BYU Law Review

Volume 48 | Issue 4 Article 9

Spring 5-12-2023

Regulating Strategic Sovereign Wealth

Paul Rose

Follow this and additional works at: https://digitalcommons.law.byu.edu/lawreview

Part of the Law Commons

Recommended Citation
Paul Rose, *Regulating Strategic Sovereign Wealth*, 48 BYU L. Rev. 1345 (2023).
Available at: https://digitalcommons.law.byu.edu/lawreview/vol48/iss4/9

This Article is brought to you for free and open access by the Brigham Young University Law Review at BYU Law Digital Commons. It has been accepted for inclusion in BYU Law Review by an authorized editor of BYU Law Digital Commons. For more information, please contact hunterlawlibrary@byu.edu.

Regulating Strategic Sovereign Wealth

Paul Rose[*]

In an era of ascendant globalization, sovereign wealth funds were used by governments around the world—and, in particular, by governments with massive natural resource wealth or balance-of-trade surpluses—to invest widely in foreign markets. Sovereign wealth funds were products of the international economic order then in existence, adapted to a political and economic environment in which borders could be easily crossed and foreign assets seemed abundant and easily acquired. After the Financial Crisis, and with the increasing nationalization seen in the 2010s, this environment began to change. Both domestic and international forces spurred the development of new, "strategic" sovereign funds. No longer operating primarily in international markets, nor tightly linked to the international economic order, these sovereign funds are developments of a more desperate age. Rather than focusing on outward investment, these sovereign funds turn inward, focusing instead on domestic concerns and prioritizing domestic political legitimacy. While these strategic funds are designed to thrive in more nationalized economic and political environments, the legal regimes of the sovereign funds' home jurisdictions must also adapt to the domestic turn in sovereign funds. This Article analyzes recent legal adaptations that attempt to manage a more mercantilist and nationalistic orientation from sovereign funds, and it outlines a framework for the legal innovations necessary to regulate and govern the funds within their home jurisdictions and minimize the risk of negative spillovers in other jurisdictions.

*Robert J. Watkins/Proctor & Gamble Professor of Law, The Ohio State University. The author thanks Bernardo Bortolotti, Diego Lopez, Brian Galle, Darien Shanske, and participants at the Yale Law School's Fourth Conference on Law and Macroeconomics for helpful comments on an earlier draft. Sarah Roveda provided excellent research assistance.

CONTENTS

INTRODUCTION....1347

I. THE EVOLUTION OF SOVEREIGN FUNDS....1351

A. A Standard Typology of Sovereign Wealth Funds....1354
B. Distinguishing Strategic Funds from Other Sovereign Funds....1359
1. Political Orientation: From International to Domestic....1361
2. Financial Orientation: From Wealth Maximization to a Multi-Equilibrium Model....1363
C. Distinguishing Mixed-Capital Strategic Funds and Public-Capital Strategic Funds....1369
D. Reflections on Strategic Funds as a Policy Choice....1372

II. ASSESSING SOVEREIGN WEALTH AND STRATEGIC INVESTMENT FUND RISKS....1376

A. Common Sovereign Fund Risks....1376
1. Legitimacy and Accountability....1377
2. Corruption and Waste....1377
3. Politicization....1378
4. Negative Political and Financial Externalities....1379
B. Strategic Fund Risks....1379
1. Competing Priorities....1380
2. Distortions....1381
3. Corruption....1382
4. Governance Gaps....1382

III. LEGAL PRINCIPLES FOR STRATEGIC FUNDS....1384

A. Common Governance Principles for Strategic Funds....1386
1. Oversight....1387
2. Investment Policies....1388
3. Conflicts and Conduct Policies....1390
4. Performance Metrics....1391
B. Domestic Regulation of Publicly Funded Strategic Funds....1393
1. The Legal Structure of the Fund....1394
2. Objectives/Mandate....1394
3. Funding and Withdrawal Mechanisms....1394
4. Ownership....1395
5. Independence....1395
6. Lending and Liquidity....1395
C. Domestic Regulation of Mixed-Capital Funded Strategic Funds....1397
D. Foreign Investment Regulations....1399
1. CFIUS and Foreign Investment Regulation....1400
2. Anti-Corruption....1401

E. International Legal Frameworks for Strategic Funds 1407
CONCLUSION 1411

INTRODUCTION

The international economic order, cobbled together through a series of treaties and agreements that focused on free trade, free markets, and intellectual property protections,[1] is under unprecedented stress. After an era of expansive globalization, a seeming "end of history" characterized by thriving international trade and cross-border capital flows, markets have made a dramatic domestic turn. The COVID-19 pandemic has hastened—but did not create—this change.[2] Indeed, the Financial Crisis of 2007 and the ongoing climate crisis are earlier contributors to this reorientation. The resonance of the "America First" doctrine, the success of the Brexit campaign, and China's political tightening in recent years all reveal the fragility of the international economic order.

The domestic turn has both international and domestic dimensions. Internationally, the international economic order—with its focus on both democratization and marketization—has come under attack from emerging powers, including China, Brazil, Russia, India, and other powers which "share an ambivalence, or even an outright rejection, of the foundational precepts . . . which shaped the post-Cold War world order."[3] Domestically, many countries' citizens are deeply anxious about rising inequality, social

1. These agreements ushered in an era that Steinberg characterizes as a "global hyperliberalism" in which "international rules more deeply adhered to laissez-faire capitalism and were less embedded in an egalitarian social contract; international relations were subject to deeper judicialization (e.g., more courts and tribunals); and the U.S. and many allies embraced regime change to spread democracy and human rights." Richard H. Steinberg, *The Rise and Decline of a Liberal International Order*, *in* IS THE INTERNATIONAL LEGAL ORDER UNRAVELING? 37, 38 (David L. Sloss ed., 2022).

2. Victoria Barbary, the strategy director of the International Forum of Sovereign Wealth Funds (IFSWF) notes, for example, that "[t]here is a general shift away from investing in international markets, to demonstrate the value of sovereign-wealth funds to citizens . . . . Countries planning new sovereign-wealth funds are increasingly focused on investing at home. This is a trend that Covid has accelerated." Simon Clark, *Sovereign-Wealth Funds Invest More at Home as Covid-19 Hits Economies*, WALL ST. J. (July 16, 2021), https://www.wsj.com/articles/sovereign-wealth-funds-invest-more-at-home-as-covid-19-hits-economies-11626427802.

3. Mohamed S. Helal, *The Crisis of World Order and the Constitutive Regime of the International System*, 46 FLA. ST. U. L. REV. 569, 636 (2019).

and technological change, the pace of change, and, for some Western countries especially, the reallocation of global power. In the words of one former U.S. President, Donald Trump, the nationalist doctrine developed in response to these changes requires "wise leaders" to "always put the good of their own people and their own country first. The future does not belong to globalists. The future belongs to patriots."[4]

The anti-globalist call echoes across political party lines. On one side of the political spectrum, "leftists, anarchists, environmentalists, and human rights activists [express] discontent at the dislocations and distortions caused by globalization,"[5] while right-wing populists also reject many of the ideas and institutions that underpin neoliberalism, including "free trade, environmental protection, pro-immigration policies, multiculturalism, and multilateralism."[6] Both groups view the economic logic of globalization to be fundamentally flawed: existing political and economic systems have been built on a belief that globalization would be a "positive sum game" such that trade concessions, for example, could "enlarge the pie to mutually benefit all participants in the system."[7] The nationalist view of globalization, by contrast, assumes a "zero sum game"; the pie of

4. President Donald Trump, Remarks to the 74th Session of the United Nations General Assembly (Sept. 24, 2019), https://www.govinfo.gov/content/pkg/DCPD-201900657/pdf/DCPD-201900657.pdf.

5. Helal, *supra* note 3, at 636. Nationalism is linked to these disparities, and particularly to a resistance to a reordering of one's perceived place in a social order. Fukuyama characterizes this resistance as a "thymotic" struggle for dignity: "Thymos . . . (following G. W. F. Hegel) has been the primary driver of the entire human historical process." Francis Fukuyama, *Identity and the End of History*, THE AM. INT. (Aug. 23, 2018), https://www.the-american-interest.com/2018/08/23/identity-and-the-end-of-history/. In this neo-Hegelian theory, thymos, a desire for recognition of one's inherent value and dignity, may manifest in two forms: as isothymia, a desire to be recognized as the equal of other people, or more perniciously as megalothymia, the demand of certain individuals to be recognized as superior to others. Nationalism, as expressed through Trump's America First doctrine or through the U.K.'s Brexit, are "a megalothymic backlash against the isothymic forces of multiculturalism and international cooperation." Tim Adams, *Francis Fukuyama: 'Trump Instinctively Picks Racial Themes to Drive People on the Left Crazy'*, THE GUARDIAN (Sept. 16, 2018), https://www.theguardian.com/books/2018/sep/16/francis-fukuyama-interview-trump-picks-racial-themes-to-drive-people-on-the-left-crazy. In Fukuyama's view, domestic policies that favor open trade and open borders accelerate change and dislocation, with a resulting and predictable backlash.

6. Helal, *supra* note 3, at 636.

7. Ian Sheldon, William McGuire & Daniel C. K. Chow, *The Revival of Economic Nationalism and the Global Trading System*, 40 CARDOZO L. REV. 2133, 2137 (2019).

global wealth is fixed such that enlarging any one nation's piece diminishes the size of other nations' pieces.[8]

The force of these nationalist responses to globalization reverberates across politics and economics, and sovereign wealth funds (SWFs)—"special-purpose investment funds that are owned by a government"[9]—are at the intersecting fault lines of both. As some of the largest investors in the world, SWFs collectively control over $10 trillion in assets, an amount roughly equivalent to 25% of the combined market value of all the companies in the S&P 500.[10] In an era of globalization, SWFs were used by governments—and, in particular, by governments with massive natural resource wealth or balance-of-trade surpluses—to invest broadly around the world. The SWF was built for a time in which wealth maximization was a primary concern, when national-level funds could be used to secure prestige and help maintain power, and when both the international economic order and the sovereign's domestic politics expected and even welcomed investments in foreign markets. SWFs were products of the international economic order, adapted to thrive in a political and economic environment in which borders could be more easily crossed and foreign assets could be more easily acquired.

But after the turmoil of recent years, new strategic sovereign funds with domestic mandates have begun to appear. Rather than focusing on outward, international investment, these strategic funds turn inward, addressing domestic concerns and social objectives. In a more globalist era, SWFs typically adopted a

8. *Id*. at 2137–38 (noting that "[t]he adoption of an approach that is so fundamentally at odds with the underlying logic of the GATT/WTO by the world's most powerful trading nation poses a threat to the entire foundations of the multilateral trading system.").

9. INT'L WORKING GRP. OF SOVEREIGN WEALTH FUNDS, SOVEREIGN WEALTH FUNDS: GENERALLY ACCEPTED PRINCIPLES AND PRACTICES: "SANTIAGO PRINCIPLES" 2 (2008), https://www.ifswf.org/sites/default/files/santiagoprinciples_0_0.pdf [hereinafter SANTIAGO PRINCIPLES].

10. *See Global SWF—Sovereign Wealth Funds & Public Pension Funds*, SWF Mar. 2023), https://globalswf.com/. This is only slightly less than the combined amount of all combined private alternative asset classes, including hedge funds, private equity funds, private debt, real estate funds, infrastructure, and unlisted natural resources (together totaling $10.74 trillion at the end of 2020). *Prequin Special Report: The Future of Alternatives*, PREQUIN (Nov. 2020), https://oss.cyzone.cn/2021/0121/0126eb26887531b1621982b5191bbd19.pdf. The total market value of the S&P 500 was approximately $40.36 trillion as of December 2021. *See S&P 500 Market Cap*, YCHARTS, https://ycharts.com/indicators/sp_500_market_cap (last visited Feb. 7, 2022).

characteristically private fund-orientation toward wealth maximization and were used to acquire financial power, financial independence, and prestige for their beneficiaries (whether elites or citizens in general). In this new age of strategic sovereign investment, however, funds are co-investing alongside private investors in support of public goods and are used as tools to more directly secure domestic political legitimacy by resolving some of the dislocations and disruptions caused by globalization.

The older, internationalist SWFs were well-adapted to the soft-law ecosystem that grew up around the international economic order. But as that environment changes, these funds may struggle to adapt to a world that has grown colder to large, foreign, state-owned investment vehicles. The new strategic funds, by contrast, operate in a more nationalized economic and political environment.

As tools of political legitimacy—and in a moment when governments and government institutions face both a climate crisis as well as potential crises of legitimacy[11]—the stakes for the successful deployment of strategic funds could not be higher. Yet existing legal and regulatory environments have not caught up to these political and economic shifts. If old-style SWFs may struggle to adapt to new political and economic conditions, sovereigns must take care that strategic funds do not behave like an invasive species that damages existing domestic ecosystems. While concerns with SWFs in years past focused on their risks as foreign-state actors operating in private, capital markets, the new, strategic sovereign wealth fund poses more danger to a sovereign's domestic markets and political legitimacy.

The paradigms that governed sovereign wealth investment for the last fifteen years are not up to these regulatory challenges. This Article offers a solution by providing the first systematic discussion of the rise of this new class of sovereign funds, then by developing a systematic legal and regulatory framework adapted to this shift. Because strategic funds represent a move away from wealth maximization to a "double-bottom-line" or multiple-equilibrium model in which the fund pursues both financial and social goals, this Article further contributes to the current debate on how legal and governance structures can make credible

11. Anthony Painter, *A Crisis of Legitimacy?*, 165 RSA J., no.3, 2019, at 10 (describing the legitimacy challenges facing EU political and economic institutions).

commitments to the achievement of social goals using for-profit business entity structures.

In Part I, the Article provides an overview of the development of sovereign funds, setting out a typology and providing a framing for why sovereigns have begun to turn away from wealth-maximizing, passive investment funds to public-good-producing strategic funds. This Part describes the evolution of strategic sovereign funds; while most sovereign funds were designed to fit into (and even reinforce) the international economic order, this new kind of fund is designed to reinforce and legitimize domestic political and economic systems.

Part II builds on this foundation and provides a framing that demonstrates the urgency of new legal and governance systems that support the goals of these new strategic funds. The part conceptualizes and categorizes the risks of sovereign investment for both sovereign funds generally and for strategic funds in particular.

Part III then sets out the crucial legal and governance adaptations that will help mitigate the risks identified in Part II. Because these adaptations must be implemented in the domestic laws of strategic fund home countries, the Article offers legal and institutional frameworks that can apply across a variety of jurisdictions. Because other countries and their regulations may impact and be impacted by strategic fund operations, the Article also describes the important roles that foreign investment laws, anticorruption laws, and international "soft" laws can play in ensuring the successful management of strategic funds.

I. THE EVOLUTION OF SOVEREIGN FUNDS

SWFs have existed as a defined category of public funds since 2005, when analyst Andrew Rozanov coined the term in an Article on the role these funds performed as a support to central banking activities.[12] But special purpose government funds—particularly natural resource-based funds that serve defined governmental purposes—have been in existence for centuries. For example, such funds have existed at the state level in the United States from the earliest days of the Republic. The Land Ordinance of 1785 prescribed a system of surveying and apportioning lands ceded by

12. *See* Andrew Rozanov, *Who Holds the Wealth of Nations?*, 15 INT'L J. CENT. BANKING 52 (2005).

states to the federal government. The Northwest Ordinance of 1787 likewise set aside a portion of the lands to provide resources, either through sale or resource extraction, for the benefit of schools in the newly-created townships.[13] The allocation of natural resources for a public purpose portended the creation of resource-based sovereign wealth funds two centuries later, as many countries set aside a portion of natural resource wealth as a store of value for future generations, to serve as transition funds to support new forms of economic activity, and to act as economic shock absorbers.[14]

Sovereign funds serve a variety of political and economic purposes. In terms of fiscal and economic policy, sovereign funds are often used to manage exchange rate risks, particularly following the currency and financial crises of 1991–1998.[15] Rather than leaving

13. States appointed surveyors who, after taking oaths before the Geographer of the United States for the faithful discharge of the duties, were to divide the territories into townships of squares of six miles on each side. Each township was then further divided into 36 sections of one square mile each, with sections numbered south to north, east to west, beginning with the southeast corner of each township. The statute then reserved the 16th lot "for the maintenance of public schools, within the said township," placing the school lands at the center of the township. *Id.* This land was not merely reserved for the physical location of a school, however; many states sold the land or natural resources from the land to fund schools. The Northwest Ordinance of 1787 states that "Religion, morality, and knowledge, being necessary to good government and the happiness of mankind, schools and the means of education shall forever be encouraged." Northwest Ordinance of 1787, 1 Stat. 51 (1787).

