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from: Secretary-General of the European Commission,  
signed by Mr Jordi AYET PUIGARNAU, Director

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to: Mr Javier SOLANA, Secretary-General/High Representative

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Council, the European Economic and Social Committee and the Committee of  
the Regions - A common European approach to Sovereign Wealth Funds

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Delegations will find attached Commission document COM(2008) 115 final.

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**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**

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**(Text with EEA relevance)**

**I. INTRODUCTION**

Sovereign Wealth Funds (SWFs) are generally defined as state-owned investment vehicles, which manage a diversified portfolio of domestic and international financial assets. Their origin dates back to the 1950s, when some major commodity exporting countries, particularly oil-rich countries, were looking for a way to invest funds originated by foreign exchange assets. While they have existed for more than fifty years, over the past decade they have rapidly expanded to become a source of investment of systemic importance. They can offer a source of investment and market liquidity at a time of real pressure. Yet, as state-owned investment vehicles, some can raise questions about the risk that these investments may interfere with the normal functioning of market economies. All projections expect SWFs to continue growing fast in size and number: a rapid growth that intensifies both the opportunities they offer and the concerns they inspire.

It is therefore not surprising that the rise of SWFs has attracted attention in several developed economies and triggered a debate within international *fora*. Within the EU, several Member States are looking at whether to make their own policy response.

The commitment to openness to investments and free movement of capital has been a long standing principle of the EU and is key to success in an increasingly globalised international system. As the world's leading trader and the largest source as well as the largest destination of foreign direct investments, the EU is a major beneficiary of an open world economic system. It is committed to ensuring that its markets remain open for investment<sup>1</sup>.

The legitimate interests of citizens and market operators in Europe, as well as the benefits of certainty to the SWFs themselves, point to the need for increased transparency, predictability and coherence in this area. As a leading global player, the EU has both the capacity and the incentive to promote a common response to the challenges posed by SWFs and to play in full its role in the ongoing debate within global economic *fora*. This common approach should be seen as a complement to the prerogatives of Member States regarding the use of national legislation in conformity with the Treaty.

This communication addresses the issues posed by SWFs as a specific category of cross-border investments. It shows how a common approach can strike the right balance between addressing concerns about SWFs and maintaining the shared benefits of an open investment environment.

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<sup>1</sup> This case is set out in detail in "Global Europe: competing in the world" - COM(2006) 567, 4.10.2006 - and in "The European Interest: Succeeding in the age of globalisation" - COM(2007) 581, 3.10.2007.

## II. SWF INVESTMENTS: DEFINING AND ADDRESSING THE ISSUES

### 2.1. Setting the scene: the rapid rise of SWFs in the international financial system

Over the past decade SWFs have grown rapidly. Originally, they were confined to a limited number of countries. Today, more than thirty countries have SWFs<sup>2</sup>, with twenty new SWFs created since 2000. Sustained surpluses for the oil producing and Asian economies have led to reserves well beyond the needs of exchange rate management. Some of these reserves have been channelled into SWFs. The assets managed by SWFs are estimated at \$ 1.5–2.5 trillion – equivalent to about half of global official reserves, or the combined assets of all hedge funds and private equity firms. This makes SWFs a small but significant share of the global equity market capitalisation of \$ 50 trillion. Even if estimates of the SWFs future scale differ, it is clear that the growth trend will continue<sup>3</sup>.

The distinguishing feature of SWFs from other investment vehicles is that they are state-funded. In general, SWFs are funded from accumulated foreign-exchange reserves in their sponsor countries, but are managed separately from the official reserves. Typically, SWFs have a diversified investment strategy, with a higher level of risk accepted in search of higher returns. SWF portfolios include a wider range of financial assets, including fixed-income securities but also equities, real estate and alternative investments.

### 2.2. Issues relating to SWF investments

#### *SWF investments offer opportunities to recipient economies...*

While much of the investment undertaken by SWFs is targeted at the domestic economies of their sponsor countries, they are also active internationally. In this way, they benefit the functioning of the global capital market and provide funding for global investment. The generally longer-term strategic outlook of SWFs can also contribute to stability in the international financial system.

