillion and $13.4 trillion in assets. However, even when we use the upper estimated aggregate size of SWFs, $3 trillion, the amount of assets held by SWFs is small when compared to the amount of global financial assets or U.S. denominated assets in existence. As a point of reference, in 2006, global financial assets were estimated to be about $164 trillion, and U.S. denominated assets about $56.1 trillion. This means that SWFs are only 1.8% and 6%, respectively, of these markets. Nonetheless, even though SWFs hold a small share of the global capital markets, they should not be ignored. At $3 trillion, they have more assets than both hedge funds and private equities combined. Even individually, the six largest SWFs are comparable to the largest institutional investors in the world. Regardless of what metric of reference we use to assess the size of their holdings, SWFs are large enough to affect market prices.

Besides their size, another important concern is their investment strategy. As noted above, traditionally, countries manage their foreign reserves

45. Lyons, supra note 5, at 29.
46. Id.
50. Hedge funds are estimated to have approximately $1–1.5 trillion in assets. Lyons, supra note 5, at 11.
51. Private equities are estimated to have $0.7–1.1 trillion in assets. Id.
52. Id.
53. Bujon de l’Estang, supra note 1, at 3.
54. Kimmitt, supra note 3, at 122.
with their central banks or financial ministries that perform central bank functions.\textsuperscript{55} Central banks and their equivalents have typically focused their investment in low-risk and low-yield assets (e.g., U.S. treasury bonds) to preserve liquidity.\textsuperscript{56} With the significant accumulation of foreign reserves, preservation of liquidity becomes less important and countries shift their asset allocation to include more higher-risk and higher-yield assets (e.g., equity, real estates, and hedge funds).\textsuperscript{57}

While SWFs do raise policy concerns, they can also be very beneficial to the global capital market if managed properly. SWFs are “in principle long-term investors, which typically do not deviate from their strategic asset allocations in the face of short-term volatility.”\textsuperscript{58} By shifting away from debt assets, SWFs are actually promoting a more stable financial market by reducing the effects of entry and withdrawal that would otherwise occur in the debt market.\textsuperscript{59} They also allow the reserve-rich countries to “recycle trade surpluses and to increase the supply of funds to the equity market,” thereby “reducing the cost of capital.”\textsuperscript{60} SWFs are particularly attractive for this function because they are not highly leveraged and can provide liquidity to the capital market.\textsuperscript{61}

\textbf{E. How Does the United States Regulate SWF Investments?}

In the United States, since 1988, foreign directed investments (“FDIs”) were subject to the Exon-Florio Amendment.\textsuperscript{62} After the controversial attempt by China National Offshore Oil Company and Dubai Ports World to acquire Unocal, and Peninsular and Oriental Steam Navigation Company, respectively, Congress passed the Foreign Investment and National Security Act of 2007 (“FINSA”) to amend the Exon-Florio Amendment.\textsuperscript{63} FINSA confers on the president the power to “suspend or prohibit any covered transaction that threatens to impair the national se-

\begin{itemize}
\item \textsuperscript{55} Id. at 120.
\item \textsuperscript{56} See Nugée, supra note 43, at 26–29.
\item \textsuperscript{57} See id. Acting Under Secretary for International Affairs Clay Lowery explains that “force diversification” is occurring because the amount of assets held by SWFs have outgrown the amount of debt assets in the world. Lowery, supra note 14.
\item \textsuperscript{58} Kimmitt, supra note 3, at 122.
\item \textsuperscript{59} Gilson & Milhaupt, supra note 1, at 1360.
\item \textsuperscript{60} Id. at 1360.
\item \textsuperscript{61} Id. at 1360; Kimmitt, supra note 3, at 122.
\item \textsuperscript{63} Gilson & Milhaupt, supra note 1, at 1349; Greene & Yeager, supra note 2, at 261.
\end{itemize}
Further, the statute makes the Committee on Foreign Investment in the United States ("CFIUS") responsible for
(i) review[ing] acquisitions by foreign persons of control of US businesses in the interest of US national security during a [thirty] day period after notice or its own initiation of the review, (ii) [investigating] such acquisitions during an additional [forty-five] day period if the transaction threatens the national security of the US, is by a foreign government controlled entity, would result in critical infrastructure coming under control of a foreign person or the government agency leading the review so recommends and (iii) report[ing] its findings to Congress.65

Since its inception in 1975, by March 2006, CFIUS had reviewed over 1600 cases of foreign acquisitions.66 In 2006, “of approximately 10,000 [mergers and acquisitions] transactions [in the United States], 1,730 were cross-border.”67 During that year, 113 of the cross-border transactions were subject to CFIUS review but none were blocked.68 Despite the number of cases it reviewed, however, the Committee has investigated only twenty-five and submitted twelve of them to the president for decision.69 Of the twelve cases, the president elected to allow eleven of the transactions to proceed.70 The only occurrence of a presidential divestment of FDI occurred in 1990 when President George H.W. Bush ordered China National Aero-Technology Import and Export Corporation to divest its interest in MAMCO, an aircraft parts company.71