14. An oddity of sovereign wealth funds, as Bortolotti, Fotak, and Megginson note, is that they walk against the traffic of privatization. *See* Bernardo Bortolotti, Veljko Fotak, & William L. Megginson, *The Rise of Sovereign Wealth Funds: Definition, Organization, and Governance*, Baffi Ctr. Rsch. Paper No. 2014-163, (Dec. 2014), available at SSRN: https://ssrn.com/abstract=2538977 or http://dx.doi.org/10.2139/ssrn.2538977. But, of course, the privatization movement is itself an unwinding of an earlier movement of nationalization of private enterprise or the creation of state enterprises following the Great Depression. In an era in which some of the great economists of the age were advocating for the nationalization of land, mineral deposits, telephone service, insurance, and the automobile industry, the ''socialization'' of the iron, steel, and chemical industries, or even the nationalization of a few firms in each industry to facilitate the comparison of public and private ownership, the privatization of classically governmental services such as prisons and education was "not even discussed by serious scholars." Andrei Shleifer, *State Versus Private Ownership*, 12 J. Econ. Persps. 133, 133 (Fall 1998) (reporting on the work of Nobel laureates W. Arthur Lewis, in THE PRINCIPLES OF ECONOMIC PLANNING, (1949); James Meade, *in* PLANNING AND THE PRICE MECHANISM: THE LIBERAL SOCIALIST SOLUTION (1948); and Maurice Allais, *Le Probleme de la Planification Economique dans une Economie Collectiviste,* KYKLOS vol. 1, no. 3 (1947)).

15. CHARLES WYPLOSZ, THE FOREIGN EXCHANGE RESERVES BUILDUP: BUSINESS AS USUAL? 1 (2007) (manuscript prepared for the Workshop on Debt, Finance and Emerging Issues in Financial Integration, 2007), https://www.researchgate.net/profile/Charles-

these hoards of currency in state-owned bank accounts, many countries have sought a market return by investing some of the funds in public markets.[16] Other sovereigns managing natural resource wealth have invested a portion of the revenues generated through sales of oil and natural gas,[17] which traded at less than $15/barrel in 1999 to around $140/barrel in 2008.[18] Furthermore, as noted by Clark and Monk, sovereign funds can serve as a buffer against the vicissitudes of modern financial markets, thereby enhancing political stability. Sovereign funds generally may also help buttress sovereign borrowing efforts, as they can serve as collateral or guarantee for sovereign debt issuances.

Yet despite the role these funds play in supporting domestic economies, sovereign funds were designed to operate within the international economic order; indeed, the Santiago Principles, a set of best practices for sovereign wealth operations and governance structures, were developed in part to show that SWFs could "help

---

Wyplosz/publication/254350493_The_Foreign_Exchange_Reserves_Buildup_Business_as_Usual/links/0f31753b50f07128e3000000/The-Foreign-Exchange-Reserves-Buildup-Business-as-Usual.pdf (asserting that countries "see their stockpiles as a way to self-ensure themselves against foreign exchange market turbulence").

16. Bortolotti, Fotak, & Megginson, *supra* note 14, at 4.

17. *Id.* While not all sovereign wealth comes from these two sources, they are the foundations for the world's largest sovereign funds. As explained by Kimmitt,

> SWFs generally fall into two categories according to the source of the foreign exchange assets. Commodity SWFs are funded by commodity exports that are either owned or taxed by the government. These funds serve different purposes, including fiscal revenue stabilization, intergenerational saving, and balance-of-payments sterilization (that is, keeping foreign exchange inflows from stoking inflation). Given the current extended rise in commodity prices, many funds initially established for the purposes of fiscal stabilization or balance-of-payments sterilization have evolved into intergenerational savings funds.
>
> Noncommodity SWFs are typically established through transfers of assets from official foreign exchange reserves. Large balance-of-payments surpluses have enabled noncommodity exporters to transfer "excess" foreign exchange reserves to standalone investment funds that can be managed for higher returns. Noncommodity funds often arise from an exchange-rate intervention involving a domestic liquidity increase that has to be absorbed by issuing domestic debt to avoid unwanted inflation. Their net return depends on the difference between the yield earned on investments and the yield paid on domestic debt. The assets of this type of SWF, accordingly, may be thought of more as borrowed money than traditional wealth.

Robert M. Kimmitt, *Public Footprints in Private Markets*, FOR. AFF. (Jan./Feb. 2008), https://www.foreignaffairs.com/articles/2008-01-01/public-footprints-private-markets.

18. *Crude Oil*, TRADING ECONS., https://tradingeconomics.com/commodity/crude-oil (last visited Feb. 15, 2023).

maintain a stable global financial system and free flow of capital and investment."[19] Because some sovereign funds were created to manage balance-of-trade surpluses, it is fair to say that such funds exist *because of* the international economic order. Additionally, they may be considered as tools of globalization in their own right, as they are designed to take wealth accumulated either through international trade or international commodities sales and reinvest those funds in other markets around the world, thus extending and strengthening economic ties between nations.

This Part sets out a framework that first describes and categorizes sovereign funds generally, then details the rise of the new class of strategic sovereign funds.

A. A Standard Typology of Sovereign Wealth Funds

Modern sovereign funds can be characterized by their macroeconomic purposes, and these purposes are generally tied to the type and source of the wealth. The IMF, for example, distinguishes sovereign funds into five main types based on their policy objectives:[20] stabilization funds, savings funds, reserve investment funds, development funds, and pension reserve funds.

Stabilization funds, as their name denotes, are used to stabilize budgets that are often highly dependent on a single or small basket of commodities, such as oil, natural gas, copper, coal, or other natural resources. SWFs are in effect a "macro hedge" against a sharp fall in revenues from export receipts, such as might occur with shifts in pricing or consumption of a country's primary export commodities.[21] This type of SWF is thus designed to insulate the budget from swings in revenues, as well as to provide other macroeconomic smoothing effects, such as helping to manage exchange rates, inflation, and Dutch Disease.[22] Such funds will set

19. SANTIAGO PRINCIPLES, *supra* note 9, at 4.

20. INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT 46 (2007), https://www.imf.org/external/pubs/ft/gfsr/2007/02/pdf/annex12.pdf. *See also* IMF, *Sovereign Wealth Funds – A Work Agenda*, IMF SURV. MAG., Mar. 2008.

21. Y. V. REDDY, GOVERNOR OF THE RRSV. BANK OF INDIA, Y V REDDY: FOREX RESERVES, STABILIZATION FUNDS AND SOVEREIGN WEALTH FUNDS – INDIAN PERSPECTIVE, *at the* GOLDEN JUBILEE CELEBRATIONS OF THE FOREIGN EXCH. DEALERS' ASS'N OF INDIA, MUMBAI (8 October 2007), https://www.bis.org/review/r071009b.pdf.

22. The Santiago Principles explain Dutch Disease as "the situation where a boom in a commodity sector of the economy could lead to a loss of competitiveness for other sectors

aside some of the wealth generated from the sale of (or taxes on the private sale of) the resource to buffer the budget from commodity price volatility or to ease an economy's transition away from natural resource sales. Stabilization funds can thus serve as a key component of a country's climate change adaptation strategy.

Savings funds serve as intergenerational wealth transfer vehicles, setting aside some of the wealth acquired through balance-of-trade surpluses or through natural-resource extraction; as with stabilization funds, savings funds are typically a macroeconomic policy choice of commodity-rich countries, such as Norway[23] or Abu Dhabi.[24] The purpose of such funds is both to

in this economy." SANTIAGO PRINCIPLES, *supra* note 9. Christine Ebrahimzadeh supplies a succinct history of the term:

> In the 1960s, the Netherlands experienced a vast increase in its wealth after discovering large natural gas deposits in the North Sea. Unexpectedly, this ostensibly positive development had serious repercussions on important segments of the country's economy as the Dutch guilder became stronger, making Dutch non-oil exports more expensive and, therefore, less competitive. This syndrome has been witnessed in many countries across the world, including but not limited to resource-rich commodity exporters. Although Dutch disease is generally associated with a natural resource discovery, it can occur from any development that results in a large inflow of foreign currency, including a sharp surge in natural resource prices, foreign assistance, and foreign direct investment. Economists have used the Dutch disease model to examine such episodes as the flow of American treasures into 16th century Spain and gold discoveries in Australia in the 1850s.

Christine Ebrahimzadeh, *Dutch Disease: Wealth Managed Unwisely*, INT'L MONETARY FUND (Feb. 24, 2020), https://www.imf.org/external/pubs/ft/fandd/basics/dutch.htm.

23. The Norwegian Ministry of Finance, for example, characterizes the purpose of Norway's $1 trillion sovereign funds as follows:

> Large state revenues from the petroleum activities have resulted in substantial financial assets in the GPFG. The Fund was established in 1990 as a fiscal policy tool to underpin long-term considerations in the phasing in of petroleum revenues into the Norwegian economy. Long-term, sound management of the Fund helps to ensure that both present and future generations can benefit from Norway's petroleum wealth.

Government Pension Fund Global (GPFG), NORWAY MINISTRY OF FINANCE, https://www.regjeringen.no/en/topics/the-economy/the-government-pension-fund/government-pension-fund-global-gpfg/id697027/.

24. The Abu Dhabi Investment Authority states that its purpose is "to receive funds of the Government of the Emirate of Abu Dhabi allocated for investment, and invest and reinvest those funds in the public interest of the Emirate in such a way so as to make available the necessary financial resources to secure and maintain the future welfare of the Emirate." *Santiago Principles Self-Assessment*: *Abu Dhabi Investment Authority*, INT'L FORUM OF SOVEREIGN WEALTH FUNDS (2019), https://www.ifswf.org/assessment/abu-dhabi-investment-authority-2019. Approximately 60% of all central bank reserves are held in U.S.

serve as vehicles to transform resources into financial assets and to provide a return on investment from the sale of the commodities. The logic at the foundation of such a fund is to compensate future generations for the loss of finite resources such as oil or natural gas; however, as future generations will likely have little or no use for fossil fuels, the fund can also be conceptualized as compensating future generations for the negative externalities caused by the use of fossil fuels or other extracted commodities by past and present generations.

Reserve investment funds help countries obtain a return on the foreign currency assets held by their central banks.[25] Central banks will often hold billions or even trillions of dollars[26] in their official accounts.[27] Reserve investment funds allow countries to invest these funds in corporate bonds, stocks, or other assets that provide a positive yield. Reserve funds will typically invest in foreign assets to help manage the exchange-rate impacts that gave rise to the sovereign wealth fund in the first place. Many sovereign funds will also invest in foreign markets because they provide deep, rich investment possibilities that are thus less likely to create domestic or foreign political waves, particularly when individual portfolio firm investments are relatively small.

dollar-denominated assets. CONG. RSCH. SERV., THE U.S. DOLLAR AS THE WORLD'S DOMINANT RESERVE CURRENCY (2022), https://crsreports.congress.gov/product/pdf/IF/IF11707. CRS notes that "[a]bout half of international trade is invoiced in dollars, and about half of all international loans and global debt securities are denominated in dollars. In foreign exchange markets, where currencies are traded, dollars are involved in nearly 90% of all transactions." *Id.*

25. As explained by the IMF, countries hold reserve foreign currencies for a variety of reasons, including a desire to "support and maintain confidence in the policies for monetary and exchange rate management including the capacity to intervene in support of the national or union currency," to "absorb shocks during times of crisis," to "provide a level of confidence to markets that a country can meet its external obligations," and to "demonstrate the backing of domestic currency by external assets[.]" *Guidelines for Foreign Exchange Reserve Management*, INT'L MONETARY FUND, (Sep. 20, 2021), https://www.imf.org/external/np/mae/ferm/eng/index.htm.

26. China, for example, holds over $3.2 trillion in official U.S. dollar reserve assets. People's Republic of China, *Official Reserve Assets*, STATE ADMIN. OF FOREIGN EXCH., (2021), http://www.safe.gov.cn/safe/2021/0202/18181.html.

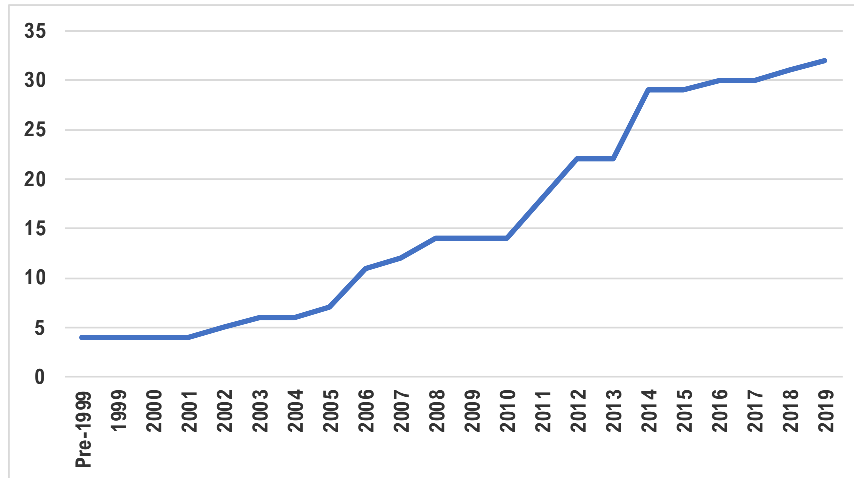
27. The U.S. dollar is the preeminent reserve currency, although the euro, the yen, the pound, the renminbi (RMB), the Canadian dollar, the Swiss franc, and the Australian dollar are also significant reserve currencies. CONG. RSCH. SERV., IF11707, THE U.S. DOLLAR AS THE WORLD'S DOMINANT RESERVE CURRENCY (2022), https://crsreports.congress.gov/product/pdf/IF/IF11707.

Pension reserve funds invest funds that are intended to meet implicit, but not defined or contractual, sovereign guarantees. A defining feature of all sovereign wealth funds, including pension reserve funds, is that they do not have defined liabilities—in other words, the funds are not designed to pay out a particular stream of income to meet a defined obligation, such as with an employee pension fund that must pay out to its beneficiaries.[28] Pension reserve funds are intended to provide a backstop for contingent liabilities, as in the event that a pension fund with defined liabilities is not able to meet its obligations.

Finally, some countries have created strategic sovereign funds, sometimes also called development funds. These recently evolved funds invest in domestic projects such as infrastructure, economic catalyzation initiatives, or climate adaptation or mitigation efforts. The growth of these funds has been dramatic in the past ten years, as shown in the chart below.

28. As discussed in Part II, *infra*, this lack of defined liabilities is one of the investment advantages of sovereign funds. Because they do not have defined liabilities, they are able to invest in illiquid assets (having no requirement to invest primarily or only in assets that can be quickly (and with minimal transaction costs) be converted into the cash needed to satisfy current liabilities). Thus, many funds with current liabilities are limited in their ability to invest in long-lived or illiquid investments, such as many infrastructure investment projects.

Figure 1. Growth in National-Level Strategic Investment Funds (Total Number of Funds)



The type of fund—and the kind of macroeconomic problem the sovereign fund is intended to solve—will typically dictate how the fund invests. As the International Forum of Sovereign Wealth Funds (IFSWF) explains, the SWF's policy purpose "guides its investment policy and asset management strategy."[29] Stabilization funds, which manage short- to medium-term budget shortfalls, will invest in financial instruments that have shorter investment horizons and that can be easily converted into cash. Savings funds, on the other hand, will often invest in less liquid financial instruments with longer investment cycles, so as to generate "higher returns over a long time horizon."[30] SWFs designed to hedge against country-specific risks, such as a downturn in commodities prices, "may hold assets with negative correlation to the country's major exports to offset terms-of-trade shocks."[31]

As described in the next section, strategic funds are designed to solve domestic policy concerns, often related to domestic system or market failures[32] that have resulted in poor infrastructure

29. SANTIAGO PRINCIPLES, *supra* note 9, at 13.

30. *Sovereign Wealth Funds – A Work Agenda*, *supra* note 20, at 11.

31. SANTIAGO PRINCIPLES, *supra* note 9, at 13.

32. Neo-classical economics justified government intervention by identifying market failures. More recently, however, other scholars have pointed to a broader category of

development or underperforming economic sectors. These problems typically call for long-term investment solutions.

B. Distinguishing Strategic Funds from Other Sovereign Funds

Unlike the other sovereign fund types, which often have a dedicated source of funds that are then used for macroeconomic purposes, strategic funds are perhaps most accurately characterized as tools of domestic political legitimacy. In this they differ from other types of sovereign funds; stabilization funds, savings funds, and reserve investment funds are created to solve economic problems. Strategic funds are designed to solve political problems, and in a more politicized, more nationalistic world economic environment, strategic funds fill a domestic policy niche by managing the effects of dislocation, disruption, and destruction caused by globalization. The difference is a matter of both scale and scope: a country uses a sovereign wealth fund to manage a national budget, but it uses a strategic fund to build a bridge, a road, or an airport.