The current financial situation has helped to underline the potential benefits of SWFs as a stabilising force. Problems in credit markets since mid-2007 have squeezed liquidity in several key financial markets and increased pressure on the capital base of financial institutions. Several of these institutions have recapitalised with the help of investment from SWFs. SWF investment has thus helped to strengthen the global banking system and to underpin confidence in the international financial system as a whole.

Another potential benefit associated with the SWFs, which is of specific relevance to the EU, relates to the euro. Given the tendency towards a diverse range of investment, SWF investment could support the international role of the euro over the medium term. For foreign exchange reserves, the goal is liquid and safe assets denominated in a currency with low foreign exchange conversion costs – which tends to favour the US dollar. SWFs have more freedom to choose their investments. This is likely to mean a higher share of the euro assets than now is the case for reserves. While an increased international use of the euro would

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<sup>2</sup> The biggest funds are sponsored by the United Arab Emirates (two funds), Norway, Russia, Saudi Arabia, Kuwait, China and Singapore (two funds).

<sup>3</sup> Some forecasts predict a fourfold increase in the next decade, putting the possible scale of SWFs at \$ 12 trillion by 2015

definitely bring benefits, an abrupt shift towards the European currency by SWFs could put unwelcome upward pressure on the euro and should be avoided.

***But they also raise concerns...***

Notwithstanding the recognised benefits of SWF investment, some concerns have been raised by recipient countries, including in the EU. At the macroeconomic level, the rise of SWFs illustrates the seriousness of current-account imbalances in the global economy that have their origin in the managed exchange rates operated by some of the countries in surplus. The accumulation of reserves for investment by SWFs should not become an end in itself. SWF owners need to show that they are not holding back appreciation in their currencies to accumulate more foreign assets for their SWFs.

A more specific concern raised by SWF investment in equities relates to the opaque way in which some SWFs function and their possible use as an instrument to gain strategic control. This concern sets them apart from other types of investment funds. More specifically, there is unease that – whatever the original motivation – SWF investment in certain sectors could be used for ends other than for maximising 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. Although in most cases, SWFs are portfolio investors and have avoided taking controlling stakes or seeking a formal role in decision-making in companies, concerns have been raised about the possibility of SWFs seeking to acquire controlling stakes in companies. National security considerations have been acknowledged by some SWFs owners, who request clarity and certainty about investments that can be made and which areas might be "off-limits" to SWFs.

**2.3. The international debate on SWFs: launching the search for common principles**

SWF investments are not an issue limited to Europe. They are by their very nature a matter of international interest. Their role in the international financial system has been the subject of discussion among both SWFs owners and recipient countries.

Recipient countries have stressed that SWFs should base their investment decisions strictly on economic objectives, and should compete on fair terms with private-sector investors. To this end, recipient countries have called for greater transparency on the part of SWFs. This implies issues like disclosure standards for the value of assets under management, investment objectives and strategies, target portfolio allocations, risk management systems and internal controls. Increased transparency is also important to ensure SWFs are included in global surveillance of financial markets. In addition, recipient countries have called for appropriate governance structures in SWFs, such as guaranteeing a clear division of rights and responsibilities between sponsoring governments and SWF managers, as well as an effective system of checks and balances in respect of investment decisions. In return, recipient countries have acknowledged that any constraints on SWF investments should be based on an objective appraisal of facts within a stable framework of rules and procedures.

Some recipient countries have already examined or have indicated their intention to examine SWF investments to protect their legitimate national interests. The US revised its legislation

concerning the scrutiny of certain transactions involving foreign government control and affecting national security. The US has emphasized the responsibilities of both sponsor countries and recipient countries and has outlined principles that it expects investors to follow. In October 2007, the G7 Finance Ministers invited major multilateral organisations, such as the IMF, and the OECD, to launch a reflection on the role of SWFs and on the mechanisms to address the challenges they pose.

The IMF is now developing a code of conduct for SWFs in cooperation with SWFs owners. This code could cover governance/institutional structure, risk management, transparency/disclosure of information, and accountability. Some SWFs owners are sensitive to the concerns expressed and have backed the idea of a code of conduct or best practice. An IMF Roundtable of Sovereign Asset and Reserve Managers took place in November 2007, focusing primarily on issues of SWF transparency. It is conducting a survey of existing practices in SWFs and will prepare a paper on best practices. In the OECD too, work is underway among recipient countries to identify best practices with respect to SWF investment frameworks, building on principles of non-discrimination, transparency, predictability and accountability.