64. 50 U.S.C. app. § 2170(d) (2007).
67. Greene & Yeager, supra note 2, at 262; Kimmitt, supra note 3, at 123.
68. Greene & Yeager, supra note 2, at 262; Kimmitt, supra note 3, at 123.
69. Kimmitt Testimony, supra note 66.
70. Id.
71. See id. (indicating that since 1988, the president only ordered one forced divestiture out of the twelve cases submitted for decision after investigation); Message from George H.W. Bush, President of the U.S., to U.S. Congress on the China National Aero-Technology Import and Export Corporation Divestiture of MAMCO Manufacturing, Incorporated (Feb. 1, 1990), available at http://www.presidency.ucsb.edu/ws/index.php?pid=18109); Ann M. Calvaresi-Barr, DIR., U.S. GOV’T ACCOUNTABILITY OFFICE, REPORT TO CONGRESSIONAL REQUESTERS, DEFENSE TRADE: ENHANCEMENTS TO THE IMPLEMENTATION OF EXON-FLorio COULD STRENGTHEN THE LAW’S EFFECTIVENESS, GAO Doc. No. 05-686, at 10 (2005); Katherine V. Schinasi, ASSOC. DIR., U.S. GEN. ACCOUNTING OFFICE, REPORT TO CHUCK HAGEL, U.S. SENATE, DEFENSE TRADE:
As Edward Greene and Brian Yeager\textsuperscript{72} noted, “despite the small number of final negative determinations by CFIUS, CFIUS review can have an \textit{in terrorem} effect that discourages transactions.”\textsuperscript{73} In addition to FINSA, SWFs are also subject to various traditional regulations such as the Securities Exchange Act of 1934, the Hart-Scott-Rodino Act, and the Bank Holding Company Act of 1956.\textsuperscript{74}

II. CONCERNS INVOLVING SWFS

The growing importance of SWFs raises various policy issues and concerns for host countries, recipient countries, and the international capital market in general. Of these concerns, lack of transparency, economic protectionism, market distortions, conflicts of interest, strategic positioning, and national security are at the forefront of the debate. Each of these issues must be addressed carefully in order to ensure that SWFs are not unduly restricted when providing necessary protection to all parties.

\textbf{A. Lack of Transparency}

One of recipient countries’ largest complaints is the lack of transparency of some SWFs.\textsuperscript{75} While some hedge funds and private equity funds are equally, if not more, secretive about their investments, recipient countries have found the opaqueness of SWFs much more alarming.\textsuperscript{76} As one commentator suggests, this is not because SWFs are nontransparent about their investments, but because they are government owned.\textsuperscript{77} Also,
the opaqueness of SWFs has the potential of affecting private investors due to uncertainties involving the funds’ behavior. 78

In regards to transparency concerns, one commentator has noted that SWFs have never conducted themselves in any way to warrant the suspicion placed on them.79 The lack of evidence of wrongful conduct, however, is largely irrelevant. This commentator failed to recognize that what is perceived to be true can be far more important than what is actually true. If an SWF is perceived to be acting with ulterior motives, a country will most likely take action against the perceived threat. The mere fact that the perception is wrong or that there is no evidence to support that perception will therefore not make much of a difference. While some might argue that States should not act in such a manner, this is the only rational decision. In terms of game theory, countries are in a non-cooperative game environment and have an asymmetry of information problem. 80 While countries often do cooperate with each other, they are still in such an environment because there is no way to form binding and enforceable agreements. 81 It is important to remember that countries cooperate with each other voluntarily and there is no meaningful way to force compliance short of going to war. 82

78. Lowery, supra note 14. See also Truman, supra note 4, at 3.
80. See generally 1 THE NEW PALGRAVE A DICTIONARY OF ECONOMICS 133–35 (John Eatwell et al. eds., 1987); 3 THE NEW PALGRAVE A DICTIONARY OF ECONOMICS 661–63 (John Eatwell et al. eds., 1987). In a non-cooperative game setting, there exists no institution that can make binding any agreement among players. 3 THE NEW PALGRAVE A DICTIONARY OF ECONOMICS, supra, at 661. Asymmetric information occurs when players of a particular game are not privy to the same information. 1 THE NEW PALGRAVE A DICTIONARY OF ECONOMICS, supra, at 133.
81. It could be argued that countries will comply with international agreements and treaties because noncompliance would be too costly and even as “soft law,” these rules can still have practical effects. Francis Snyder, The Effectiveness of European Community Law: Institutions, Processes, Tools and Techniques, in IMPLEMENTING EC LAW IN THE UNITED KINGDOM: STRUCTURES FOR INDIRECT RULE 64 (Terence Daintith ed., 1995). However, because compliance of international law in general is voluntary, there is always a risk that a country will decide that the benefit of noncompliance outweighs the cost of compliance. Thomas M. Franck, Legitimacy in the International System, 82 AM. J. INT’L L. 705, 705 (1988). In such a non-cooperative environment, one cannot assume that the mere fact that a party is complying with international agreements or treaties now means there will be compliance in the future.
82. See Alex Glashausser, What We Must Never Forget When It Is a Treaty We Are Expounding, 73 U. CIN. L. REV. 1243, 1285 n.264 (2005) (citing Patricia McGowan
Countries are also plagued with the problem of asymmetry of information. There is simply no way for a country to predict how counterparties will behave, and there is always a risk that they will guess wrong. Therefore, countries can only act on the information that they perceive to be true, and depending on the urgency of the situation, there may not be an opportunity to ascertain the accuracy of the information before taking adverse action.

Furthermore, even though some SWFs have existed for a long time, their opaqueness also creates concerns about their potential impact on market stability. Markets and investors do not have extensive experience dealing with SWFs or similar entities because countries tended to prefer debt assets in the past and held little, if any, equity assets. Therefore, because SWF investment policies are poorly understood, markets will experience greater volatility when they have, or are suspected to have, SWF participation. With no information or experience to guide them, market participants have no way to distinguish mere rumors from actual facts, or minor comments from significant ones. This increases the level of uncertainty and risk associated with participating in the market. Elevated risk levels will increase the cost of capital because a higher risk premium will be needed to compensate parties for the amplified risk.