To delineate strategic funds more clearly from other forms of sovereign wealth, the World Bank identifies six characteristics exhibited by all strategic funds. Strategic funds:

- Are initiated by, and fully or partly capitalized, by one or more governments, or by quasi sovereign entities (e.g., government-owned global or regional development finance institutions);
- Invest primarily in unlisted assets—either domestically or thematically—to achieve financial returns as well as the fulfillment of a policy objective ("double bottom line"); the latter is sometimes referred to as the pursuit of economic returns;

systems failures, such as "failure in infrastructure provision" (like higher education, regulatory agencies, libraries, and even government agencies and ministries), "transition . . . failures" (the inability of firms or industries to adapt to technological shifts), "lock-in failures" (where a socio-economic system may be locked in to a particular technological paradigm), and "institutional failure" (where an entire public and private system may form bottlenecks that impede innovation). Luke Georghiou, *Impact and Additionality of Innovation Policy*, *in* INNOVATION POLICY AND SUSTAINABLE DEVELOPMENT: CAN PUBLIC INNOVATION INCENTIVES MAKE A DIFFERENCE?, 57, 61 (Patries Boekholt ed., 2002), http://www.merit.unu.edu/training/DEIP/2008_jordan/Bart%20Verspagen/Georghiou%20obs40.pdf.

- Aim to mobilize commercial co-investment at the fund and/or project level;
- Provide long-term patient capital, primarily as equity, but also quasi-equity and debt;
- Operate as professional fund managers on behalf of their investors, targeting commercial financial returns;
- Are established as pools of assets (or funds) through a variety of legal structures, such as investment company, trust, statutory corporation or a limited partnership.[33]

Strategic funds may also be categorized by their specific objectives as well as their links to existing national assets, such as state-owned enterprises that already perform important public-goods functions. Clark and Monk categorize strategic funds in four categories of purpose and linkage to national assets: reinforcing, crowding-in, catalytic, and financializing.

Reinforcing funds provide a government with an entity to help manage "underperforming national assets, be it companies, infrastructure, or other real assets."[34] Reinforcing funds can help "reorganize, professionalize and innovate state holdings so as to drive commercialization and higher returns."[35]

Crowding-in funds can help drive investment in domestic projects or industries. Some projects would not be possible without the commitment of a sovereign to act as a guarantor and facilitator of a project, and if a fund can "credibly display commercial acumen, it can syndicate local deals with investors who might have sought opportunities elsewhere."[36]

33. *Id.*

34. Peter B. Clark & Ashby H.B. Monk, *Sovereign Development Funds: Designing High-Performance*, *Strategic Investment Institutions*, 1, 11 (2015), https://www.top1000funds.com/wp-content/uploads/2015/10/SDFs-Designing-High-Performance-Strategic-Investment-Institutions.pdf.

35. *Id.*

36. *Id.* Divakaran et al. elaborate on this point, calling the crowding-in function the "raison d'etre" of strategic funds:

> The secondary, and interrelated, argument for setting up a SIF is also its raison d'etre: to crowd in commercial capital. In addition to the condition for additionality is the requirement that government capital be used to stimulate and mobilize additional capital, or crowd in commercial capital. As discussed, SIFs are set up precisely to stimulate commercial investment in underserved sectors. This function is again similar to the requirement for DFIs and MDBs that must use their

Catalytic funds generally work to spur new investment opportunities, "thereby diversifying the economy away from those industries that are either no longer profitable or sustainable over the long-term."[37] Catalytic strategic funds can also help anticipate and build industries in emerging technologies that, for whatever reason, have been underfunded or underdeveloped in the country.

Finally, financializing funds focus not on infrastructure or sustainable projects directly, but rather they help to build the financial infrastructure of a country, "thereby underwriting the development process simply through the growth of the capital market and the emergence of new financial intermediaries and investors focused on opportunities in the region."[38]

Strategic funds represent the domestic ebb to the internationalist flow of SWF capital. The following two sections seek to more clearly define strategic funds along two dimensions: political orientation and financial orientations. The section provides context for the particular questions of legitimacy that strategic funds are designed to answer, but also prepares the ground for Part II by highlighting differences from SWFs that present novel legal and governance challenges in the management of strategic funds.

1. Political Orientation: From International to Domestic

As noted above, sovereign funds typically serve macroeconomic purposes that indirectly fulfill the fund sponsors' political goals. However, large pools of capital tempt to mischief, and a primary concern with sovereign funds is that they could be used as tools of both domestic and international political aggression or suasion. And indeed, some research on sovereign

> capital to mobilize private resources. The World Bank, for example, typically employs a systematic approach to assessing its mode of intervention, focusing first on upstream reforms to determine where market failures really lie and where public capital may best be put to use. The idea is to ensure that policy actions focus first on correcting market failures to unfetter private capital before deploying scarce public capital to fill a financing gap.

SHANTHI DIVAKARAN, HÅVARD HALLAND, GIANNI LORENZATO, PAUL ROSE & SEBASTIAN SARMIENTO-SAHER, WORLD BANK GRP., STRATEGIC INVESTMENT FUNDS: ESTABLISHMENT AND OPERATIONS 27 (2022) [hereinafter WORLD BANK GROUP].

37. Håvard Halland, Michel Noël, Silvana Tordo & Jacob J. Kloper-Owens, *Strategic Investment Funds: Opportunities and Challenges* 31 (World Bank Policy Rsch., Working Paper No. 7851, Oct. 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2849143.

38. *Id.*

funds points to an attempt to use sovereign funds as a political buffer and as a tool to retain or reclaim state autonomy. Clark and Monk, for example, chart the development, use, and purpose of GIC Private Limited, formerly known as Government of Singapore Investment Corporation (GIC).[39] They note that the purpose of the GIC has been shaped by the development of Singapore itself but also in response to the politics of the region "in relation to near-neighbors," the policies and pressures of multilateral institutions (such as the IMF), and the impact of global financial crises. In this light, the GIC's "purpose" is a political-economic adaptation that serves to maintain Singapore's autonomy and to foster the long-term stabilization of domestic welfare.[40]

Hatton and Pistor, in a similar vein, argue that sovereign wealth funds act to maximize the "autonomy of the ruling elite in the sovereign sponsor."[41] While they use their theory to explain the behavior of Singapore, China, Kuwait, and Abu Dhabi's externally oriented sovereign funds, such as these funds' large, passive investments in Western markets, they also argue that SWFs can be used to "pacify domestic constituencies."[42] Among other purposes, sovereign funds can be used to provide "[f]avorable loans and large minority investments [that] function to buy out potential political rivals"[43] and to invest domestically in labor-intensive businesses so as to "reduce political opposition among the masses."[44] Additionally, holding a controlling stake in domestic financial institutions "ensures that the existing elite will structure the

39. Before explicating the purpose of the GIC, Clark and Monk offer a useful caveat which applies equally well to discussions of purpose in this paper: institutions are "rarely, if ever, so transparent about their activities and are rarely systematically held to account to the design 'moment'." In other words, while some funds were clearly developed for an express purpose, the fund may take on a life of its own, and one must therefore be careful in assuming that funds operate according to their stated purposes, and, conversely, assuming that they were created for the purpose suggested by the fund's activities. A scholar may dispute "any idealization of the design process, arguing that, in most cases, institutional firm and functions are 'not' governed by a single coherent 'purpose'" (citing Mark J. Roe, *Political Foundations for Separating Ownership from Corporate Control*, *in* CORPORATE GOVERNANCE REGIMES: CONVERGENCE AND DIVERSITY 113–46 (Oxford Univ. Press ed., 2002).

40. Gordon L. Clark & Ashby Monk, *Government of Singapore Investment Corporation: Insurer of Last Resort and Bulwark of Nation-State Legitimacy*, PAC. REV. (forthcoming).

41. Kyle J. Hatton & Katharina Pistor, *Maximizing Autonomy in the Shadow of Great Powers: The Political Economy of Sovereign Wealth Funds*, 50 COLUM. J. TRANSNATIONAL L. (2011).

42. *Id.* at 2.

43. *Id.*

44. *Id.*

economic development of the sovereign sponsor (protecting their autonomy in this area of domestic policy)."[45]

Building on the notion that sovereign funds can serve important domestic policy purposes, strategic funds are an evolution of sovereign funds. They serve to redirect capital to economic sectors or geographical regions where private investment is limited or non-existent.[46] Strategic funds attempt to exploit the space between public and private by operating as professional financial intermediaries "at arm's length from government" and "placed to take advantage of their strategic position between the state and the market."[47] Unlike sovereign wealth funds, which operate more as purely public funds—with public funding and public purposes—strategic funds could more properly be characterized as inhabiting legal and regulatory space that does not lie between the public and private spheres but overlaps with both. Strategic funds, for example, benefit from government backing, but often take on the legal form of a private fund that seeks to "mobilize capital from private investors and other sources, such as development finance institutions (DFIs) or sovereign wealth funds (SWFs), which may invest public capital but on commercial terms."[48]

2. Financial Orientation: From Wealth Maximization to a Multi-Equilibrium Model

A basic tenet of SWF investment is that sovereign funds should (and have tended to) act as wealth maximizers.[49] To the extent that they do not act as wealth maximizers, they are more exposed to increased transaction costs from host countries that may impose more onerous regulations on investments with even a hint of politicization. Just as importantly, however, wealth maximization acts as an agency-cost reducing mechanism—it clarifies the goals of fund governance and provides a limiting principle that helps constrain managerial behavior.

45. *Id.*

46. HÅVARD HALLAND, ADAM DIXON, SOH YOUNG IN, ASHBY MONK & RAJIV SHARMA, MOBILISING INSTITUTIONAL INVESTOR CAPITAL FOR CLIMATE-ALIGNED DEVELOPMENT, 12 (OECD DEV. POL'Y PAPERS 2021).

47. *Id.*

48. WORLD BANK GROUP, *supra* note 36.

49. SANTIAGO PRINCIPLES, *supra* note 9, at 5.

In the corporate context, the logic of wealth maximization has been thoroughly enshrined in corporate governance practice. The vibrant debate on corporate purpose in recent years accompanies a pendulum swing away from a position of pure wealth maximization.[50] This move has been applauded by some observers as an important shift to a more stakeholder-oriented, sustainable form of capitalism.[51]

50. The Business Roundtable's 2019 Statement on the Purpose of a Corporation reoriented the ends of corporate governance away from wealth maximization to a more stakeholder-friendly corporate purpose:

> While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:
>
> - Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
> - Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
> - Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
> - Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.
> - Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.
>
> Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.

Statement on the Purpose of a Corporation, BUS. ROUNDTABLE (Aug. 19, 2019), https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationwithSignaturesJanuary2023.pdf. Note that this reorientation is not a legally enforceable statement, and indeed is not legal in any sense as it does not fundamentally alter directors' obligations under state statutes. Delaware's corporate law is still shareholder focused, despite this statement. However, it does supply an indication of how directors may choose to operate within the relatively broad path of action afforded by the business judgment rule.

51. Another view, however, is that the shift is a response to increasing shareholder power and a desire by directors to reassert control of the corporate enterprise. *See, e.g.*, Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563 (2021). An irony of modern corporate governance is that many of the perceived excesses of corporate behavior—exemplified by a dogged pursuit of wealth—are the natural consequence of a more shareholder-oriented corporate governance system. Indeed, excessive risk-taking is also a result of a more shareholder-oriented form of corporate governance, rather than the result of too little shareholder influence. *See* John Armour & Jeffrey N. Gordon, *Systemic Harms and Shareholder Value*, 6 J. LEGAL ANALYSIS 35 (2014).

Governments have also been engaged in a mirrored discussion of whether and how to reorient the ends of economic governance. As with corporations, governments often pursue multiple economic and political goals. Similar to long-term stock-price appreciation, economic growth in the form of a rising gross domestic product has been viewed as a reasonable measure of overall economic performance.[52] This view of growth essentially allows a rising GDP to act as a kind of public-sphere equivalent to the corporate manager's goal of shareholder wealth maximization.

Yet, the Organisation for Economic Co-operation and Development (OECD) has identified numerous "significant harms"[53] arising from a focus on GDP growth in OECD countries. First, contrary to the assumptions of trickle-down economic theories, GDP growth not only fails to remedy income inequalities, but it is instead associated with higher income inequalities. The OECD notes, for example, that in almost all OECD countries over the last forty years, the share of income going to wages and salaries—the workers—has decreased, while the share of capital going to the "owners" of capital—the shareholders—has increased.[54] Relatedly, the share of income captured by the top 10% of income earners has increased in almost every country.[55] The metaphor of a rising tide lifting all boats has some truth, however, in that all incomes have increased over the past forty years. Nevertheless, the level of rise has not been equal.[56]

52. ORG. FOR ECON. CO-OP. AND DEV., BEYOND GROWTH: TOWARDS A NEW ECONOMIC APPROACH 6 (Sept. 12, 2019), https://www.oecd.org/naec/averting-systemic-collapse/SG-NAEC(2019)3_Beyond%20Growth.pdf.

53. *Id.*

54. *Id.* Legal scholarship has not failed to recognize this shift. See, for example, the work of David Webber in THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON (Harvard Univ. Press 2018) and *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106 (2014), as well as the work of Grant M. Hayden and Matthew T. Bodie in RECONSTRUCTING THE CORPORATION: FROM SHAREHOLDER PRIMACY TO SHARED GOVERNANCE (Cambridge Univ. Press 2020) and *Codetermination in Theory and Practice*, 73 FLA. L. REV. 321 (2021).

55. FACUNDO ALVAREDO, LUCAS CHANCEL, THOMAS PIKETTY, EMMANUEL SAEZ & GABRIEL ZUCMAN, WORLD INEQUALITY LAB, WORLD INEQUALITY REPORT (2018), https://wir2018.wid.world/files/download/wir2018-full-report-english.pdf.

56. The rise in equality in a particular country is shaped by "a variety of national[,] institutional[,] and political contexts." *Id.* at 40. For example, the rise in inequality "was particularly abrupt in Russia, moderate in China, and relatively gradual in India, reflecting different types of deregulation and opening-up policies pursued over the past decades in

Further, while higher levels of national income may be associated with greater health outcomes generally, inequality appears linked to disparities in health outcomes. In the U.S., for example, while top earners have enjoyed higher levels of income growth in recent decades, low- and middle-income earners have experienced only weak growth; this income disparity is matched by a mortality rate disparity among the middle-aged.[57] Similarly, studies of wellbeing in recent years show that income is important, particularly for those at the lower ranges of the income distribution, but a subjective perception of a "fulfilled and flourishing life" comes from a host of factors, including security and satisfaction at work, physical and mental health, social and family relationships, social services affecting the levels of crime, trust in society, education, and health care.[58] The OECD argues that "[n]one of these are automatically improved simply by higher GDP, and can often be harmed by the ways it is generated—particularly for those on lower incomes and in more precarious work, and where private consumption is prioritised over public goods."[59]

Additionally, a pursuit of high growth may also produce unequal impacts from negative externalities. Those who hold greater wealth are generally able to better protect themselves against the negative effects of high growth, such as some of the effects of pollution. Our current patterns of economic growth, "based on fossil fuels, present forms of intensive and meat-based agriculture and the unlimited exploitation of global natural resources,"[60] transfers natural wealth into financial assets which are disproportionately enjoyed by those already in a better financial position, while the costs associated with these activities are

these countries." *Id.* at 10. Tax policy and educational subsidies play an important role in equality outcomes. The share of national income received by the top 1% in the United States doubled between 1980 and 2016, from 10% to 20%, "largely due to massive educational inequalities, combined with a tax system that grew less progressive despite a surge in top labor compensation since the 1980s, and in top capital incomes in the 2000s." *Id.* Europe, meanwhile, saw an increase from 10% to 12% in the share held by the top 1%, as "wage inequality was also moderated by educational and wage-setting policies that were relatively more favorable to low- and middle-income groups." *Id.*

57. DIANE SCHANZENBACH, MEAGAN MUMFORD, RYAN NUNN & LAUREN BAUER, MONEY LIGHTENS THE LOAD, HAMILTON PROJECT (2016) at 1.

58. ORG. FOR ECON. CO-OP. AND DEV., BEYOND GROWTH: TOWARDS A NEW ECONOMIC APPROACH, *supra* note 52, at 6.

59. *Id.*

60. *Id.*

"already damaging the lives and livelihoods of millions of people around the world."[61]

The OECD report does not argue for the abandonment of economic growth as a goal of economic policy, but rather seeks to turn attention to "the form of economic growth which a country experiences and aims to achieve."[62] The way in which an economy grows matters. Inequality also creates significant political risks, ranging from milder forms of political disengagement to deep instability and even the risk of political collapse or upheaval.[63]

The animating purpose of many strategic funds becomes more clearly defined against a backdrop of rising inequality. Indeed, the rise of strategic funds may also be seen as a response to the wave of privatization that accompanied the globalization of the 1970s and 1980s, which resulted in the sale of public entities for over $1 trillion by the end of the century.[64] The standard account of privatization[65] traces its roots to economist Milton Friedman[66] and managerialist Peter Drucker, who argued that private enterprise was better suited to manage industry—even industries producing important public goods.[67] But governments would still play important roles in "the

61. *Id.*

62. *Id.*

63. Christian Houle, *Why Class Inequality Breeds Coups but Not Civil Wars*, 53 J. PEACE RSCH. 680 (2016) (emphasis omitted).