### **III. IMPROVING THE FRAMEWORK FOR SWF INVESTMENTS**

#### **3.1. International rules and European framework applying to SWF investments**

The recent new focus on improved SWF governance does not however mean that SWFs operate in a legal vacuum today. In Europe, between the EU and the Member State level, there exists a comprehensive regime to regulate the establishment and the actions of foreign investors, which covers SWFs in exactly the same way as any other foreign investor. As soon as they invest in European assets, SWFs have to comply with the same EU and national economic and social legislation that any other investors have to respect.

**The international legal framework** is not fully developed, but a combination of WTO and OECD rules, bilateral and sectoral agreements provides a number of international obligations framing what the EU can do.

The EC and its Member States are bound by these obligations when considering measures on investment by SWFs as for measures pertaining to any other investment. At the same time, both the WTO and the EC bilateral agreements foresee exceptions for reasons of public order or of public security, which allow measures to be taken for genuine national security reasons.

**With regard to the EU legal framework**, investments by SWFs in the EU are subject to the same rules and controls as any other form of investment, either foreign or domestic, where the principles of free movement of capital between Member States, and between Member States and third countries stipulated in Article 56 EC apply.

The free movement of capital is not absolute. As a fundamental principle of the Treaty, it may be regulated in two respects at the European level under Article 57 (2) EC: first, the Community may adopt by qualified majority measures on the movement of capital from third countries involving direct investment. Second, it is not excluded that the Community can introduce – by a unanimous decision - measures that restrict direct investments.

The Merger Regulation allows Member States to take appropriate measures to protect legitimate interests other than competition. Such measures must be necessary, non-

discriminatory and proportionate as well as compatible with other provisions of Community law. Public security, plurality of the media and prudential rules are regarded as legitimate interests, whilst other interests can be considered legitimate on a case by case basis on notification to the Commission.

**Turning to national legislation,** Member States have national instruments which could be used to control and condition SWF investments or any other investors and they can also develop new measures suitable to tackle specific needs if these arise, as long as those measures are compatible with the Treaty, are proportionate and non-discriminatory, and do not contradict international obligations.

The European Court of Justice has provided further guidance on how Member States can take these national measures in full compatibility with the Treaty, stressing that purely economic grounds can never justify obstacles prohibited by the Treaty<sup>4</sup>. The Court has also provided criteria to assess the proportionality of authorisation systems: these must aim at the protection of a legitimate general interest and foresee strict time limits for the exercise of opposition powers, assets or management decisions targeted must be specifically listed, and the system's objective and stable criteria must be subject to an effective review by the courts<sup>5</sup>.

Lastly, there is scope to monitor and control the behaviour of SWFs as investors on an ongoing basis via the regulatory framework, which offers an effective tool to protect public interests irrespective of ownership. This is particularly the case in network industries.

### **3.2. The case for a common approach**

The EU therefore has tools to address problems which may result from the operations of SWFs. Likewise, Member States have adequate powers under the Treaty to deal with public order and public security considerations. Furthermore, SWFs have behaved so far as reliable investors and their activities have not resulted in problems for the functioning of the internal market. However, recent experience shows that the opacity of some SWFs risks prompting defensive reactions. Indeed, in recent months, several Member States have been under pressure to update national legislation and to explore applying exceptions to the application of the principles of free movement of capital and establishment. This pressure can only be increased by SWFs future expected growth in size and importance. There is therefore a case for enhancing the transparency, predictability and accountability of SWF operations. Clearing away unnecessary concerns makes it easier to maintain an open investment environment that allows the EU and its Member States to continue reap the benefits of SWF investments.

There are three reasons that require a common EU approach to SWFs.

- First, as SWFs are a global issue, multilateral solutions offer greater advantages than individual national responses. An international approach can bring a degree of certainty, and allow SWFs to take investment decisions against the backdrop of a common approach. The initiatives now under way at the multilateral level will promote common understanding of the challenges raised by SWFs and the possible mechanisms through which these can be addressed. A common EU approach would maximise European

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<sup>4</sup> In addition, as required by Article 58(3) EC, the measures taken by Member States shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital, Article 56 EC.

<sup>5</sup> See e.g. Judgment of 4 June 2002, case C-503/99, *Commission v. Belgium*, paras. 48-52.

influence in these wider discussions. The same is true of further dialogue with third countries, including those that own and/or operate SWFs.