With that said, however, it is important to bear in mind that mere formal disclosure would not resolve any of the transparency concerns. Disclosures are only as meaningful as the creditability of the disclosing party. A party’s denials and disclosures have little creditability when the party is already suspected or accused of misconduct. Similarly, if a host government lacks creditability, any statements made or disclosures published are unlikely to be taken at face value. This illustrates that the real concern regarding transparency is the problem of asymmetric information and underscores the need for a credible method to ascertain the truth. This problem places SWFs that lack creditability but are innocent of any misconduct at risk of unwarranted adverse actions. Any regulation of SWFs must address these transparency and creditability concerns.

Wald, *Judging at the Hague*, JUD. DIVISION REC., Summer 2002, at 19–20 (noting that international law has been enforced “only by voluntary compliance, diplomacy, threats of war or war itself”).


84. *See id.*

85. *Id.*

86. *See id.*

B. Economic Nationalism and Protectionism

Another concern raised by the increased globalization of the financial market is the growing sentiments of economic nationalism and protectionism that FDIs have sparked. Despite the benefits that globalization can bring, this is a sensitive issue that is not just limited to industrialized countries, but is also prevalent in emerging market economies.88 China’s and Dubai’s attempted acquisition of major U.S. assets caused such a political outcry in the United States that the parties withdrew their bid for acquisition.89 Similarly, Germany recently proposed new legislation to allow the Economy Minister to scrutinize purchases of stakes of twenty-five percent or more in German firms by buyers from outside the European Union and its four partners in the European Free Trade Association and, if necessary, to block the transaction.90 Even African countries, which were initially enthusiastic about Chinese investments, are experiencing backlash due to concerns over “China’s intentions and . . . whether its investment was in the Continent’s best interests.”91

The real fear for the recipient countries is that if they sell off more and more of their economy and country each year, they will be subjugating themselves to a “sharecropper economy.”92 While this would be undesirable, economic protectionism or nationalism is not the answer. Globalization of the financial capital market has many benefits.93 For example, businesses are no longer tied to their own domestic capital market and can obtain capital at a lower cost94 by tapping into international capital.95

88. Lowery, supra note 14.
89. Lyons, supra note 5, at 16–17.
91. Lyons, supra note 5, at 16.
94. To illustrate the benefits of and differences between a purely domestic (“closed”) capital market and an international (“open”) capital market, we can look at the cost of capital. N. GREGORY MANKIW, MACROECONOMICS 53, 115 (4th ed. 2003). The cost of capital is really the cost of borrowing or the interest rate. Id. at 54–55. The interest rate is determined by the supply of capital and the demand for capital, and is inexplicably tied to a country’s economic output. Id. at 59–61. One measure of the output of a country’s economy is the gross domestic product (“GDP”). Id. at 15–16. Under the expenditure method of measuring GDP in a closed economy, GDP = Consumption (C) + Investment (I) + Government Spending (G). Id. at 53. A simple reorganization of this equation shows that I = GDP – C – G – net exports (NE); in other words, investment is always equal to the national savings in a purely domestic market. Id. at 59–61. As we can see, the nation-
It also helps countries finance current account deficits. Among these benefits is the increased ability of investors to spread risk by diversification into different markets, contributing to the stability of the global financial market. The biggest threat to maximizing the benefits of a global capital market, as Deputy Secretary Kimmitt noted, is “investment protectionism,” the erection of barriers to foreign investment. To reduce the risk that countries will engage in protectionist conduct, regulations need to encourage SWFs to behave in a purely commercial manner.

C. Market Distortions

SWFs have the potential of creating market distortion because of their size and their governmental connections. SWFs are “already large enough to be systemically significant,” and if they are imprudently managed and misguidedly take risk, there will be broad consequences for the whole market. For example, there is a danger that SWFs might not perceive risk correctly. Unlike traditional financial institutions, SWFs are accountable only to their respective governments because they are their only principal. This feature is a benefit for the financial market because capital requirements or investor withdrawals cannot force SWFs to liquidate their holdings; however, this very feature also creates the risk of

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96. Kimmitt, supra note 3, at 124.


98. Kimmitt, supra note 3, at 126.

99. See generally Truman Testimony, supra note 4, at 3.

100. Kimmitt, supra note 2, at 122; Lowery, supra note 14.

101. Kimmitt, supra note 2, at 122; Lowery, supra note 14.
low accountability.\textsuperscript{102} SWFs typically have no clearly defined liabilities like pension funds or other institutional investors; instead, they tend to have broadly defined goals and are rarely earmarked for specific government expenditures.\textsuperscript{103} With essentially no liabilities,\textsuperscript{104} there is a danger that fund managers may take excessive risks and treat losses as irrelevant so long as there is no strong domestic accountability.

Unfortunately, there is usually little, if any, regulation governing SWF behavior either directly or indirectly.\textsuperscript{105} Therefore, investor discipline will depend on citizen monitoring because there is no market discipline through institutional investors.\textsuperscript{106} The problem with this reliance is that there is no incentive for individual citizens to monitor the performance of the SWF. There is also a free-rider problem with citizen monitoring. Even one of the smaller SWFs has a value of $400 million, assuming the information is available, any monitoring of the fund will require significant time, effort, and expense. Furthermore, a party that monitors the SWF will not be able to capture all of the benefits because other parties will benefit from the monitoring without incurring the expense.\textsuperscript{107} Therefore, parties will have no incentive to do anything more than the average citizen, which, in this case, will be nothing.