64. William L. Megginson & Jeffry M. Netter, *From State to Market: A Survey of Empirical Studies on Privatization*, 39 J. ECON. LIT. 321, 326 (2001).

65. *See, e.g.*, LISHENG DONG, PUBLIC ADMINISTRATIVE THEORIES: INSTRUMENTAL AND VALUE RATIONALITIES 101–12 (2015).

66. Friedman argued, for example, that rather than directly provide education, governments could

> require a minimum level of education which they could finance by giving parents vouchers redeemable for a specified maximum sum per child per year if spent on "approved" educational services. Parents would then be free to spend this sum and any additional sum on purchasing educational services from an "approved" institution of their own choice. The educational services could be rendered by private enterprises operated for profit, or by non-profit institutions of various kinds. The role of the government would be limited to assuring that the schools met certain minimum standards such as the inclusion of a minimum common content in their programs, much as it now inspects restaurants to assure that they maintain minimum sanitary standards.

Milton Friedman, *The Role of Government in Education*, *in* ECONOMICS AND THE PUBLIC INTEREST (Robert A. Solo ed., 1955).

67. Peter F. Drucker, *The Sickness of Government*, 14 PUB. INTEREST 3, 7 (1969). In stating the "case for nonperformance" of the government, Drucker argues:

determination of major objectives, and as the 'conductor' of social diversity."[68] The conductor does not play an instrument and need not even know how to play an instrument. But the conductor must "know the capacity of each instrument and [how] to evoke optimal performance from each."[69] The conductor does not perform but merely conducts; instead of "doing," the theories assert, the conductor should merely lead.[70]

The OECD notes a connection between privatization and inequality. Net private wealth accounted for 200–350% of national income in most developed countries in 1970; by 2016, that percentage had increased to 400–700%, an amount "largely unaffected by the 2008 financial crisis."[71] Meanwhile, net public wealth has concomitantly decreased. In China and Russia, which have taken different paths to increased privatization, public wealth declined from 60–70% of total national wealth to about 20–30%.[72] Net public wealth—defined as public assets minus public debts—has actually become negative in the United States and the U.K. following the Financial Crisis.[73] The decline in public wealth is important, the OECD argues, because it "arguably limits [a] government['s] ability to regulate the economy, redistribute income, and mitigate rising inequality."[74] The only exceptions to

> The greatest factor in the disenchantment with government is that government has not performed. The record over these last thirty or forty years has been dismal. Government has proven itself capable of doing only two things with great effectiveness. It can wage war. And it can inflate the currency. Other things it can promise, but only rarely accomplish. Its record as an industrial manager, in the satellite countries of Eastern Europe as well as in the nationalized industries of Great Britain, has been unimpressive. Whether private enterprise would have done worse is not even relevant. For we expected near-perfection from government as industrial manager. Instead, we only rarely obtained even below-average mediocrity.

Id.

68. *Id.* at 18.

69. *Id.* at 19.

70. *Id.*

71. ALVAREDO ET. AL, *supra* note 71, at 15.

72. *Id.*

73. This is due in large part to heavy borrowing (at very low rates of interest) by both governments. *See What Is the National Debt?*, FISCAL DATA: TREASURY.GOV, https://datalab.usaspending.gov/americas-finance-guide/debt/country-comparison/.

74. ALVAREDO ET. AL, *supra* note 55, at 15.

the general trend of declining public wealth are countries like Norway that are oil-rich and have large SWFs.[75]

Strategic funds represent a reversal of privatization, which potentially presents an opportunity to reverse some of the inequalities resulting from privatization and globalization. Rather than adopting a private market goal of wealth maximization, strategic funds have a double bottom line: to produce a return and also to service social goals such as climate remediation or adaptation, job creation, economic expansion, support for fledgling innovators, or any other important governmental policies. Strategic funds are thus a policy instantiation of the waning of globalization and the waxing of nationalism. Put more bluntly, strategic funds operate as a means for politicians to manage what might be called the "guillotine risk" that results from political and economic disempowerment and governmental illegitimacy.

To summarize, strategic funds differ from other sovereign wealth funds by their explicitly domestic and double-bottom-line orientations. Strategic funds enable governments to resolve system or market failures by crowding in capital and building capacity. Private financial intermediaries may have the technical expertise to develop needed infrastructure projects, for example, but lack the financial (let alone political) incentives to do so. On the other hand, government bureaucrats may wish to develop infrastructure projects but lack the technical expertise to build a financing consortium and manage the legal intricacies of such a project. Strategic funds can span this gap.

C. Distinguishing Mixed-Capital Strategic Funds and Public-Capital Strategic Funds

Three levels of legal structures will typically provide the governance architecture of a strategic fund. How much each level matters to the overall legal and governance workings of the fund depends on two primary factors: first, where the fund gets its money, and second, where the fund spends its money.

Strategic funds that receive funding primarily through public coffers—public capital strategic funds—will typically be created through bespoke domestic legislation. In other words, the fund will typically not adopt a commercial legal structure, such as a limited

75. *Id.*

partnership, but will instead be created through specific legislation that creates legal and governance arrangements tailored specifically to the interests of the government in creating such a fund. Because the fund does not need to receive capital from outside sources, there is no direct need to provide a credible commitment (in the form of a standard market structure) that the fund will operate predictably and commercially.

On the other hand, private fund investors are arguably subject to greater collective-action problems and information asymmetries than a single government interest-holder faces with a sovereign fund, and mixed capital funds that seek private investments must adopt structures that provide legal and governance mechanisms, such as actionable fiduciary duties, election mechanisms, and disclosure obligations, which help to mitigate these problems. To say that a mixed capital fund—a fund which receives investment both from the government and from private investors—chooses a particular legal structure also implies that the fund has chosen a particular domicile for the fund. In other words, the choice for a fund is not merely whether they should adopt a limited partnership structure or a trust structure, for example, but whether the fund should adopt a Delaware limited partnership (LP) structure or a Luxembourg special limited partnership (SCSp) structure, to mention just two of many possible choices.

The difference in approach on choice of law questions is apparent from the structure and domicile choices of some of the most prominent strategic funds:

Table 1. Ownership, Structure, and Domicile of Select Strategic Funds[76]

Strategic Fund	Ownership	Legal Structure	Domicile
ISIF	Public	No legal entity	Domestic
NSIA	Public	Statutory corporation	Domestic
Ghana Infrastructure Investment Fund	Public	Statutory Corporation	Domestic
FONSIS	Public	Limited liability company, under OHADA framework [77]	Domestic
Khazanah Nasional Berhad	Public	Public limited company, under Malaysian Companies Act	Domestic
Palestine Investment Fund	Public	Public shareholder company, under Palestinian corporate law	Domestic
National Infrastructure Investment Fund	Mixed	Trust, under the Indian Trusts Act	Domestic
Asia Climate Partners	Mixed	LP, under the Exempted Limited Partnership Law	Offshore (Cayman Islands)
Marguerite II	Mixed	SCSp,[78] under Luxembourg Law	Offshore (Luxembourg)

As shown in the table, mixed capital strategic funds not only adopt a legal entity structure that is familiar to investors (such as a

76. Information in this table comes from the World Bank. WORLD BANK GROUP, *supra* note 36.

77. ORGANISATION POUR L'HARMONISATION EN AFRIQUE DU DROIT DES AFFAIRES, ACTE UNIFORME RÉVISÉ RELATIF AU DROIT DES SOCITÉTES COMMERCIALES ET DU GROUPEMENT D'INTÉRÊT ÉCONOMIQUE (2014).

78. The SCSp was introduced in Luxembourg in 2013. The SCSp is a variation of the long-established, standard Luxembourg partnership (*Société en Commandite Simple*, or "SCS"). Unlike the SCS, the SCSp does not have a legal personality separate from its partners and can be structured more flexibly.

limited partnership model) but may also seek to "borrow" another commercially oriented jurisdiction's legal system. By contrast, a publicly funded strategic fund will not need to attract outside investors and so will typically adopt a standard domestic entity structure that is used for domestic state-owned enterprises.

D. Reflections on Strategic Funds as a Policy Choice

A crucial question for governments responding to political and economic problems caused by rapid societal and economic changes is whether existing market forces, either at the local, regional, or national level, can respond to such changes without state intervention. Intervention may not only be costly, but it may also create unintended consequences and negative impacts on the legitimacy of the government. Consider the politics of managing climate change compared to the politics of managing dislocations related to globalization and international trade as an example. Both trends have created severe economic disruptions (and the disruptions caused by climate change are only just beginning), but the politics of intervention with respect to climate change are dramatically different from—and even at times opposed to—the politics of interventions with respect to globalization disruptions. Trump's "America First" doctrine, for example, prioritizes international trade interventions, such as tariffs and restrictions on the sale and import of certain goods and services but deprioritizes climate-related interventions.[79]

Assuming the government has determined that intervention is necessary, the corollary consideration is the market intervention vehicle. Why use a sovereign fund to intervene in climate-finance or infrastructure markets, for example? Why not simply allocate a portion of the budget to resolve the issues that led to the creation of a sovereign fund?

As an initial observation, most countries *don't* employ strategic funds to catalyze private markets or to otherwise shore up weak markets. For example, while there exist state-level sovereign funds in the United States, as well as state development agencies

79. The literature on government intervention in markets is deep, rich, and of ancient vintage. For a recent review of some of the arguments for and against intervention, see Stephen K. Aikins, *Political Economy of Government Intervention in the Free Market System*, 31 ADMIN. THEORY & PRAXIS 403, 403–08 (2021).

or corporations that operate in each of the fifty states, there is no national-level U.S. sovereign fund.[80] Considering why some countries have created sovereign funds helps explain why many countries, such as the U.S., do not have sovereign funds.

First, as discussed above, most sovereign funds are designed to resolve macroeconomic problems that typically arise from large cash flows, such as from the sales of commodities like oil and gas, or from a large surplus in the balance of trade in other products. Sovereign funds are thus typically designed to deal with a straightforward but momentous problem: what should a country do with excess cash that it has acquired from natural resources or trade? How can it use that money to ensure political stability, protect or transform the economy, and provide for future generations? These are not first-world problems, typically—they are more often the problem of emerging economies in resource-rich, market-poor countries, such as the Emirates of the 1970s and 1980s. Developed economies like the United States, Germany, and Japan have a more stable balance of trade and are not massive net exporters of natural resource wealth.

Second, most large economies like the United States, Germany, U.K., and Japan—none of which have national-level sovereign wealth funds—have well-developed markets that adequately fund most enterprises, even some highly-risky enterprises that are not likely to generate large profits. At the national level, these markets arguably provide adequate capital, even for green projects. At the local level, city, state, department, or provincial governments are typically able to fund projects through debt offerings (though, as described below, some jurisdictions have created green banks to spur sustainable investment). For example, S&P Global estimates that roughly $18 billion or green-labeled municipal bonds were issued in 2021, with strong growth expected in the years to come.[81]

80. There have been calls to create such a fund, however. *See, e.g.*, Robert C. Hockett & Saule T. Omarova, *Private Wealth and Public Goods: A Case for a National Investment Authority*, 43 J. CORP. L. 437 (2018).

81. Andrew Bredeson, *2021 Sustainable Finance Outlook: Large Growth in Green, Social, Sustainable Labels as Municipal Market Embraces ESG*, S&P GLOBAL (Feb. 16, 2021), https://www.spglobal.com/ratings/en/research/articles/210216-2021-sustainable-finance-outlook-large-growth-in-green-social-sustainable-labels-as-municipal-market-embra-11828597. S&P Global notes that

In addition, state development agencies also provide billions to support existing businesses, recruit new business to the state, and encourage entrepreneurship.[82] By contrast, most countries employing national-level sovereign development funds do not have developed capital markets.[83] Strategic funds step in to help support weak or limited capital markets and boost economic growth, whether through the development of infrastructure projects or as a lender to small- and medium-sized enterprises (SMEs) that cannot otherwise obtain funding.[84]

Strategic funds are not the only kind of entity that can play this gap-filling role, however. Some countries (and some states)[85] have established green banks, defined by the OECD as "publicly capitalised entit[ies] established specifically to facilitate private investment into domestic LCR [low-carbon and climate-resilient] infrastructure and other green sectors such as water and waste management."[86] Green banks have also been described as "publicly owned, commercially operated, specialized financing institution[s] or facilit[ies] that act[] as a focal point for scaling up domestic investment in climate-friendly, sustainable projects."[87]

> the green bond market share has increased to 3.4% in 2020 from 0.03% in 2013. Including all sustainable debt, the market share expanded to 5.8% in 2020, from 3.2% in 2019 and it has never been higher than 2.5% in all prior years. On average, sustainable debt's share of total municipal market issuances increased 51% per year from 2014 through 2020.

Id. Further, the COVID-19 pandemic has driven not only the growth of green bonds, but of social bonds as well. *Id.*

82. NORTON FRANCIS, URBAN INST., WHAT DO STATE ECONOMIC DEVELOPMENT AGENCIES DO? 1 (2016), https://www.urban.org/sites/default/files/publication/83141/2000880-What-Do-State-Economic-Development-Agencies-Do.pdf.

83. There are, of course, notable exceptions to this general statement, such as the Ireland Strategic Investment Fund.

84. Halland et al., *supra* note 37.

85. *See, e.g.*, CONNECTICUT GREEN BANK, https://www.ctgreenbank.com; NEW YORK GREEN Bank, https://greenbank.ny.gov/.

86. ORG. FOR ECON. CO-OP. AND DEV., GREEN INVESTMENT BANKS: SCALING UP PRIVATE INVESTMENT IN LOW-CARBON, CLIMATE-RESILIENT INFRASTRUCTURE 15 (May 31, 2016), https://www.oecd-ilibrary.org/finance-and-investment/green-investment-banks_9789264245129-en.

87. ANGELA WHITNEY, TAMARA GRBUSIC GEORGE, JULIA MEISEL & PAUL BODNAR, ROCKY MOUNTAIN INSTITUTE, STATE OF GREEN BANKS 2020 5 (2020), https://rmi.org/insight/state-of-green-banks-2020/. The Green Bank Design Platform is a collaboration between Rocky Mountain Institute, the Green Finance Institute, and the Natural Resources Defense Council.

The theory animating the creation of green banks is fundamentally the same as for climate-oriented strategic funds: a public organization essentially stands as a market intermediary between "[g]overnments . . . struggling to source and subsequently deploy sufficient levels of funding for high-priority, low-carbon solutions"[88] and capital sources "hungry for climate-smart investments."[89] As with strategic funds, green banks "act[] as the focal point for climate investment, addressing market barriers, and channeling private capital into low-carbon, climate-resilient projects,"[90] and will often have tailored metrics to measure their progress in achieving these goals. The UK Green Investment Bank, for example, stated in 2015 that it mobilized 3 GBP of private capital for every 1 GBP of public funding[91] and has worked with over 70 co-investors.[92] Among specific investment activities, some green banks have created subfunds to develop offshore wind power; created city-specific, clean-city initiatives; engaged in energy-efficiency partnerships with financial institutions (to aid in brokering green loans); assisted municipalities in green bonds issuances; provided funding for energy-efficient street lighting; and supported early-stage, clean-energy companies, among many other projects.[93]

Green banks typically receive their initial funding from national or subnational government budgets, special appropriations, or levies. In contrast to strategic funds, they are also typically only created in developed economies,[94] because "[e]stablishing a GIB [green investment bank] presumes a domestic context in which relatively limited interventions are sufficient to facilitate domestic private investment."[95] Green banks function best when strong

88. *Id.* at 12.