- Second, the imperative of maintaining a well-functioning internal market based on open and non-discriminatory rules requires that a common approach is followed. An uncoordinated series of responses would fragment the internal market and damage the European economy as a whole. In an integrated single market, the advantages of individual measures can be illusory. Diversity of interpretation and approach risk creating new ways to by-pass the rules and steering investment away from Europe – a disincentive effect that could spread from SWFs to other potential investors. Such risks are real if Member States were to act alone, and in an uncoordinated way, and develop burdensome and binding mechanisms to control or condition investment. By applying the provisions of the Treaty, we guard against this.
- Finally, one of the main goals of EU trade policy is to open third country markets to EU investors, on the basis of the same principles used to govern the internal market. These efforts would be more difficult if the EU was seen as imposing barriers within the EU.

#### **IV. MOVING FORWARD: PRINCIPLES FOR AN EU POLICY RESPONSE TO SWF ISSUES**

##### **4.1. Options for a common EU approach to SWF issues**

The EU approach aims at maintaining a clear, predictable and reliable legal environment, fostering open capital markets and investment worldwide. The EU and its Member States can and should be able to protect legitimate policy objectives without falling into the trap of protectionism. At the same time, the EU has to keep the balance between measures taken vis-à-vis third countries investments and actions taken in the context of the internal market with respect to EU investments.

Various suggestions have emerged in the public debate as possible avenues to step up the European response to SWFs. These have included an EU committee on foreign investments to mirror arrangements in the US, an EU-wide screening mechanism or some "golden shares" mechanism for non-EU foreign investment. All these suggestions run the risk of sending a misleading signal – that the EU is stepping back from its commitment to an open investment regime. They would also be difficult to reconcile with EU law and international obligations.

Instead, the Commission considers that the right approach is to promote a cooperative effort between recipient countries and SWFs and their sponsor countries to establish a set of principles ensuring the transparency, predictability and accountability of SWFs investments. It is essential that all relevant actors are actively involved and have ownership in the creation of a balanced and stable framework covering SWF investments.

There are two dimensions to this approach. The EC expects SWFs to voluntarily commit to certain standards with regard to transparency and governance – to provide sufficient clarity to assuage public concerns. In this respect, the efforts already undertaken by the IMF to design a code of conduct for SWFs and by the OECD to identify best practices for SWF investments in recipient countries should be fully supported. The EU should be a driving force to furthering international work in that regard. At the same time, the SWFs adherence to these standards will help guaranteeing investor countries a clear, predictable and stable investment framework in the EU and its Member States, as well as in other recipient countries.



The Commission therefore proposes a common approach, which should be the EU contribution to efforts at international level to establish a framework to improve transparency, predictability, and accountability of SWFs.

#### 4.2. Principles for a common EU approach to the treatment of SWFs as investors

The common EU approach to the treatment of SWFs as investors should be based on the following principles:

- **Commitment to an open investment environment:** in line with the Lisbon Strategy for growth and jobs, the EU should reaffirm its commitment to open markets for foreign capital and to an investor-friendly investment climate. Any protectionist move or any move perceived as such may inspire third countries to follow suit and trigger a negative spiral of protectionism. The EU prospers from its openness to the rest of the world – and from its investments abroad – and hence would be among the first to suffer from a trend towards protectionism. At the same time, the EU should endeavour to open SWFs owners' countries to EU investors and secure a fair and equitable treatment for them, notably through FTA negotiations.
- **Support of multilateral work:** the EU should actively drive forward work carried out by international organisations, in particular the IMF and the OECD. The EU welcomes an open dialogue with SWFs owners and recognises the benefits of a global approach to a common framework for SWF investment.
- **Use of existing instruments:** the EU and the Member States already have specific instruments that enable them to formulate appropriate responses to risks or challenges raised by cross-border investments, including investments by SWFs, for reasons of public policy and public security.
- **Respect of EC Treaty obligations and international commitments:** the EU and its Member States will continue to act in a way fully compatible with the principles laid down in the Treaty establishing the EC and with international obligations of the EU.
- **Proportionality and transparency:** measures taken for public interest reasons on investment should not go beyond what is necessary to achieve the justified goal, in line with the principle of proportionality, and the legal framework should be predictable and transparent.