Due to the fact that “SWFs represent large, concentrated, and often opaque positions in financial markets,” if the funds have distorted risk preferences, it will have the potential of influencing the market.\textsuperscript{108} This is because investment prices may be artificially inflated and misrepresent the true relative market value.\textsuperscript{109} There is also a danger that parties will not practice market discipline in assessing the risk of a particular transaction, but instead rely on the notion of “sovereign guarantee.”\textsuperscript{110} With the

\textsuperscript{102}See Lowery, supra note 14.
\textsuperscript{103}Adrian Blundell-Wignall et. al., Sovereign Wealth and Pension Fund Issues, 94 FIN. MARKET TRENDS 117, 124 (2008).
\textsuperscript{104}This, of course, does not include SWFs that also serve as a pension fund such as Norway’s SWF.
\textsuperscript{105}Lowery, supra note 14.
\textsuperscript{106}Id. Accountability of SWFs will depend on “what their citizens know and how active they are in monitoring fund activities.” Id.
\textsuperscript{107}It is unclear whether there are actual benefits for citizens to monitor their country’s sovereign wealth fund; however, any hypothetical benefits that may or may not exist will just have a free-rider problem. Furthermore, if no benefits exist, there would be no incentive to expend the necessary resources to conduct such monitoring.
\textsuperscript{108}Kimmitt, supra note 3, at 122–23.
\textsuperscript{109}It is conceivable that if a large SWF fails to assess risk properly, it can influence the market price for that asset by purchasing more of the asset than is prudent. This price, which is driven up, will not reflect the value of the asset relative to other alternative investments.
\textsuperscript{110}Lowery, supra note 14.
threat of parties not practicing market discipline, a substantial risk to market stability arises if SWFs are not regulated because there is typically limited disclosure of their investment policies, and the private sector may react to speculation and rumors of potential SWF shifts. Therefore, SWFs and the capital market would benefit from regulations that impose greater transparency, improve the governing and monitoring structure, and further accountability of the funds.

D. National Security

One of the most critical concerns regarding foreign acquisitions is national security. When dealing with foreign investment, countries need to be able to “ensure that national security concerns are addressed, without unnecessarily limiting the benefits of an open economy.”

The problem with national security issues is that there is no way to clearly define what types of investment invoke these concerns and what types of investments do not. While it may be clear that foreign investment in a country’s defense industries would raise national security concerns, there are many other industries that do not fall within the traditional notion of defense but are nonetheless essential to a country’s security. Furthermore, something short of acquisition of de jure control, such as when “an investor seeks board seats or outsized voting rights,” could still trigger national security concerns. Accordingly, anything but purely passive investment by SWFs has the potential of raising these issues. Moreover, as much as FDI may trigger national security concerns, there is also a risk that recipient countries will use national security as a guise for protectionism policies. This risk creates a twin tension that any governing policy and principle must balance with care.

111. Kimmitt, supra note 3, at 122–23.
112. Id. at 123.
113. See Lyons, supra note 5, at 17.
114. For example, the media, the communication, and the energy industries are essential infrastructures for a country’s national security. Id. at 15. There are also companies that supply essential war-making materials, e.g., ball bearing manufacturers, but FDI would only raise national security concerns during a war. The difficulty in determining which industries raise legitimate national security concerns makes determinations by organizations such as CFIUS highly subjective and could be used as a guise for protectionism. See id. at 17; Kimmitt, supra note 3, at 126.
115. Kimmitt, supra note 3, at 123.
116. Id.
117. Id. at 126.
E. Strategic Positioning

There is also a fear that SWFs will invest for strategic positioning purposes.118 These purposes may motivate the funds to make investments with the objective of acquiring intellectual property, skills, and other advantages, and transferring these assets to domestic companies.119

On a macro level, strategic acquisitions may not seem like a problem because the party that values those assets the most is making use of them; however, on a micro level, this creates a conflict of interest problem between the SWFs and other investors. Objectives other than maximization of share values conflict with the interest other investors because transferring technology or other expertise from a portfolio company to a domestic company will reduce the value of the portfolio company.120 All owners share in this reduction in value, while only the SWF and its government will benefit from the transfer.121 Thus, the fund is essentially stealing from the portfolio company when it induces these kinds of transfers.

Not only is strategic acquisition fundamentally unfair to the company and other investors it will also have detrimental effects on the market.122 If investors come to believe that they are at a disadvantage in relation to the publicly backed entity, it could damage the stability and confidence in the market.123 After all, who would want to play when the other party always has an Ace up its sleeve? Therefore, any regulation of SWFs must address the problem of strategic acquisitions.

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118. See Greene & Yeager, supra note 5, at 259; Lyons, supra note 2, at 15.
119. See Lyons, supra note 5, at 15. See also Gilson & Milhaupt, supra note 1, at 1361–62 (“SWFs may wish to help domestic companies secure technology or other expertise.”). Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A Common European Approach to Sovereign Wealth Funds, at 5, COM(2008) 115 provisional (Feb. 27, 2008), available at http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf (“SWF investment in certain sectors could be used for ends other than for maximizing return. For example, investment targets may reflect a desire to obtain technology and expertise to benefit national strategic interests, rather than being driven by normal commercial interests in expansion to new products and markets. By the same token, holdings could influence decisions by companies operating in area of strategic interest or governing distribution channels of interest to the sponsor countries. More generally, business and investment decisions could be influenced in the political interest of the SWFs owners.”). Governments as investors may pursue interests other than economic ones, such as “technology transfer, access to raw materials, access to buyers or even larger political or social purposes.” Greene & Yeager, supra note 2, at 259.
120. Gilson & Milhaupt, supra note 1, at 1361.
121. Id. at 1362.
122. See Greene & Yeager, supra note 2, at 259.
123. See id.
F. The Real Problem: Asymmetric Information

At the root of these concerns is the problem of asymmetric information. The outcries for more transparency on the part of SWFs arise out of insufficient or unreliable information. The asymmetric problem can be due to the inability to ascertain the accuracy of information, the lack of incentives to acquire information, or the inability to acquire the information. While they cannot be attributed to insufficient information per se, the problems associated with nationalism or protectionism are still based on the fear and misunderstanding of SWFs. So, too, is the problem of market distortion, which occurs when other parties cannot understand an SWF’s market behavior and objectives because of insufficient information. Finally, lessening the informational disadvantage of recipient countries can mitigate the dangers of strategic positioning and national security problems. This is because the recipient country will be able to make decisions on how to respond to foreign acquisitions with accurate information rather than on mere speculation. Also, by strengthening the informational position, host countries have an incentive to limit, if not eliminate, strategic motives from their investments since they do not want their opportunities limited by restrictive pressures. Thus, creating a method of disclosures that is credible and reliable can decrease most of these concerns.