89. *Id.*

90. *Id.*

91. ORG. FOR ECON. CO-OP. AND DEV., GREEN INVESTMENT BANKS: POLICY PERSPECTIVES 13 (Dec. 2015), https://www.oecd.org/environment/cc/Green-Investment-Banks-POLICY-PERSPECTIVES-web.pdf.

92. *Id.* The UK Green Investment Bank has been privatized and is now a part of the Macquarie Group, a "diversified financial group employing over 15,000 people." GREEN INV. GRP., PROGRESS REPORT 2020 3 (2020), https://www.greeninvestmentgroup.com/assets/gig/corporate-governance/GIG_ProgressReport_2020.pdf.

93. ORG. FOR ECON. CO-OP. AND DEV., *supra* note 86, at 48–52.

94. *See* HALLAND ET AL., *supra* note 46, at 11–12.

95. ORG. FOR ECON. CO-OP. AND DEV., *supra* note 86, at 27.

capital markets and developed policy environments are already in place,[96] and they function at a smaller scale in jurisdictions with smaller funding gaps. Additionally, green banks are "exclusively focused on green investment and face fewer competing agendas."[97] This virtue, of course, also narrows their ability to effectively manage all of the broader societal disruptions that have accompanied globalization. Green banks are thus much more limited than strategic funds not only in scale but also in scope.

To summarize, strategic funds fill market gaps to achieve political goals. Whether funded through the government or a mix of public and private funding, strategic funds can help build up market capacity, catalyze weak markets, and drive transition, mitigation, or adaptation strategies. Having described the "why" of strategic funds, the next Part helps develop the question of how strategic funds should be structured and regulated to maximize their effectiveness. To provide a foundation for that analysis, Part II conceptualizes and categorizes the legal and governance risks associated with sovereign funds in general and strategic funds in particular.

II. ASSESSING SOVEREIGN WEALTH AND STRATEGIC INVESTMENT FUND RISKS

Sovereign funds were primarily designed as tools of macroeconomic policy, and for both host countries and sponsor countries, the expectation for most SWFs is that they will act as commercially-oriented, external investors.

A. Common Sovereign Fund Risks

The use of any sovereign fund creates a common set of risks, including (though not limited to) legitimacy and accountability risks, corruption and waste, politicization, and negative political and financial externalities. These risks can be conceptualized as flowing from two potential sources of sovereign fund failure, politics and governance, and along two dimensions, domestic and international.

96. *Id.*
97. *Id.* at 28.

Figure 2. Dimensions of Sovereign Wealth Fund Risk

	Political	**Governance**
Domestic	Legitimacy and Accountability	Corruption and Waste
International	Politicization	Negative Political and Financial Externalities

1. Legitimacy and Accountability

A sovereign fund, as a government entity, must be viewed as legitimate and accountable by a variety of domestic audiences. The lack of legitimacy of a sovereign fund may reduce the legitimacy of the sponsoring government. To protect the legitimacy of the fund, the fund must be constructed and operated so that the government, as the principal of the fund (with the fund's directors and managers operating as agents of the government principal), has confidence in the operations of the fund. The fund must have accountability mechanisms in place so that the government can be assured of the security of the fund's accounts and the accuracy of the fund's accounting procedures.

2. Corruption and Waste

Funds also risk losing legitimacy through corruption and waste. In the world of sovereign funds, the 1MDB scandal exemplifies both the governance challenges of creating an accountable, resilient sovereign, and the grave consequences for governance failures. 1 Malaysia Development Fund Bhd (1MDB) was a sovereign fund set up in 2009 to catalyze "the sustainable long-term economic development and growth of Malaysia."[98] The fund was conceived as a typical strategic investment fund with a commercial orientation as part of a domestic investment mandate.

98. *1MDB Frequently Asked Questions*, NEW STRAITS TIMES (Dec. 23, 2014, 7:07 AM), https://www.nst.com.my/news/2015/09/1mdb-frequently-asked-questions.

The fund thus had the "double-bottom-line" orientation that characterizes strategic funds and was supposed to help transform the Malaysian economy by reducing its dependence on natural-resource wealth and diversifying its economy over the long term. Instead, poor governance at the fund allowed it to be used as a kind of private bank for one fund official—with billions of dollars lost to personal spending—and as a means to allegedly help "steal an election and keep the corrupt prime minister in power for five additional years, when his opponents were crushed and at least one prosecutor was brutally murdered."[99]

3. Politicization

The rapid rise in sovereign wealth following the spike in oil prices concerned Western politicians and regulators whose markets were increasingly the desired incubator of sovereign nest eggs from oil-rich Middle Eastern countries like Kuwait and Qatar, as well as from Asian countries enjoying large trade surpluses with the United States, such as Singapore and China. SWFs were thought to present "operational concerns stemming from government control," such as relative lack of transparency compared with private economic actors, as well as the risk of "non-commercial investment goals."[100] More worryingly, SWFs were (and sometimes still are) thought to be potential tools of state capitalism to "secure stakes around the world in strategic areas such as telecommunications, energy and mineral resources, and financial services, among other sectors,"[101] thus implicating host countries' national security. Sovereign funds risk losing legitimacy in the eyes of other nations if the sovereign fund is perceived to be operating as a mercantilist vehicle. As stressed earlier, all sovereign funds are inherently political in that they act as government entities that are tasked to achieve a political goal. The kind of politicization that presents a danger to other countries—and thus risks eroding the legitimacy of the sovereign

99. Dennis M. Kelleher, Better Markets, *Goldman Sachs and the 1MDB Scandal*, HARV. L. SCH. F. CORP. GOV. (May 14, 2009), https://corpgov.law.harvard.edu/2019/05/14/goldman-sachs-and-the-1mdb-scandal/.

100. MARTIN A. WEI, CONG. RSCH. SERV., RL34336, SOVEREIGN WEALTH FUNDS: BACKGROUND AND POLICY ISSUES FOR CONGRESS, (2009) https://www.everycrsreport.com/files/20090115_RL34336_a7ea655551d2435a8e05992d4ac1b1367b3e3635.pdf.

101. *Id.*

fund—is a new form of mercantilism that seeks to benefit one country's economy at the expense of others.[102]

4. Negative Political and Financial Externalities

Finally, sovereign funds may present risks to other investors by using their influence as government-linked investors or, as with administration or regime change, the fund could be liquidated or could change its investment strategy. As large investors in less-liquid markets, strategic funds play an outsized role in the health of the target market, and while sovereign funds are generally prized for their stability and long-term investment focus, they may also end up crowding out private investors. Economists have also expressed the concern that SWFs could "perpetuate undesirable underlying macroeconomic and financial policies," such as simply accumulating foreign currency reserves in order to keep a country's own currency from appreciating.[103]

B. Strategic Fund Risks

In some ways, strategic funds are mirrors of other sovereign funds: where sovereign wealth funds present greater international risks, strategic funds present greater domestic risks. Most sovereign fund scholarship and commentary has likewise focused on the international dimension of sovereign fund investment risks, such as how sovereign funds could be used as international political tools. Strategic funds present some of the same risks as internationally oriented funds, but they present other risks as well. It is these risks, described below, that create a need for legal solutions that go beyond the regulatory and governance structures used for sovereign wealth funds.

102. In Nachbar's straightforward definition, mercantilism is "control of the economy in order to further national interests." Thomas B. Nachbar, *Monopoly, Mercantilism, and the Politics of Regulation*, 91 VA. L. REV. 1313, 1318 (2005). Here, however, I wish to emphasize the negative international externalities (if any are created) from the use of a sovereign fund.

103. Kimmit, *supra* note 17. Kimmitt notes that this concern is less pronounced with commodity-based sovereign wealth funds, as "governments are essentially replacing a physical asset in the ground with a financial asset in a bank account to be drawn on by future generations." *Id.*

1. Competing Priorities

A multi-equilibrium or double-bottom-line approach to entity governance is gaining momentum in both the private and public contexts, but such an approach also presents agency risks. A wealth-maximizing fund has a governance advantage in that the metrics by which the fund is measured are straightforward: a fund may single-mindedly focus on returns, net of the fees and costs in generating those returns. The fund can be easily benchmarked against similar funds; this is not to imply that it is an easy thing to generate returns beyond the benchmark, but only that the focus of the fund is a single, simple goal, even if that goal may be difficult to achieve. The performance of managers can be measured against this benchmark and compared to the performance of managers operating similarly situated funds. By contrast, a fund with a multi-equilibrium mandate—such as the Ireland Strategic Investment Fund (ISIF)—faces competing priorities. As described by the fund's managers:

> The overarching purpose of the ISIF is to invest "on a commercial basis in a manner designed to support economic activity and employment in the State." This unique mandate reflects a shift from being a Sovereign Wealth Fund focused solely on wealth creation, to a Sovereign Development Fund with a "Double Bottom Line" objective. In other words, ISIF's success will be measured by both investment returns and economic impact achieved.[104]

The difficulty for funds is in creating metrics to measure more amorphous objectives such as "economic impact." Indeed, whether the fund will be successful as a strategic fund depends on whether this legal and governance challenge can be met.[105]

104. ORG. FOR ECON. CO-OP. AND DEV., FINANCING SMES AND ENTREPRENEURS 277 (2016), https://doi.org/10.1787/fin_sme_ent-2016-en.

105. As described by the World Bank, "the legal framework helps provide a robust governance system that allows the SIF to formulate and implement its objectives and investment policies. In doing so, the legal framework minimizes risks, maintains the confidence of domestic constituencies (such as the general public), host country regulators, and co-investors; and supplies efficient dispute resolution mechanisms in the event of conflict among SIF stakeholders. Conversely, a poorly structured legal framework exposes SIFs to both domestic and international governance and political risks that may jeopardize the effective execution of a fund's mandate. In turn this can sap managerial time and attention, create significant liabilities, increase transactions costs, and reduce returns." WORLD BANK GROUP, *supra* note 36, at 45 (citations omitted).

2. Distortions

Many sovereign wealth funds invest in non-controlling interests in publicly traded securities (or through intermediaries, such as private equity funds, venture capital funds, and hedge funds), so the risk of market distortions through sovereign fund investment is minimized. Further, sovereign wealth fund investments are typically portfolio investments that are designed to maximize wealth, and this financial orientation disciplines investment decisions. Investments are not made to bend the market for a government purpose, such as enhancing a weak market for sustainable investment products or supporting an infrastructure project, but to produce a financial gain. However, strategic funds are attempting to fill market gaps and resolve market failures, and so they are necessarily intervening in the market with potentially dramatic distortive effects. Because many SWFs are founded in countries with underdeveloped markets, domestic portfolio investment could swamp other market actors and dramatically shift the balance between public and private investment.[106] Further, a shift to domestic investment by SWFs disquiets other important government policies. Bauer summarizes several of these, noting that some SWFs are specifically designed to combat Dutch Disease, and "[i]f governments transfer money to a fund, then transfer money back into the economy through domestic spending, the fund's macroeconomic objective of sterilizing capital inflows could be undermined."[107]

106. Bauer goes as far as arguing that the opportunity costs for avoiding domestic investment entirely are negligible in developing economies:

> SWF managers generally set an investment target (e.g., 4–6 percent annually), which is an implicit declaration of risk appetite. In order to achieve this objective, fund managers will choose financial instruments that are likely to generate the target financial return while minimizing the risk of loss. In most developing countries, the chance is quite low that any single domestic asset can satisfy the fund managers' criteria for maximizing return and minimizing risk (this would not necessarily be the case in China, Europe or the United States, for instance, due to the size of their economies or the sophistication of their financial markets). Therefore, in developing countries, the opportunity cost of prohibiting domestic investment in order to maximize financial returns is near zero.

Andrew Bauer, *Six Reasons Why Sovereign Wealth Funds Should Not Invest or Spend at Home*, NAT. RES. GOVERNANCE INST. (Apr. 7, 2015), https://resourcegovernance.org/blog/six-reasons-why-sovereign-wealth-funds-should-not-invest-or-spend-home-0.

107. *Id.*

3. Corruption

Corruption is a risk for any government entity, including sovereign funds. Corruption risks are more acute for strategic funds, however, as these funds often invest into and broker the kinds of large-scale public works projects that present the highest likelihood of bribery of any industrial sector.[108] As Transparency International notes, public-works contracts are typically large and unique and are therefore "difficult to benchmark for costs and time."[109] Bribes are thus easier to hide, aided by the fragmented nature of projects with many different contractors and subcontractors and making "the tracing of payments and the diffusion of standards of practice more complex."[110]

4. Governance Gaps

Finally, many (though not all) strategic fund sponsor countries lack strong institutional intermediaries and governance structures

108. TRANSPARENCY INT'L, BRIBE PAYERS INDEX 2011 15 (2011), https://www.transparency.org/en/publications/bribe-payers-index-2011.

109. *Id.* at 20.

110. *Id.* More specifically, Locatelli et. al. point to the following features that create corruption risks in infrastructure projects:

- Size ("it is easier to hide bribes and inflated claims in large projects than in small projects");
- Uniqueness ("mak[ing] costs difficult to compare");
- Government involvement (public officials "can use their arbitrary power especially where there are insufficient controls on how government officials behave");
- Number of contractual links (each link providing an opportunity for a bribe);
- Project complexity;
- Lack of frequency of projects ("winning these projects maybe critical to the survival or profitability of contractors, which provides an incentive for contractors to use bribes");
- Work is concealed ("subsequent processes cover the basic components of the work");
- Culture of secrecy;
- Entrenched national interests ("the government selects local and national companies justifying the choice to favor national interests. These positions have often been cemented by bribery");
- Lack of 'due diligence';
- The cost of integrity ("in several cultures bribery and deceptive practices are often accepted as the norm").

Giorgio Locatelli, Giacomo Mariani, Tristano Sainati & Marco Greco, *Corruption in Public Projects and Megaprojects: There Is An Elephant in the Room!*, 35 INT'L J. PROJECT MGMT. 252–57 (2017).

that could provide support for funds, including experienced lawyers, accounting firms, sophisticated finance intermediaries, and sophisticated institutional investor partners. Project finance relies on a framework of strong and intersecting relationships, each governed by regulations, codes of conduct, and ethical standards that provide mutual support to the rest of the legal and governance structure. SWFs from jurisdictions with less-developed institutions and intermediaries are able to fill in governance gaps by borrowing standards and expertise from more developed markets.[111] Because strategic funds typically invest in domestic markets, they may have to rely on less-developed, domestic, legal systems and governance frameworks and less-experienced intermediaries and support personnel. Strategic funds often invest alongside domestic co-investors, so the fund must also provide a credible governance commitment that assures counterparties and co-investors of the dependability of the fund. Finally, the ultimate beneficiary of the fund's efforts, the country's people, should have confidence in the legitimacy of the fund. Strategic funds, like other sovereign funds, maintain legitimacy in part by providing information on investment strategies, the investments themselves, the returns, and the public goods created by the fund's investments. Strategic funds risk losing legitimacy by, among other things, operating opaquely and operating outside the fund's mandate.

SWFs can also create shadow public fiscal management processes, "each with its own appraisal, procurement, and monitoring system."[112] Rather than repairing a flawed budget process, SWFs can act as a detour around the process. However, while such a process may allow for more efficient decision-making and disbursement of public resources, it also may evade important legal and political checks designed to protect against waste and corruption.[113]

---

111. These structures are far from perfect, as seen in governance failures of Libya Investment Authority and 1MDB, both of which relied heavily on Western intermediaries (and Goldman Sachs in particular). However, they are generally able to augment what would otherwise be a less robust legal and governance structure of a SWF's home jurisdiction.

112. Bauer, *supra* note 106.

113. Bauer notes that "[b]ypassing normal budgetary systems can also undermine legislative oversight and democracy. Budget allocations are usually examined and approved by legislatures. This is rarely the case for specific SWF investments. In Azerbaijan and Iran, for instance, governments have used SWFs to finance politically motivated projects without submission to parliamentary scrutiny. Given the private interests that politicians and SWF

Further, the execution of the financial mandates of an SWF requires different expertise than the development mandate of a sovereign development fund, and a "single institution may not be well placed to achieve both financial returns and domestic development, unless there are strict firewalls between the two portfolios."[114] Multiple mandates can also lead to "inconsistent and confused decision-making."[115] Similarly, Truman argues that a shift to domestically-oriented mandates by SWFs could lead to several problems.

First, the SWFs may squander their financial resources in low-return domestic investments. Second, the potential for corruption associated with the large amounts involved is amplified by increased spending on domestic investments, through which deals that pass funds into personal accounts are easier to arrange. Third, once SWFs get into a pattern of investing in the domestic operations of financial and nonfinancial firms, it will be natural for them to invest more heavily than at present in the foreign operations of those firms. These foreign investments may raise many sensitive issues in the countries in which they invest, including with respect to fair international competition, again raising the issue of the role of the state in the global economy.[116]

The overlapping legal frameworks described below—at the level of the sovereign sponsor, at the level of the host country, and through international soft law—are designed to manage these risks. The frameworks reinforce one another, so that compliance with a set of domestic entity regulations, for example, may aid in compliance with international anti-bribery conventions and governance mechanisms that provide a credible commitment to private co-investors may also provide enhanced accountability that in turns promotes public legitimacy.