These basic principles should define the common EU approach which should be proposed as the basis for an understanding between recipient countries on the treatment of SWFs investments. Transposed at international level, this common approach should draw on the above principles of openness to cross-border investments, preference for multilateral solutions, respect of existing international obligations, proportionality and predictability of rules.

#### 4.3. Building confidence in the operation of SWFs: the European contribution to a code of conduct for sponsor countries and for SWFs

There are two keys to effectively addressing concerns about the uncertainty and unpredictability of SWFs, and they should be at the heart of the European contribution to global work on a common framework for SWF investment. The first is to obtain greater

clarity and insight into the governance of SWFs. The second is to deliver greater transparency on their activities and investments. These two elements need to be addressed by the sponsor countries and the sovereign funds.

**(a) Governance**

Clarity about the degree of possible political interference in the operation of a SWF is a prerequisite for addressing concerns about the existence of political and other non-commercial considerations in the operation of a fund. The 2001 IMF *Guidelines for Foreign Exchange Reserve Management*<sup>6</sup> lay down important principles which could be extended to SWF. Equally, the OECD *Guidelines on Corporate Governance of State-Owned Enterprises*<sup>7</sup> put forward principles relevant for SWFs that undertake cross-border investments.

Principles of good governance include:

- The clear allocation and separation of responsibilities in the internal governance structure of a SWF;
- The development and issuance of an investment policy that defines the overall objectives of SWF investment;
- The existence of operational autonomy for the entity to achieve its defined objectives;
- Public disclosure of the general principles governing a SWF's relationship with governmental authority;
- The disclosure of the general principles of internal governance that provide assurances of integrity;
- The development and issuance of risk-management policies.

**(b) Transparency**

Transparency provides a disciplinary effect on the management of sovereign assets, as relevant stakeholders can exercise some degree of oversight on the activities of investors, and monitor whether or not funds deviate from their stated objectives. As such, transparency promotes accountability. In the case of SWFs, transparency not only serves to foster market discipline, but also reduces the incentives for any government intervention. It is therefore a critical factor in offering the confidence that underlies an open investment environment.

Since SWFs are managed independently from a country's foreign exchange reserves, they are excluded from transparency mechanisms such as the IMF maintains for foreign exchange reserves (IMF Special Data Dissemination Standard, SDDS). The extension of specific transparency standards to SWFs should be considered. Existing IMF and OECD guidelines already contain such standards, and some SWFs, such as those of Norway and Singapore are governed by principles which could be seen as a reference. However, SWFs should not be expected to follow transparency practices going beyond those developed by the IMF and the OECD and already applicable to similar state-owned investors.

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<sup>6</sup> <http://www.imf.org/external/np/mae/ferm/eng/index.htm>

<sup>7</sup> <http://www.oecd.org/dataoecd/46/51/34803211.pdf>

Transparency practices that could be considered would include:

- Annual disclosure of investment positions and asset allocation, in particular for investments for which there is majority ownership;
- Exercise of ownership rights;
- Disclosure of the use of leverage and of the currency composition;
- Size and source of an entity's resources;
- Disclosure of the home country regulation and oversight governing the SWF.

## V. CONCLUSION

The Spring European Council offers an opportunity for the Member States to endorse a coherent approach to SWF investments in response to emerging concerns. Such a coordinated approach does not impinge on national prerogatives and existing powers to protect legitimate public policy objective and interests. It aims at setting out shared expectations for increased transparency, predictability and accountability of SWF operations and to bring additional influence to the European contribution to the global search for solutions to this challenge.

In line with its Treaty principles and the renewed Lisbon Strategy, Europe must remain committed to its tradition of openness to capital investments, as they are a vital source of strength for the European economies in a globalised world. At the same time, the case for openness must be sustained by engaging SWFs in a cooperative effort to enhance their governance standards and the quality of information they provide to markets. This is not only to the benefit of the EU, but is in the mutual interest of all recipient countries as well as of sponsor countries.

The EU common approach should serve as a contribution to the IMF efforts to set up a code of conduct for SWFs and for their owners and to the OECD work to define principles applied by recipient countries when dealing with SWFs. It should help to reach an agreement, preferably by the end of 2008, on a set of guidelines that will build the necessary confidence in the fair and transparent operation of SWFs.