III. SWFs Should Be Regulated in an International Forum

International regulation and monitoring of SWFs is preferable to domestic regulations and monitoring. In particular, such a forum is attractive because of its ability to alleviate many of the concerns discussed above. Furthermore, while it is true that even without an international regime a country can still impose disclosure requirements and other forms of protections on SWFs, international regulation provides several additional benefits. Beyond the ability to address the concerns surrounding SWFs, an international forum would protect the host and recipient countries’ interests, create a level playing field and avoid over-regulation due to nationalist and protectionist pressures.

First, drafting and implementing regulations internationally protects both the host countries’ and recipient countries’ interests. It would do this by creating an opportunity for these countries to have a meaningful dialog over how SWFs should be regulated. If left solely to domestic regulations, there is a risk that only recipient countries’ concerns will be

124. See Lyons, supra note 5, at 16.
125. While there are a lot of opportunities available to SWFs, all else equal, I believe any investor will prefer having more opportunities than less.
addressed, as SWFs and their host countries will not have an opportunity to voice their concerns. The ability to express different opinions is essential because SWFs and recipient countries have competing interests. On the one hand, SWFs want to have unlimited freedom to invest however they want. On the other hand, recipient countries may want to limit what SWFs can invest in. Recipient countries have an incentive to enact, and do enact, legislation and policies that restrict SWFs’ activities to protect domestic industries from foreign acquisitions.\(^\text{126}\) Such unilateral development of regulation has the potential of placing SWFs in an unduly disadvantageous position, and even if SWFs are not disadvantaged by the legislation, a perception that SWFs are being discriminated against may still result and harm the capital market.

Second, international regulation could create a level playing field and prevent a race to the bottom. Preventing harmful investments and encouraging beneficial ones should be a major goal of regulating SWFs. Domestic regulations, however, cannot adequately serve this mission because recipient countries have two opposing interests in regards to SWFs. On the one hand, they would like to prevent harmful investments and even prevent foreign acquisition of domestic interests by imposing regulations. On the other hand, they want to attract foreign investment to fund other investments by lowering the barriers to investment.\(^\text{127}\) This could lead to under regulation of SWFs by recipient countries, which creates its own problems.

There is also a genuine risk that underregulation will occur because countries are in constant competition for investment and capital. Since the credit crisis began in 2007, the competition for foreign capital has

\(^{126}\) Motivated by the interest in “defending French companies from unwanted predators,” France has proposed to create its own SWF and encouraged other EU countries to do so. Emma Vandore, *France to Create Sovereign Fund*, AP News (Paris), Oct. 23, 2008, http://www.blnz.com/news/2008/10/23/France_create_sovereign_fund_4890.html. This kind of response to the growing acquisition and diversification by SWFs is a great example of how countries may and do act to resist foreign acquisitions. While the French response is not using legislative restrictions to prevent foreign acquisitions, this type of response is still a hostile move towards the free flow of capital and should not be encouraged.

become even greater. Some countries have not only been open to SWF investments but also actively sought them. They accomplish this by lowering transaction costs or giving preferred treatment to certain investors, which can be done by offering preferential tax treatments, such as deferred taxes or lower tax rates, or by having favorable regulations. In an environment where countries are in desperate need of capital, countries may decide that the benefit of more capital outweighs the cost of bad investments and lower their regulations to attract more investments. Market forces will then force other countries to lower their regulations or miss out on the benefits of investments by SWFs. Eventually, if the need for competition is strong enough, market forces will cause countries to reduce their regulation to the minimum level and, perhaps, to no regulation at all.

Because of the macroeconomic impact that SWFs can have on the global economy, it is undesirable for countries to decide that capital is more important than a safe and stable investing environment. Not only will competition for capital create incentive problems on the regulation of SWFs; it will also create global and regional systemic problems. Any regional market has a certain level of liquidity and shock absorbent abilities. Because SWFs control a significant block of wealth, any sudden movement by them will have significant impacts on the local markets. Take Romania, for example, one of the newest members of the European Union. Its annual nominal GDP in 2007 was $166 billion, and

129. See id.
130. In a personal income context, we can see tax deferred and tax exempted savings plans performing a similar function to incentivize individuals to allocate their wealth to a particular area. These plans encourage deferring consumption to a later time by saving for retirement.
131. The country that has the least amount of regulation (let us call it “Country A”) receives two benefits. First, the potential pool of investors has just increased because more of the SWFs are able to meet their regulations, of course, assuming that not all SWFs are already able to meet the regulatory requirements. Second, the cost of investing is lower since the component cost of compliance is lower. Because the cost of investing is less, SWFs, both good and bad, will flock to Country A because they are able to retain more profits. However, once other countries observe that Country A is receiving these benefits, they too will likely want a piece of the pie and also lower their regulation, even though these benefits would not exist if all States had the same regulations.
132. See Lyons, supra note 5, at 18–19.
133. See id. at 19.
134. Kimmitt, supra note 3, at 122–23. See also Lyons, supra note 5, at 19.
it had approximately $46 billion in investments that year.\footnote{CENT. INTELLIGENCE AGENCY, supra note 34.} Compared to the United States, which has $13.84 trillion in GDP with $2.1 trillion in investments, Romania’s market is relatively small, and an influx of capital or sudden decrease in capital availability will have significantly greater effects on its economy.\footnote{Id.} Furthermore, there is a chance that any capital market regardless of size could experience a total collapse given a sufficiently large market shock. In addition to the risk of market shock and stability, the risk of sudden movement by SWFs will cause a rise in interest rates, because an interest rate is an aggregate of the real interest rate, inflation expectation, risk premium, and liquidity preference.\footnote{See Mankiw, supra note 94, at 57, 89–95, 271–73.} An increase in risk will require borrowers to offer additional risk premiums to compensate the investors.\footnote{See id. at 57.} Therefore, \textit{ceteris paribus}, an increase in risk will cause an increase in interest rates.\footnote{See id.}