III. LEGAL PRINCIPLES FOR STRATEGIC FUNDS

The variation in strategic funds provides an additional challenge in formulating robust legal and governance principles.

investment managers often have in their own countries, lack of accountability can lead to politically motivated investments or investments for personal gain." *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

As an initial matter, it is crucial to distinguish funds by funding source because the governance and legal structure of a strategic fund is directly tied to its funding. Another way of stating this contingency is that different agency costs are related to different funding structures, so the legal and governance structure of a sovereign fund will be built to minimize the agency costs of the fund. To emphasize the level of variation among strategic funds, the following table summarizes the legal creation, including source law and legal structures, of a sample of strategic funds:

Table 2. Strategic Fund Source Law

Fund	Source Law/Decree	Legal Structure
Ireland Strategic Investment Fund	National Treasury Management Agency (Amendment) Act 2014 (NTMA Act 2014)	Government account (not a legal entity)
NSIA-NIF (Nigeria)	NSIA Act 2011	Body corporate/SOE
Ghana Infrastructure Investment Fund	Act 877: Ghana Infrastructure Investment Fund Act, 2014 Act	Body corporate/SOE
Turkey Wealth Fund	Law No. 6741 on Establishment of Turkish Wealth Fund Management Company	Private Corporation
Senegal FONSIS	Law 2012-43: Authorizing the Creation of a Sovereign Fund of Strategic Investments ("FONSIS")	Limited liability company under private business laws of OHADA[117]

117. The Organisation pour l'harmonisation en Afrique du droit des affaires ("OHADA") was created by treaty in 1993, and was intended to produce "a simple, up-to-date, harmonized and suitable business laws for its Member States, in order to facilitate business activities." *History of Ohada*, OHADA, https://www.ohada.org/en/history-of-ohada/.

Samruk Kazyna (Kazakhstan)	Presidential decree dated October 13, 2008, No.669[1] and Government Resolution No. 962 of 17 October 2008.	Joint stock company[1]
Palestine Investment Fund	Presidential decree in 2000	Public shareholding company

As will be described in more detail below, if a fund is primarily or totally supported by public funds, the fund will typically be structured through special legislation that creates a bespoke legal structure for the fund. For publicly funded strategic funds, there are no direct investors in the fund, although there may be deal partners for particular projects. Because these strategic funds are not acting as managers of others' money, they are not required by market imperatives to make use of traditional, private-entity, legal frameworks. Instead, these funds are established with country-specific laws that define the nature of the entity, its accountability mechanisms, and its purposes.

On the other hand, if the sovereign fund is financed through mixed public and private capital, the legal and governance structure will reflect private fund structures. The funds will offer a familiar set of rules, constraints, and governance mechanisms that will encourage investment from private actors. For mixed-capital strategic funds, the fund functions as a kind of public-benefit general partner with wealth-maximizing limited partners. The sovereign sponsor is willing to potentially absorb some losses but also ultimately expects long-term wealth-creation, in addition to supporting the fund's enumerated social goals.

A. Common Governance Principles for Strategic Funds

Despite these important differences between public and mixed-capital funds, however, there are some common principles of legal structure and governance that can be applied across all strategic funds, irrespective of their funding source, and irrespective of the relevant domestic or fund domicile law that may apply to the fund. As noted above, primary domestic political and governance concerns for sovereign funds include legitimacy and accountability, on the one hand, and corruption and waste on the other. A strong

domestic legal framework for a strategic fund will provide, among other things, agency cost-reducing mechanisms and protections against political interference with the fund. In particular, sovereign funds must develop oversight mechanisms, investment policies, conduct and conflicts policies, and performance metrics that foster discipline, transparency, and accountability.[118]

1. Oversight

As with other managed entities, sovereign funds are typically structured as separate legal entities that operate under a board of directors. Unlike many private funds, however, boards typically play an important role in sovereign fund management. The primary reason for this difference is the centrality of exit rights for private-fund investors, whereas the investor in a sovereign fund—the sovereign itself—has no intention of exit. Indeed, whereas "most [private] fund investors have unusually strong exit rights and most [private] fund managers have unusually strong performance incentives,"[119] neither of these features are present in sovereign funds. Sovereigns do not have a set investment time horizon or desire for liquidity, and sovereign fund managers are typically well-compensated but do not have a share of the fund profits (or "carry").[120] Thus, it is essential for sovereign funds to rely on other governance mechanisms besides the discipline imposed by exit rights and incentive-based compensation.

The use of a board has several benefits, including its efficiencies in information development and transmission and its ability to constrain agency costs.[121] Empirical studies also suggest that board decision making is generally superior to individual decision making.[122] In the context of sovereign funds, however, the presence of a powerful (and typically sole) sovereign investor enhances the

118. WORLD BANK GROUP, *supra* note 36, at 45.

119. John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1245 (2014).

120. As described by Fleischer, "Private equity fund managers take a share of partnership profits as the equity portion of their compensation . . . this profits interest is also known as the "carry" or "carried interest." The profits interest is what gives fund managers upside potential: If the fund does well, the managers share in the treasure." Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. Rev. 1, 3 (2006).

121. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002).

122. *Id.* at 19–32.

need for board independence. An independent board will help ensure that fund managers follow established legal, regulatory, and policy limitations on the fund's investment activities.

Establishing a truly independent board is often a challenging task. The corporate law of the State of Delaware is instructive in this respect. In determining independence, Delaware courts consider not only financial independence but also social ties such as "love, friendship, and collegiality."[123] To promote independence, sovereign funds will often seek independent directors who have served as managers of foreign funds or in foreign finance ministries. However, as with most single-party-controlled corporations sovereign funds will also have board representation from the fund's sponsor, the sovereign. These directors typically include a representative from the country's central bank and/or ministry of finance.

2. Investment Policies

Sovereign funds will generally develop investment policies to promote commercial discipline. Indeed, the very purpose of some funds is to replicate private investment structures so that the fund, though a government entity, can perform "at the speed of business."[124] Unlike private enterprises, however, sovereign funds should not be competing for market share; instead, they are designed to fill market gaps. An important principle to ensure that strategic funds do not displace private markets and funding is the concept of *additionality.* Borrowed from principles used to govern

123. Marchand v. Barnhill, 212 A.3d 805, 818 (Del. 2019) (quoting In re Oracle Corp. Derivative Litig., 824 A.2d 917, 938 (Del. Ch. 2003)).

124. This slogan is used by Ohio's economic development fund, JobsOhio, which "is built to produce and deliver a measurable return for the people of Ohio. JobsOhio's team comprises of professionals with extensive private sector experience reflecting Ohio's growing sectors, and combined with its private structure and funding model, allow it to pivot quickly—at the speed of business—to meet demand and when facing unexpected challenges." William Batchelder, *10 Years Later, JobsOhio Continues to Move at the Speed of Business*, JOBSOHIO BLOG (Feb. 26, 2021), https://www.jobsohio.com/blog/posts/10-years-later-jobsohio-continues-to-move-at-the-speed-of-business/. Critics have criticized JobsOhio for a lack of transparency, employee compensation, and whether it has provided any net positive benefits to Ohio's economy. Andrew J. Tobias, *JobsOhio, The State's Private Economic Development Arm, Could Be Forced to Be More Open About What It Does*, CLEVELAND.COM, (Apr. 3, 2019), https://www.cleveland.com/news/g66l-2019/04/66b55a92039666/jobsohio-the-states-private-economic-development-arm-could-be-forced-to-be-more-open-about-what-it-does.html.

multilateral banks and development finance institutions like the World Bank, the European Investment Bank, and the Inter-American Development Bank, additionality refers to an intervention that makes a contribution "beyond what is available, or that is otherwise absent from the market, and should not crowd out the private sector."[125] The DNA of strategic funds is similar to development finance in that "they must invest only when there is a confirmed financing gap and must seek to provide non-financial value that facilitates private investment."[126] These sovereign funds thus operate "adjacent to development banks and development finance institutions that pursue investment on a near-commercial basis, but with elevated requirements for economic and social benefits, and the precondition that private capital is not crowded out."[127] Additionality may be achieved not only through direct investment, but also by providing a diversity of investment instruments or by providing indirect, non-financial benefits such as "mitigating risk, triggering regulatory change, setting higher ESG standards, capacity building, building an investor base," or as a proof of concept.[128]

Strategic funds must also demonstrate their utility as a policy mechanism. As discussed above, governments may pursue a variety of initiatives to achieve policy goals; sovereign funds should not have mandates that overlap with other governmental agencies. To justify the use of a sovereign fund as the policy vehicle, the fund must "produce more and higher quality infrastructure for each dollar spent while also crowding in private capital to confirmed financing gaps. It also means that investments justified primarily by economic, environmental or social returns—that do not satisfy financial return benchmarks—should be funded through the traditional government budget process, not by a [sovereign fund]."[129]

125. IFC, *DFI Working Group on Blended Concessional Finance for Private Sector Projects Summary Report* (Oct. 2017) 1, 5, https://www.ifc.org/wps/wcm/connect/a8398ed6-55d0-4cc4-95aa-bcbabe39f79f/DFI+Blended+Concessional+Finance+for+Private+Sector+Operations_Summary+R. . ..pdf?MOD=AJPERES&CVID=npes1Dq.

126. WORLD BANK GROUP, *supra* note 36, at 22-23.

127. *Id.*

128. *Id.*

129. *Id.*

3. Conflicts and Conduct Policies

Like other types of managed business entities in which agency costs are present, sovereign funds must establish policies and procedures to regulate conflicts of interest, such as related-party transactions (when an entity controlled by a board member, for example, is on the other side of the transaction). The policies should also serve to manage conflicts between governmental departments and agencies, so that the sovereign fund's mandate is not jeopardized by transactions pressed by other governmental units.

Additionally, other agency cost-reducing policies should be established, such as a "revolving door" policy that would prohibit former fund managers from lobbying the fund for business opportunities, such as through employment as a private asset manager that brokers investments for the sovereign fund.[130] Sovereign funds should also create anti-nepotism policies to prohibit public officers from hiring or bestowing other forms of patronage on individuals related by blood or other family relationship.

Finally, and perhaps most importantly, funds should develop standards of conduct to help ensure that agents faithfully fulfill their duty to the sovereign. These standards of conduct are often established through statutory provisions (and supplemented by case law, in common law jurisdictions). Many jurisdictions refer to these standards as "fiduciary duties," a term more common in common-law countries. As summarized by Johnson,[131] these standards typically address loyalty (including "faithfulness to the interests of beneficiaries and purpose of the fund and impartiality when taking different interests of beneficiaries into account"); care and prudence in management; transparency and accountability; and compliance with policies, regulations, and other legal requirements.

Because sovereign funds are sometimes established with bespoke legislation, they are not able to borrow the statutory and caselaw framework of standards and duties that apply to

130. For example, 18 U.S.C. § 207(a)(1) prohibits a former officer or employee of the U.S. government from knowingly attempting to influence any governmental entity in connection with a particular matter in which the government has an interest if that former officer or employee participated personally and substantially in that same matter while working for the government.

131. KEITH L. JOHNSON, INTRODUCTION TO INSTITUTIONAL INVESTOR FIDUCIARY DUTIES, INTERNATIONAL INSTITUTE FOR SUSTAINABLE DEVELOPMENT 1, 3 (2014), https://www.iisd.org/system/files/publications/fiduciary_duties_en.pdf.

private funds. As a result, the government may create a separate statute or code of conduct to provide such a framework. As an example, Ireland's National Treasury Management Agency, which manages the Ireland Strategic Investment Fund, has a detailed code of conduct that includes a requirement that agency members be "loyal and committed to the Agency and remain mindful that the organisation itself must at all times take into account its functions as a State body," "discharge their duties and responsibilities with the highest standards of integrity," and "at all times exercise due care, skill, prudence and diligence, acting in the utmost good faith in the discharge of their functions."[132]

4. Performance Metrics

Finally, funds must establish performance metrics that are ties to their mandate. Rather than establishing benchmarks tied to a single goal of risk-adjusted wealth-maximization, strategic-investment sovereign funds must establish benchmarks to track both financial performance and social impact. Financial performance is relatively easy to measure; however, choosing the metric for measuring social impact requires thoughtful consideration. Consider, for example, the four objectives of the Saudi Public Investment Fund:

- Grow the assets of the Public Investment Fund;
- Unlock new sectors through the Public Investment Fund;
- Build strategic partnerships through the Public Investment Fund; and
- Localize cutting-edge technology and knowledge through the Public Investment Fund.

In its Public Investment Fund Program 2021-2025 strategy report, the first objective is measured through growth in assets under management and total shareholder returns. The second objective is measured by the number of companies established in strategic sectors (each of which is described). Discussions of international strategic investments with the SoftBank Vision Fund,

132. NAT'L TREASURY MGMT. AGENCY, CODE OF CONDUCT FOR MEMBERS OF THE NATIONAL TREASURY MANAGEMENT AGENCY AND ITS COMMITTEES (Sept. 17, 2019), https://www.ntma.ie/uploads/general/Code-of-Conduct-for-the-Agency-and-its-Committees.pdf.

Blackstone, the Russia Direct Investment Fund, and others provide insight into the achievement of the third objective. Finally, the report provides information on the establishment of the National Development Division as well as educational partnerships, among other things, which gives insight into the fund's progress on the fourth objective. These are the outward-facing disclosures, intended for national and international audiences.

Regardless of the goals of the strategic fund, the metrics used to determine success should be clear and verifiable. As Halland et al. suggest, "the policy objectives of an investment should be expressed in terms of its [economic rate of return] ERR estimated in accordance with one of several accepted methodologies . . . . Although externalities can be hard to identify and objectively quantify, the ERR provides a single estimate of the social and economic impacts of an investment project."[133] Strategic funds should also establish more specific metrics and disclosures for intra-governmental use, so that the sovereign is able to measure the performance of individual fund managers and individual fund investment decisions.

The work in developing metrics to track progress on social, economic, and environmental goals will benefit from parallel work occurring in the private ESG investments market. Dan Esty has proposed, for example, an ESG reporting framework that could be characterized through three tiers of metrics. The first metric would specify a "core set of mandatory disclosure elements covering environmental and social indicators that have the prospect of being material from either a financial or societal perspective over the next decade."[134] The second tier would include industry-specific disclosures with "metrics that are relevant in narrow circumstances but need not be applied to all companies in all sectors." Thus, for example, transportation companies might make specific disclosures about their use of fossil fuels. This tier might also include disclosures through which "corporate leaders could highlight elements of their sustainability strategies, which they believe set themselves apart from the pack," a proposal that reflects

133. Halland et al., *supra* note 34, at 13.

134. Daniel C. Etsy, *Creating Investment-Grade Corporate Sustainability Metrics*, *in* VALUES AT WORK: SUSTAINABLE INVESTING AND ESG REPORTING, NEW YORK: PALGRAVE MACMILLAN 51 (Daniel C. Etsy & Todd Cort eds. 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3809904 (emphasis omitted).

the Management Discussion and Analysis section of an annual report that provides "a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management."[135]

Finally, a third tier third tier would specify "a set of governance issues—going above and beyond the sustainability elements of tiers one and two—on which disclosure would be mandatory," including information on board structure, internal oversight, and "the breadth and depth of corporate transparency and reporting."[136] Measurement and disclosure policies across funds are likely to coalesce over time. Given differing fund mandates and differing country needs and emphases, however, fund metrics will likely retain some important differences.

The general governance structures, policies, and disclosure standards described here will rest upon a foundation of legal rules that sets out the structure of the fund, the obligations of fund fiduciaries, and the mechanisms for funding and withdrawing funds, among other things. As noted above, the nature of these legal rules is directly related to the public or mixed public/private source of the strategic fund's capital. The following two sections discuss the creation of legal frameworks for public capital and mixed-capital strategic funds respectively.

B. Domestic Regulation of Publicly Funded Strategic Funds

Publicly funded strategic funds are generally set up using strategic-fund-specific legislation that clearly delineates the multiple equilibria the fund is designed to achieve. In some jurisdictions, specific legislation may be a necessity, as the commercial law governing investment funds and business entities generally may not contemplate multiple equilibria, having been focused on wealth maximization. For development funds that are created with and funded by public funds, the fund will frequently rely on legal structures designed to regulate state-owned enterprises. However, the law is often incomplete for fund

135. *Financial Reporting Manual*, U.S. SECURITIES AND EXCHANGE COMMISSION 9110.1, https://www.sec.gov/corpfin/cf-manual/topic-9 (last updated Sept. 30, 2008).