Above all else, a level playing field will ensure that investments and allocation of capital will be made on the basis of risk and reward, rather than on the cost of compliance with regulatory requirements. If we accept that the principle goal of international finance is to place capital in the hands of those who can use it best, a system that allocates resources based on compliance cost is untenable. In such a system, compliance cost operates as a tax on SWFs. While it is not entirely clear who will ultimately bear the cost of the tax, companies that depend on SWF investments are the most likely candidates. This is because no one market dominates the international capital market to such a degree that there are no alternative venues for SWFs to invest.\footnote{Elizabeth K. Brill, \textit{Privacy and Financial Institutions: Current Developments Concerning the Gramm-Leach-Bliley Act of 1999}, 21 ANN. REV. BANKING L. 167, 216–17 (2002).}

A uniform, or even a mostly uniform, regulatory system will have the additional benefit of lower compliance cost and redundancy.\footnote{With $164 trillion in global financial assets, it will not be difficult for SWFs to find opportunities all over the world to invest their 1.8% worth of global financial assets. \textit{See McKinsey Global Inst.}, supra note 49, at 10–11 (indicating the amount of global financial assets). Even if SWFs are foreclosed from investing in U.S. denominated assets, there still remains almost $100 trillion worth of other financial assets in which SWFs can invest. \textit{See id.}} The banking privacy regulation in the United States demonstrates these benefits in a domestic context. In the United States, banks are subject to a situation similar to what SWFs experience. They are subject to regula-
tions by multiple jurisdictions and benefit from a uniform system. With varying privacy regulations among states, and between state and federal requirements, large financial services organizations will likely face overlapping and conflicting privacy regulations.\footnote{Id.} Financial services will also “be vulnerable to more stringent, and inevitably conflicting, state regulation.”\footnote{Id.} Uniform regulation is necessary for maximum efficiency and equity\footnote{Id.}: “[c]ompanies benefit from decreased compliance cost . . . . Consumers benefit from a more consistent and comprehensible regulatory system.”\footnote{Id.}

Using the same logic, these benefits of uniform regulations also extend to SWFs. By adopting uniform international regulations to govern SWF behavior, the funds only have to comply with one set of regulatory requirements, rather than comply with requirements of each individual country. The recipient countries also benefit because they are able to pool the cost of monitoring compliance, rather than having to individually monitor each and every potential SWF investor. Finally, this approach discharges the problem and possibility of conflicting regulations.

The danger also remains that certain countries will take a protectionist position and overregulate SWF investments.\footnote{Id.} One of the major goals of regulating SWFs is to prevent harmful investments and encourage beneficial ones, and overregulation has the potential of driving away foreign investment.\footnote{See Henny Sender & Mure Dickie, China Fears Scupper $2bn Deal for 3Com, FIN. TIMES, Feb. 20, 2008, http://www.ft.com/cms/s/0/0b3e3988-dfc6-11dc-8073-000077962ac.html.} While international regulations are unlikely to eliminate all protectionist problems, they do have the potential to reduce protectionist pressures.\footnote{See INT’L WORKING GROUP OF SOVEREIGN WEALTH FUNDS, supra note 16, at 4.}
IV. THE SANTIAGO PRINCIPLES

A. What Are the Santiago Principles?

In October 2007, the International Monetary and Financial Committee expressed the need for “further analysis of key issues for investors and recipients of SWF flows, including a dialogue on identifying best practices.” Based on this need, the International Working Group of Sovereign Wealth Funds (“IWG”) was founded April 30—May 1, 2008. With Hamad Al Hurr Al Suwaidi and Jaime Caruana as co-chairs, the IWG consists of twenty-six IMF members with SWFs. Using results from an IMF-commissioned voluntary survey on current structures and practices, drawing from widely-accepted international principles and practices, and taking input from a number of recipient countries, the IWG developed a set of Generally Accepted Principles and Practices (“GAPP”), also known as the “Santiago Principles.” Underlying the different principles of the GAPP are four foundational objectives:

i) To help maintain a stable global financial system and free flow of capital and investment;

ii) To comply with all applicable regulatory and disclosure requirements in the countries in which they invest;

iii) To invest on the basis of economic and financial risk and return-related considerations; and

iv) To have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability.

The IWG identified several purposes for the development of the GAPP: (1) increase countries’ and the financial markets’ understanding of SWFs; (2) ensure that the international financial market continues to benefit from SWF participation in the financial market; (3) support the “institutional framework, governance, and investment operations of SWFs

149. The International Monetary and Financial Committee is a committee of the Board of Governors of the IMF. Id. at 1.
150. Id.
151. Id.
152. Hamad Al Hurr Al Suwaidi is the Undersecretary of the Abu Dhabi Finance Department. Id.
153. Jaime Caruana is the Director of the Monetary and Capital Markets Department of the IMF. Id.
154. Id. at 1 n.2.
155. Id. at 1–2.
156. Id. at 4.
that are guided by their policy purpose and objectives and consistent with a sound macroeconomic policy framework”; and (4) “improve understanding of SWFs as economically and financially oriented entities in both the home and recipient countries” for the “stability of the global financial system, reduc[tion of] protectionist pressures, and . . . maint[enance] of an open and stable investment climate.” To achieve these goals, the IWG is relying on cooperation from recipient countries and the Organisation for Economic Co-operation and Development (“OECD”).