136. Etsy, *supra* note 134, at 61.

management, as questions such as the mechanisms for investment selection will not be part of a government's state-owned, enterprise rules. Some jurisdictions also have relatively inflexible business entity laws and may not allow for the specific governance structures that are essential for the successful operation of a strategic fund.

Alternatively, some funds are not created through legislation but simply by executive decree (as is the case in Angola, Kazakhstan, and Azerbaijan); while creating a strategic fund through a decree has the advantage of speed and a clear executive vision, the strategic fund may also suffer from long-term funding issues (if a legislature or parliament controls the finances) and is subject to the whims of a succeeding executive. Irrespective of whether the strategic fund is created by decree or formal legislation, however, the enacting document of a publicly funded strategic fund typically should include the following features:

1. The Legal Structure of the Fund

The legislation should describe whether the fund will be created as a separate legal entity or simply as an account controlled by a government agency or ministry; the lifespan of the fund; and, if the fund is to be dissolved, the procedures for dissolution.

2. Objectives/Mandate

The legislation should describe the purpose of the fund and clarifies, consistent with the Santiago Principles, the non-financial goals the fund is intended to achieve (such as public infrastructure projects).

3. Funding and Withdrawal Mechanisms

The legislation must also describe the funding mechanisms for the fund—how the fund will receive its initial funding. In typical global practice, "the ministry of finance is the proxy capital provider to the fund (or shareholder, as the case may be), given the ministry of finance is usually responsible for the financial and fiscal implications involved with the strategic fund."[137] The legislation may also specify whether the fund will receive additional distributions and whether the fund may borrow from

137. WORLD BANK GROUP, *supra* note 36, at 51.

public or private sources to provide leverage for the fund.[138] The legislation would also clarify withdrawal procedures, addressing questions of whether fund returns will be reinvested within the fund or distributed to a government account or a ministry as a dividend.

4. Ownership

The legislation will also note who is the legal owner of the fund. For example, the statute may state that the government or a specific agency or ministry is the investor or shareholder in the strategic fund, but typically the strategic fund itself will be the legal owner of the assets.[139]

5. Independence

The legislation should also provide for independent operation of the fund. Although a publicly funded strategic fund does not have potential investors that may demand a credible commitment to independence, the fund should still operate independently from the government. Independence helps ensure that the fund is protected against short-term pressures that invite corruption and waste, and it provides the fund with operational legitimacy. Ideally, then a strategic fund will have operational independence from a government, while still enjoying full financial support from the government.[140]

6. Lending and Liquidity

Strategic fund legislation should also provide whether the strategic fund's assets may be used as collateral for other fund investments or whether the assets may be loaned. Because many of

138. Leverage may be essential for the fund to achieve market returns, as most comparable private funds are highly leveraged *See* Gregory Brown, *Debt and Leverage in Private Equity: A Survey of Existing Results and New Findings*, INST. FOR PRIV.CAP.: PRIV. EQUITY RSCH. CONSORTIUM (2021), (observing that "[s]ince the earliest days of leveraged buyouts, private equity managers have used debt financing, multiple arbitrage and operational improvements, as the primary drivers of value creation.") *Id*. at 4. Higher amounts of leverage also create higher levels of risk, though this is not always the case. *Id.* (noting that debt is a "choice variable that will depend on market and deal characteristics, and as a consequence, "it is not necessarily the case that measures of leverage are positively associated with returns or risk.")

139. *Id.*

140. *Id.*

the strategic funds' assets are likely to be illiquid investments, such as interests in a limited partnership that is investing in an infrastructure project, it is unlikely that lending of assets would be an issue. However, some funds may occasionally hold liquid securities to generate a return on investment while waiting for investment opportunities to arise. In such cases, the fund may choose to lend securities to other investors, such as short sellers, and reap a "rental fee" from the lending activities.[141] If the fund does lend securities or allow fund assets to serve as collateral, the legislation may prescribe policies and procedures for such activities. In addition, the legislation may provide or limit guarantees by the fund. A guarantee by the fund of a subsidiary, portfolio company, or project implicitly becomes a guarantee of the sponsoring sovereign, and while it is such a guarantee that may induce other investors to participate in a project, the sovereign may want to clearly delineate responsibilities and obligations of the sovereign and the fund, respectively. The legislation may also specify that contingent liabilities may not transfer from a project or portfolio company to the strategic fund or the sovereign[142] and that other assets of a sovereign may not be used to satisfy obligations of the strategic fund.[143]

141. In a short sale, an investor that believes a stock price will go down may borrow the stock from another investor, immediately sell the stock, then repurchase the stock later when the stock price has fallen. *See Short Sales*, U.S. SECS. & EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/glossary/short-sales-0 (last visited Mar. 8, 2023). Just as with buying and holding a stock (in trading terms, taking a long position), a trader makes a profit by buying low and selling high; it is simply the order of the trades that is reversed in a short sale. In a long trade, an investor buys low and (hopefully) later sells high. In a short sale, the investor borrows securities, sells high, then later buys low. *See id.* Many institutional investors are regular short sellers. In a 2019 survey, Finadium, a financial consultancy firm, reported that of 78 large pension funds, 87% engaged in "securities lending via a custodian agent or other third party," and that "securities lending [could] add from 1 to 10 basis points to [the funds'] portfolio returns." *US Pension Plans in Securities Lending: A Statistical Analysis*, FINADIUM (Feb. 2019), https://finadium.com/finadium-report-desc/us-pension-plans-in-securities-lending-a-statistical-analysis/. As an example of securities lending by a large, sophisticated public investor, CalPERS reported over $109 million in securities lending income in 2020 and $111 million lending income in 2019. CALPERS, 2019-20 COMPREHENSIVE ANNUAL FINANCIAL REPORT 23 (2020), https://www.calpers.ca.gov/docs/forms-publications/cafr-2020.pdf.

142. WORLD BANK GROUP, *supra* note 36, at 52.

143. As an example of this asset and liability partitioning, Section 4 of the Nigeria Sovereign Investment Authority Act (NSIA Act) describes that the funds are "ring-fenced." *Nigeria Sovereign Investment Authority (establishment, etc.) Act, 2011*, FED. REPUBLIC NIGERIA OFF. GAZETTE, June 3, 2011, at A 227.

C. Domestic Regulation of Mixed-Capital Funded Strategic Funds

Because some strategic funds—typically those receiving funding from mixed public and private sources—are set up to catalyze and crowd in private sources of funding, the legal structures for such funds will tend to be set up using common commercial entity forms. The fund will attempt to look and operate like a private fund in all respects, from its choice of entity to its choice of domicile to the type and structure of agreements that make up the fund's legal and governance framework.

However, private funds have features that work against some of the goals of strategic funds. As noted above, private funds are designed to allow for exit by the investor and have incentive compensation structures that reward fund managers for wealth maximization.[144] Sovereigns, by contrast, do not have a need for exit and do not use incentive compensation strategies to align managers' interests with those of the sovereign.[145] Indeed, some impact-focused private funds are innovating by developing a long-term, double-bottom-line structure that can operate alongside strategic funds, many of which are designed to catalyze impact-oriented private investment.[146]

144. *See* Morley, *supra* note 119.

145. Many sovereign funds rely on low-powered (but still effective) incentives to align interests, such as reputational benefits and patriotism. Bachher and Monk suggest that sovereign funds are particularly adept at attracting "green, grey, and grounded" managers. Ashby Monk & Jagdeep Bachher, *Attracting Talent to the Frontiers of Finance* (July 30, 2012), https://ssrn.com/abstract=2120167. Sovereign funds are able to attract "early career individuals (i.e., the green)," because at an early career stage "the disparity between the public sector salaries and the private sector salaries are lowest," and sovereign funds strong opportunities to learn asset management techniques. *Id.* Sovereign funds are also competitive in attracting the "grey": experienced individuals "that have had successful careers in the private sector (e.g., 15 to 25 years' experience)," and have "made their money and are now interested in giving back or, depending on the circumstances at the fund, escaping the rat race." *Id.* In addition, they benefit by avoiding the fundraising cycle "that so many private managers dread," and are able to work in a "(relatively) stress free environment to 'practice their trade' through to the end of their careers." *Id.* Finally, sovereign funds also attract the "grounded" through "family, identity or affinity" ties to the region: "Indeed, many employees at public funds are there because they want to stay close to relatives, give back to their country, or just because they want to be close to some great skiing or fishing." *Id.*

146. Among the innovations used by impact-focused private funds are mandatory impact reports to investors, descriptions of impact mission in the fund's purpose section, the use of a Benefit Corporation, Benefit LLC, or non-profit entity as the management company,

The legal framework for strategic funds can be tremendously complex, as a web of private agreements similar to a standard investment fund structure (like a private equity fund) may be supplemented by a series of intra-governmental arrangements that are designed to ensure that the fund meets its investment mandates and is subject to proper oversight by government ministries or agencies. At the same time, the supervision must be subject to strict rules that ensure independence and predictability, so that the fund is not viewed as subject to the political whims of the ministry or as a vehicle for corruption. Striking this balance is challenging yet essential; the mission of the fund may be jeopardized by a weak legal and governance structure, and the legitimacy of the fund and the associated ministry or agency may be jeopardized by governance failures.

Similar to the framework for public-funded strategic funds, a mixed-capital legal framework must provide a legal structure; rules surrounding ownership, funding, and withdrawal; and governance and management structures. Rather than developing these through special legislation, however, mixed-capital funds make use of common private fund structures that provide a familiar and credible legal and governance framework that appeals to potential investors.

Consider, as an example, the European mixed-capital fund, Marguerite II, which operates as a "pan-European investor in long-life infrastructure focussed on greenfield and brownfield expansion initiatives."[147] Marguerite II was set up using a Luxembourg special partnership (Societé en Commandite Spéciale (SCSp)), which operates similarly to a U.S./UK limited partnership (LP)—the structure typically used by hedge funds, private equity funds, and venture capital funds. As with the LP structure, the SCSp structure allows for one or more relatively passive, limited partner investors (associés commanditaires) to rely on a general partner (associé commandité) to manage the affairs of the fund. As with LPs, SCSp limited partners enjoy limited liability, pass-through taxation, and

the suspension of payment of management fees if the fund's managers fail to meet impact reporting requirements (with mechanisms for removal, in some cases), and compensation tied to achievement of impact goals. MORRISON & FOERSTER, LEGAL INNOVATION IN IMPACT INVESTING (2021), https://www.mofo.com/resources/insights/210422-legal-innovation-in-impact-investing.html.

147. *Who We Are*, MARGUERITE, https://www.marguerite.com/who-we-are/ (last visited Mar. 8, 2023).

a high level of contractual flexibility. Created in 2013, the SCSp has quickly become the most popular private equity fund vehicle in Luxembourg.[148] By establishing the Marguerite II fund as a SCSp, the sovereign sponsors of the fund[149] are able to offer their co-investors the same stability and predictability in legal structure and governance that they would be able to expect from a SCSp established by a private manager. And, like private funds but unlike most other sovereign funds, Marguerite II was established with a ten-year life, thus operating with a standard commercial structure and a standard investment horizon.[150]

Having provided a brief description of essential legal and governance frameworks for both public-capital and mixed-capital strategic funds, the following section turns to international regulation of strategic funds. While domestic regulation is at the core of how governments can manage the risks arising from the operation of strategic funds, international regulation can also play an important role in strategic fund governance. Section III.D examines the U.S. regulatory framework impacting strategic funds, and section III.E turns to multilateral regulation and the impact of soft law guidance such as the Santiago Principles.

D. Foreign Investment Regulations

Foreign investment regulation also shapes the legal and governance environment in which sovereign funds operate.

148.

> Luxembourg Partnerships, in particular the SCSp, and to a lesser extent the SCS, have become the most popular private equity fund vehicles in Luxembourg. The regimes for the SCSp and the SCS are modelled on the successful Anglo-Saxon limited partnership regimes and offer features similar to foreign partnership regimes applicable in England, Scotland, Delaware and other common law jurisdictions.

Andrew Wylie, Michelle Barry, & Johan Terblanche, *English and Luxembourg Private Equity Funds: Key Features*, THOMSON REUTERS PRACTICAL L. UK, (May 29, 2020), https://uk.practicallaw.thomsonreuters.com/w-025-5920.

149. The fund sponsors are the Bank Gospodarstwa Krajowego (Poland), Caisse des dépôts et consignations (France), Cassa Depositi e Prestiti (Italy), European Investment Bank, Instituto de Crédito Oficial (Spain), and KfW (Germany), all of which are state-sponsored funds.

150. It is worth noting here the trade-off for funds like Marguerite that do operate on limited time horizons; one advantage of sovereign investment is its lack of defined time horizon, which enables the fund to invest over the long term. However, most investors do not have such long time horizons. To attract other investors, a mixed-capital fund—which serves to leverage private capital—may offer a standard ten-year investment term.

Because strategic funds are domestically oriented, the fund's domestic law is of primary importance. However, because some funds may employ U.S. intermediaries to assist with certain transactions or administrative functions, may have U.S.-domiciled co-investors, or may occasionally make investments in the U.S., U.S. law may govern some of these sovereigns' deals and may impact fund governance. Two sets of regulations have the potential to impact sovereign-fund investment activity: foreign investment regulations through section 721 of the Defense Production Act, the Exon-Florio Amendment in 1988, the Foreign Investment and National Security Act, and the recently enacted Foreign Investment Risk Review Modernization Act (FIRRMA), among others; and corruption regulation through the Foreign Corrupt Practices Act (FCPA) and the Global Magnitsky Human Rights Accountability Act.

1. CFIUS and Foreign Investment Regulation

The regulation of foreign investments implicating national security is coordinated by the Committee on Foreign Investment in the United States (CFIUS), an interagency group tasked with reviewing (and potentially blocking) problematic transactions. [151] Like the domestic turn in sovereign funds, foreign investment law has become more domestically focused with more concern over not only national security impacts of foreign trade, but also their economic effects as well.[152] More to the point, the two domestic reorientations are linked and recursive: both trends are linked as responses to globalization, and they are recursive because a more defensive foreign investment regime discourages sovereign

151. CFIUS includes "nine Cabinet members[:] . . . the Secretaries of State, the Treasury, Defense, Homeland Security, Commerce, and Energy; the Attorney General; the United States Trade Representative; and the Director of the Office of Science and Technology Policy." CONG. RSCH. SERV., RL33388, THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS) 22 (2020), https://fas.org/sgp/crs/natsec/RL33388.pdf. Other non-voting members include the "Secretary of Labor and the Director of National Intelligence," as well as the "Director of the Office of Management and Budget; the Chairman of the Council of Economic Advisors; the Assistant to the President for National Security Affairs; the Assistant to the President for Economic Policy; and the Assistant to the President for Homeland Security and Counterterrorism." *Id.*

152. *Id.* at ii (observing that "[r]ecent debate over CFIUS reflects long-standing concerns about the impact of foreign investment on the economy and the role of economics as a component of national security.").

investment from other countries, thereby promoting more domestic investment. On the other hand, a more political, socially focused sovereign fund is also more likely to create concerns over its investment policies and draw the attention of regulators, who prefer predictable, commercially oriented, wealth-maximizing investment behavior.

The recently enacted FIRRMA regulations place increased scrutiny on sovereign investment and so arguably contribute to the domestic turn. These regulations arose largely because of concerns that sovereigns were obtaining controlling or influential interests in sensitive U.S. industries, and particularly due to concerns over "Chinese and other foreign investment in U.S. companies with advanced technology."[153] But among the varied types of state-owned investment, the larger concern should not be with SWFs but with state-owned enterprises. SWFs typically invest in small, non-controlling stakes of public companies and do not seek to manage or operate the firms in which they invest. State-owned enterprises, on the other hand, are designed to own and operate business lines. They are also not repeat players in investment markets the way that SWFs and strategic funds are, and unlike many strategic funds, state-owned enterprises do not tend to rely on private partners—and private legal regimes—to impose investment discipline and help manage agency costs. Strategic funds are closer to state-owned companies, however, in that strategic funds may take an active management role in some projects, sometimes acting as a general partner. However, these activities will almost always occur within the sovereign's own borders. Because strategic funds are domestically oriented, they are less likely to be subject to the CFIUS review process.