Comprised of twenty-four rules, the Santiago Principles are a voluntary set of criteria “that the members of the IWG support and either have implemented or aspire to implement.” These principles are subject to applicable laws of the home country and any intergovernmental agreements. The IWG expects that the GAPP will guide SWF activities so that the funds will invest professionally and help institute-related reforms. Finally, the IWG assumes that all SWFs will operate on a good faith basis and comply with all applicable regulatory and disclosure requirements.

The Santiago Principles are divided into three groups: “(i) legal framework, objectives, and coordination with macroeconomic policies; (ii) institutional framework and governance structure; and (iii) investment and risk management framework.” The IWG explains that the principles in the first area “underpin a robust institutional framework and governance structure of the SWF, and facilitate formulation of appropriate investment strategies consistent with the SWF’s stated policy objectives.” The second area ensures that SWF investments are free from political influences by separating the owner, the government, and the management to create operational independence. The third area promotes sound investment operation and accountability as well as demonstrates operational discipline. The IWG expects that different SWFs will have different time frames for adopting the GAPP because of the evolving nature of SWFs, the different maturity levels of the funds, as well as their different investment objectives, horizons, and strategies.

157. Id.
158. Id.
159. Id. at 5.
160. Id.
161. Id.
162. Id.
163. Id.
164. Id.
165. Id.
166. Id.
167. Id.
Finally, the IWG considers the GAPP to be a minimum standard for SWFs, but recognizes that not all principles will be applicable to every SWF.168

B. Criticisms of the Santiago Principles

The Santiago Principles offer important guidelines for the structure, governance, and management of SWFs; however, they have several flaws that will constrain their effectiveness in achieving their stated objectives. First, the GAPP is too focused on SWFs as entities and not enough on their relationship with recipient countries. Second, there are no standards to measure compliance with or achievement of the Principles. Third, the Santiago Principles do not address the asymmetric information problems faced by recipient countries. Finally, there are no sanctions or rewards available to ensure compliance.

Rather than balancing the interests and concerns of both host and recipient countries, the Santiago Principles focus exclusively on what SWFs and the host countries should do. While principles concerning the proper structuring, governance, and management of SWFs are important, the relationship among the funds, the host countries, and the recipient countries is far more important. As demonstrated above, the problems surrounding SWFs or foreign investments in general are not one-sided. Instead, it is the tension among the competing interests of parties that is the source of the problems and deserves the attention of the international community.

For instance, it is not necessary for SWFs to disclose every piece of financial data or every strategy; however, it would be insufficient for the funds to merely release a statement containing only publicly available information. Excessive disclosure requirements are also problematic, because they would inhibit the SWFs’ daily management and goal of maximizing returns, since every strategy decision would be public information. Additionally, disclosures for the sake of formality alone would not create a more stable global capital market since they do not actually ease the informational barrier. Simply repackaging publicly available information is convenient for other parties, but it does not improve their informational position in the least.

A similar situation exists for asset allocation. SWFs should not be required to provide the world with a detailed list of which companies they have invested in and the size of their investment. This would simply impose an unnecessary cost because whether or not an SWF invested in a paper towel company does not matter to recipient countries or the finan-

168. Id. at 6.
cial market. However, a system could be created that requires disclosures when an SWF invests in a particular list of companies or industries. This kind of scheme would put SWFs on notice that recipient countries are concerned about these companies and industries for either strategic or national security purposes, and would also limit potential protectionist regulations. As the above two examples illustrate, the international community needs to focus not on SWFs and recipient countries separately, but as one problem. By dealing solely with the SWFs' side of the problem, the Santiago Principles are essentially putting a Band-Aid over a gaping wound.

The GAPP lacks measurable standards that an SWF, host country, recipient country, counterparty, or third-party can use to determine to what extent and how effectively a particular SWF has achieved these minimum principles. It is important to remember that these Principles should not be adopted simply for the sake of having basic principles. Instead, constructive feedback is essential for the continued development of international norms governing SWFs in this ever-changing financial market landscape. The GAPP lacks measurable standards that an SWF, host country, recipient country, counterparty, or third-party can use to determine to what extent and how effectively a particular SWF has achieved these minimum principles. It is important to remember that these Principles should not be adopted simply for the sake of having basic principles. Instead, constructive feedback is essential for the continued development of international norms governing SWFs in this ever-changing financial market landscape.169 Constructive feedback requires that there is some method of measuring success. How can one know whether SWFs and recipient countries can work together to increase the stability of the financial market, avoid protectionism, etc., without knowing whether the measures implemented thus far are effective or even serving the purposes that they are suppose to serve? By not creating a standard to measure whether the Santiago Principles are a success, the IWG deprived the GAPP of an essential tool to improve the Principles’ effectiveness and make them a success.

Furthermore, the Santiago Principles do not address the asymmetric information problems faced by recipient countries. The GAPP in a number of sections and subsections calls for various public disclosures.170 This movement towards transparency is an important step in dealing with the asymmetric information problem, because the adoption of these Principles demonstrates that SWFs and the IWG recognize the importance of transparency. However, the asymmetric information problem does not lie solely with the lack of information, but with the lack of credible information. By failing to create a method to ascertain this, the effectiveness of any disclosure will be limited.171 This cripples the Santiago Principles in

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169. The IWG noted in the introduction that “constructive and collaborative response from the recipient countries will be essential” to ensure the success of the GAPP. Id. at 4.
170. See id. at 7–9. (Articles 2, 4, 15–19, and 21–22 of the GAPP are particularly relevant.)
171. See supra Part II. This would be similar to the former USSR claiming to be destroying its nuclear arsenal but not allowing inspectors to verify the claim. Setting aside
the area where they are most needed. When countries trust each other and have a good relationship, they do not need to rely on the Principles because they have no reason to suspect foul play. National security and strategic acquisition concerns are not a concern. In contrast, when countries do not trust each other, disclosures that comply with the GAPP would not ease the concerns of recipient countries because they will consider the disclosures unreliable. If the Santiago Principles are only effective when they are not needed and are ineffective when they are actually needed, what possible benefit will they provide besides recognizing that there is a problem?

Finally, because the GAPP is a voluntary set of principles subject to the laws of host countries, there are no rewards or sanctions available to encourage or force compliance. Given the recognized importance of sound regulation of SWFs, ideally there should be a mechanism that will ensure that parties comply with the Principles and will encourage the adoption of the GAPP. It is foreseeable that counterparties could require the adoption of the GAPP through contract; however, the adoption of the GAPP by SWFs, limited as it is, should not be left to private dealings. Instead, it should be required as a systemic control for the stability of the world’s financial market.

C. How to Improve the Santiago Principles

Given the limitations of the Santiago Principles, there are several devices that could improve their operation and effectiveness. Crippled by the failure to address the relational element between SWFs and other market participants, the lack of standards, and the asymmetric information problem, I propose four changes to the structure and elements that I believe will improve the Santiago Principles’ chance of success.

First, the IWG and OECD should collaborate and create an expanded list of guiding principles to address not only what SWFs should do as best practices, but also the relationship and competing interests of parties. A collaborative approach would allow both sides to voice various

the dissimilarity of any relationship between an SWF or its host country and a recipient country, and the relationship between the United States and the former USSR, this example illustrates that a mechanism to ascertain creditability is essential for any long-term monitoring arrangements.

172. See Lyons, supra note 5, at 16–17 (demonstrating that the cases towards which there was strong political opposition involved SWFs whose host countries were considered unfriendly to the recipient countries).

173. Parties can require compliance with the Santiago Principles as a condition to doing business, but this assumes that any counterparty will have the leverage necessary to force SWFs to accept these kinds of restrictions.
concerns, and identify a balanced approach to deal with the problems surrounding SWFs. As discussed above, it would be ideal if the IWG and OECD developed a single system of regulation. Furthermore, the collaboration between the two needs to deal with SWFs’ relationships with third-parties because recipient countries are not the only interested participants. Unlike the current Santiago Principles, this method would address a fuller spectrum of concerns that are raised in the international capital market.

Second, this collaborative group should create more specific guidelines for disclosure requirements and create standard disclosures. The development of specific disclosure requirements would benefit the market by creating a more level playing field and address the information imbalance among the parties. Standard disclosures reduce the informational imbalance by creating reasonable expectations of what will be disclosed and establishing a minimum standard of transparency. This method would protect SWFs from having unreasonable disclosure requirements imposed on them and would also ensure that recipient countries have the information necessary to protect their national security and other domestic interests. Standardized disclosure requirements, by avoiding duplication, would also benefit SWFs by lowering costs associated with their production.

Third, the GAPP should create a standard that permits the IWG and its corollary to measure how successful the Santiago Principles are in accomplishing their objectives. It would aid them in developing a plan for improving the effectiveness of the Principles. More importantly, such standards would enable the parties to monitor the actions of both SWFs and recipient countries, which would help ensure fair play and minimize systematic risk.

Finally, an independent audit committee should be created. This committee should be composed of individuals appointed from an equal number

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174. See supra Part IV.A.
175. See supra Part IV.C.
176. See supra Part IV.A (discussing the benefits of a level playing field).
177. The drive towards transparency will probably lessen with increased disclosure, and the adoption of disclosures similar to those of Norway’s SWF will help alleviate the fear of SWF activities. As discussed above, disclosure of reliable information is essential not only for the protection of national security interests, but also to the stability of the international capital market. Standard disclosure, however, will not eliminate the threat of overregulation until the GAPP or its successor evolves from a voluntary set of principles to a binding treaty that controls both SWFs and recipient countries.
178. By using a collaborative approach, recipient countries can seek to integrate into the standard disclosure the information necessary for the protection of their national security and domestic interests.
of members from SWFs and recipient countries, and one member nominated by the IMF. It should be granted access to all relevant materials to ensure compliance with the GAPP and the validity of disclosures, and be required to publish its findings. By using an independent committee to verify information, parties could be assured that the information disclosed by the SWFs is indeed credible. Furthermore, this approach would recognize the risk of unlimited access to confidential information. In exchange for unlimited access to the SWFs’ information, the committee should be required to sign nondisclosure agreements that would limit the use of the information for the sole purpose of verifying the disclosures. By addressing both what should be disclosed and the creditability issue, the GAPP could significantly reduce the asymmetric information problem.

CONCLUSION

While there are severe limitations to the Santiago Principles, they still remain an important first step in the creation of a new international norm. The GAPP outlined the various concerns relating to SWFs and created a forum for addressing how SWFs should behave and how other parties should treat them. However, despite these advances, the Santiago Principles will eventually need to address the asymmetric information problem as well as the relational element between SWFs and recipient countries in order to more fully address the concerns connected to state capitalism and the use of SWFs. The development of standardized disclosures, benchmarks of success, and an independent audit committee would be a beneficial step for the future of regulating and monitoring SWFs’ activities and their evolution as financial instruments.

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