2. Anti-Corruption

Corruption is a "corrosive disease" that "rapidly spreads to infect the whole body politic."[154] The U.S. government promotes

153. *Id.*

154. Drucker, *supra* note 65, at 15. Drucker notes that

> the temptation to dishonesty is always great. People of modest means and dependent on a salary handle very large public sums. People of modest position dispose of power and award contracts and privileges of tremendous importance to other people—construction jobs, radio channels, air routes, zoning laws,

numerous transparency initiatives that impact governance and combat corruption in other states. For example, each year the State Department is authorized to make expenditures under Section 7031(b)(1) of the Department of State, Foreign Operations and Related Programs Appropriations Act to support fiscal transparency, particularly in regimes that are largely supported through natural resource extraction. The assumption undergirding these expenditures is that "[f]iscal transparency is a critical element of effective public financial management, helps build market confidence, and underpins economic sustainability."[155] Further, it "fosters greater government accountability by providing a window into government budgets for citizens, helping citizens hold their leadership accountable, and facilitating better-informed public debate."[156] In its annual anti-corruption reporting, the State Department analyzes over 140 countries' fiscal transparency through their adherence to a set of "minimum requirements of financial transparency," defined as "the public disclosure of . . . national budget documentation (to include income and expenditures by ministry)"[157] and "government contracts and licenses for natural resource extraction (to include bidding and

> building codes, and so on. To fear corruption in government is not irrational. This means, however, that government 'bureaucracy'—and its consequent high costs—cannot be eliminated. Any government that is not a 'government of paper forms' degenerates rapidly into a mutual looting society.

Id.

155. U.S. DEP'T OF STATE, 2020 FISCAL TRANSPARENCY REPORT (2020) [hereinafter TRANSPARENCY REPORT], https://www.state.gov/2020-fiscal-transparency-report/.

156. *Id.*

157. *Id.* Budget information should be "publicly available, substantially complete, and generally reliable." *Id.* Publicly available means that budget documents "should be widely and easily accessible to the general public[,]"from "government offices or libraries, widely available government publications, or mass media channels," and should be available within a "reasonable period of time." *Id.* "Substantially complete" means that the publicly available budget documents "should provide a substantially full picture of the government's planned expenditures and revenue streams, including natural resource revenues," and "should include expenditures broken down by ministry and revenues broken down by source and type." *Id.* The documents should also "detail [the financial] allocations to and [the] earnings from state-owned enterprises." *Id.* Further, "[s]ignificant, large state-owned enterprises should have publicly available audited financial statements." *Id.* "Reliable" means that the information in the budget is "credible, meaning actual government revenues and expenditures correspond to the enacted budget." *Id.* "Financial statements should be prepared according to internationally accepted accounting principles that yield consistent and comparable statements[,]" and the budget and financial statements "should be audited by an independent supreme audit institution." *Id.*

concession allocation practices)."[158] The State Department also provides direct aid to countries to "enhance budget transparency, advance public financial management, and improve the transparency of licensing and contracting in natural resource extraction"[159] through the Fiscal Transparency Innovation Fund.

The Foreign Corrupt Practices Act (FCPA) is the core U.S. anti-bribery regulation, and it has two functions relevant to state-controlled enterprises and funds. First, the FCPA requires companies traded on exchanges to make and keep books and records that "accurately and fairly reflect the transactions" of the corporation and to "devise and maintain a system of internal accounting controls."[160] This provision applies to any listed company, including foreign companies, as well as to their subsidiaries. For example, the SEC brought an action in 2010 against RAE Systems, Inc., a California company, for failure to maintain "adequate internal control[s]" in its subsidiaries.[161] Two of RAE's joint venture entities in China were found to have paid $400,000 to various government officials in China to obtain or retain

158. *Id.* Fiscal transparency for "government contracts and licenses for natural resource extraction" was assessed by determining whether the "criteria and procedures for the contracting and licensing [were] publicly available and codified in law or regulation," and whether they were actually "followed in practice." *Id.* "The basic terms of concessions and contracts should be made publicly available" after a grant, and the disclosure "should include the geographic area covered by the contract or license, the resource being developed, the duration of the contract, and the company to which the contract or license is awarded." *Id.*

159. *Fiscal Transparency Innovation Fund*, U.S. DEP'T OF STATE, https://www.state.gov/fiscal-transparency-innovation-fund/ (last visited Mar. 8, 2023). Among other things, the fund helps to

> [b]uild public financial management capacity and strengthen financial management policies[;] [f]acilitate pro-transparency legislative reforms at the local and national level[;] [c]onstruct innovative tools for the public dissemination of budget documents[;] [s]trengthen collaboration between government officials and civil society leaders and promote public participation in the budget process; [e]mpower civil society and media to monitor public funds and hold governments accountable for expenditures and public debt[;] [and] [f]und other innovative approaches to advance fiscal transparency[.]

Id. In fiscal year 2019, fund recipient countries included "Angola, The Bahamas, Burma, Chad, Democratic Republic of Congo, Ecuador, The Gambia, Guinea, Mauritius, Mozambique, Seychelles, Tajikistan, Tanzania, Tunisia, and Uzbekistan." TRANSPARENCY REPORT, *supra* note 155. "The projects [were] targeted to advance efforts by government and civil society to enhance fiscal transparency and public financial management practices and to improve public awareness and involvement in the expenditure of public resources." *Id.*

160. 15 U.S.C. § 78m(b)(2).

161. *See* Complaint at 2, SEC v. RAE Sys. Inc., No. 10-cv-2093 (D.D.C. filed Dec. 10, 2010).

business from Chinese governmental entities.[162] The payments were made exclusively in China by Chinese employees, who took out cash advances to fund "business fees" and "travel and entertainment" expenses.[163] The SEC found that RAE failed to act on red flags indicating bribery and corruption, and the SEC required the company to "pay $1,147,800 in disgorgement" of the profits obtained through the payments ("plus $109,212 in pre-judgment interest").[164] Second, and more directly applicable, are the anti-bribery provisions of the FCPA, which prohibit the "use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to" a foreign official to "influenc[e] . . . [the] foreign official in his [or her] official capacity . . . , induc[e] . . . [the] foreign official to do or omit to do any act in violation of . . . [his or her] lawful duty . . . , or . . . [to] secur[e] any improper advantage . . . in order to assist such issuer in obtaining or retaining business for or with, or directing business to, any person."[165]

The U.S. government also targets corruption through the Global Magnitsky Human Rights Accountability Act.[166] The Global Magnitsky Act builds on the earlier Sergei Magnitsky Rule of Law Accountability Act of 2012,[167] which was named after a Russian tax

162. *Id.* at 1.

163. *Id.* at 1–2, 5.

164. RAE Sys. Inc., Litigation Release No. 21770, 99 SEC Docket 4176 (Dec. 10, 2010), https://www.sec.gov/litigation/litreleases/2010/lr21770.htm.

165. 15 U.S.C. § 78dd–1(a)(1).

166. Global Magnitsky Human Rights Accountability Act, Pub. L. No. 114-328, 130 Stat. 2000, 2533 (2017) (codified as amended at 22 U.S.C. § 2656 note).

167. Sergei Magnitsky Rule of Law Accountability Act of 2012, Pub. L. No. 112-208, 126 Stat. 1496, 1502 (codified as amended at 22 U.S.C. § 5811 note). The Act describes the corruption uncovered by Magnitsky, as well as his death in prison:

> Sergei Leonidovich Magnitsky died on November 16, 2009, at the age of 37, in Matrosskaya Tishina Prison in Moscow, Russia, and is survived by a mother, a wife, and 2 sons. . . . On July 6, 2011, Russian President Dimitry Medvedev's Human Rights Council announced the results of its independent investigation into the death of Sergei Magnitsky. The Human Rights Council concluded that Sergei Magnitsky's arrest and detention was illegal; he was denied access to justice by the courts and prosecutors of the Russian Federation; he was investigated by the same law enforcement officers whom he had accused of stealing Hermitage Fund companies and illegally obtaining a fraudulent $230,000,000 tax refund; he was

lawyer, auditor, and dissident who documented "rampant tax fraud and other corruption by individuals associated with the Russian government."[168] The Global Magnitsky Act authorizes the executive agencies to block assets under U.S. jurisdiction, deny individuals access to the U.S., revoke any already-issued visa, and prohibit certain transactions in the U.S. The original act was designed to require the President to identify each person who was "responsible for the detention, abuse, or death of Sergei Magnitsky, participated in efforts to conceal the legal liability for the detention, abuse, or death of Sergei Magnitsky, financially benefitted from the detention, abuse, or death of Sergei Magnitsky, or was involved in the criminal conspiracy uncovered by Sergei Magnitsky[.]"[169] Identified persons then were ineligible for visas, had existing visas revoked, had their assets frozen, and were prohibited from "all transactions in all property and interests in property."[170] A Magnitsky designation may be made either for human rights abuses or for corruption. As of October 2020, 107 individuals had been so designated; of the 105 "active designations" as of that date, "60 individuals [were] designated . . . for human rights abuses, 42 . . . for corruption, and 3 . . . for both[.]"[171] The Treasury Department has also sanctioned a Chinese, state-owned enterprise under the Magnitsky Act for "seizure and demolition of local

> denied necessary medical care in custody; he was beaten by 8 guards with rubber batons on the last day of his life; and the ambulance crew that was called to treat him as he was dying was deliberately kept outside of his cell for one hour and 18 minutes until he was dead. The report of the Human Rights Council also states the officials falsified their accounts of what happened to Sergei Magnitsky and, 18 months after his death, no officials had been brought to trial for his false arrest or the crime he uncovered. . . . The systematic abuse of Sergei Magnitsky, including his repressive arrest and torture in custody by officers of the Ministry of the Interior of the Russian Federation that Mr. Magnitsky had implicated in the embezzlement of funds from the Russian Treasury and the misappropriation of 3 companies from his client, Hermitage Capital Management, reflects how deeply the protection of human rights is affected by corruption.

Id. at 1503.

168. CONG. RSCH. SERV., IF10576, THE GLOBAL MAGNITSKY HUMAN RIGHTS ACCOUNTABILITY ACT 1 (2020), https://crsreports.congress.gov/product/pdf/IF/IF10576/11.

169. Sergei Magnitsky Rule of Law Accountability Act of 2012, *supra* note 167, at 1505–06.

170. *Id.* at 1507–08.

171. CONG. RSCH. SERV., *supra* note 168, at 1–2.

Cambodians' land for the construction of the Dara Sakor development project."[172]

To the extent that strategic funds are conducting transactions within the U.S. or are using U.S. entities as intermediaries, other laws may apply. For example, securities laws and laws and regulations governing investment funds and investment advisors may apply, particularly in cases involving mixed-capital strategic funds that issue securities (in the form of limited partnership interests) to U.S. investors. While these transactions would operate under exemptions from securities registration requirements, the fund would nevertheless be required to comply with certain disclosure and offering requirements. The managers for the fund may also be required to provide disclosures about themselves. Both fund and advisor disclosures would generally be subject to antifraud rules.

In addition, tax laws may impact the structuring and operation of strategic funds. Mixed-capital strategic funds that are investing on behalf of other investors would most likely be subject to taxation, but public-capital, strategic funds often would be treated like a state-owned enterprise and would generally not be subject to taxation.[173] For mixed-capital funds, tax issues arise at four levels: the investor, the fund, the portfolio investment, and the fund manager. Each of these parties seeks to "minimize tax obligations[,]" and strategic funds (like their private counterparts, the private equity funds) will typically be "structured so that the fund itself does not pay tax, but so that the gains and losses pass through to the investors, who are then taxed individually."[174]

172. *Treasury Sanctions Chinese Entity in Cambodia Under Global Magnitsky Authority*, U.S. DEP'T OF TREASURY, (Sept. 15, 2020), https://home.treasury.gov/news/press-releases/sm1121.

173.

> Jurisdictions exempting SIFs and other state-affiliated entities from taxation may do so through the application of sovereign immunity doctrines, which traditionally limit the application of a recipient country's laws to most areas of activity undertaken by sovereign entities within its borders. However, such grants of immunity are becoming increasingly narrow as cross-border investments by sovereigns increase. Some politicians, academics, and others have called for the elimination of sovereign immunity from taxation.

WORLD BANK GROUP, *supra* note 36, at 70 (footnote omitted) (citing Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 NYU L. REV. 440 (2009)).

174. *Id.*

E. International Legal Frameworks for Strategic Funds

Aside from the "hard" regulation of sovereign-fund activity through foreign-investment regulations such as those administered by CFIUS and anti-corruption regulations administered by the Departments of State and Treasury and agencies such as the SEC, "soft law" (non-binding governance frameworks such as the Santiago Principles) plays an important role in how sovereign funds are structured, governed, and regulated. Strategic funds operating in foreign countries are subject to a variety of host-country laws that serve to protect investors in those markets, the competitiveness of the market itself (such as through antitrust regulation), and national security interests. As previously discussed, states are increasingly concerned not only with national security interests but also with the ways in which globalization may create externalities that exacerbate inequalities.

Through international conventions and adherence to soft-law governance frameworks, sovereign funds often also create governance structures and develop disclosure regimes that enhance their overall function and help to mitigate the political and governance risks identified above.

To help combat systemic corruption around the world, the OECD developed an anti-bribery convention for its member states. The convention states that "bribery is a widespread phenomenon in international business transactions, including trade and investment, which raises serious moral and political concerns, undermines good governance and economic development, and distorts international competitive conditions[.]"[175] Similarly, the U.N. Convention against Corruption, adopted in 2003, is intended to promote and support "measures to prevent and combat corruption more efficiently and effectively; . . . international cooperation and technical assistance . . . including in asset recovery; [and] integrity, accountability and proper management of public affairs and public property."[176] In particular, the convention states that states shall develop "[p]reventive[,] anti-corruption policies and practices . . . that promote the

175. OECD, CONVENTION ON COMBATING BRIBERY OF FOREIGN PUBLIC OFFICIALS IN INTERNATIONAL BUSINESS TRANSACTIONS (1997).

176. UN OFF. ON DRUGS & CRIME, UNITED NATIONS CONVENTION AGAINST CORRUPTION 7 (2004).

participation of society and reflect the principles of the rule of law, proper management of public affairs and public property, integrity, transparency and accountability."[177] "State part[ies]" are to "adopt . . . hiring, retention, promotion[,]" and firing practices "[t]hat are based on . . . efficiency, transparency, and objective criteria[;]" provide anti-corruption "education and training[;]" and "tak[e] . . . measures . . . to enhance transparency in the funding of candidatures for elected public office and, where applicable, the funding of political parties."[178] The convention asks states to apply "[c]odes of conduct for public officials . . . such as [those found in] the International Code of Conduct for Public Officials[.]"[179]

Of special importance to the governance of strategic funds are public procurement policies; domestically oriented sovereign funds are often focused on infrastructure development, for example, and will engage numerous local contractors to complete the work (thereby also providing extensive employment opportunities for local workers). A lack of regulation around these activities not only invites corruption, but also introduces political risk by avoiding the checks and balances of standard regulation and lawmaking.[180] To help mitigate some of these risks, the convention requires states "to establish appropriate systems of procurement, based on transparency, competition and objective

177. *Id.* at 9.

178. *Id.* at 10–11.

179. *Id.* at 11. *See* G.A. Res. 51/59, annex, (Dec. 12, 1996) (laying out the International Code of Conduct for Public Officials).

180. As Michaels notes,

> [I]nvestments may be chosen to promote welfarist objectives, to the apparent detriment of the government's rate of return. Among other things, government pension managers might invest in solar energy companies (and divest from fossil fuel firms); they might prioritize local firms with the hope that government investments lead to local job growth, an expanded tax base, and a happier electorate, and they might divest from firms that sell harmful products or do business with rogue nation-states. Making policy through investments rather than legislation or regulation can no doubt save time and political capital. . . . [I]nvestment decisions may be directed and constrained by statutes and regulations. But the decisions themselves are not generally subject to the substantive and procedural requirements of lawmaking. Yet such an investing-as-regulating approach to governing expands State powers in potentially troubling ways: the government employs its commercial tools and resources to reach further and act more expediently than it could were only sovereign, coercive tools at its disposal.

Jon D. Michaels, *Sovereigns, Shopkeepers, and the Separation of Powers*. 166 U. PA. L. REV. 861, 887 (2018) (footnote omitted).

criteria in decision-making, that are effective, inter alia, in preventing corruption" and "effective system[s] of domestic review, including an effective system of appeal, to ensure legal recourse and remedies in the event that the rules or procedures established pursuant to this paragraph are not followed."[181]

Finally, strategic funds often operate under the soft law of the Santiago Principles. These Generally Accepted Principles and Practices (GAPP) were intended at least in part (and probably in the largest part) to provide host countries with reassurances that strategic funds operate under commercial norms.[182] The first section of the Santiago Principles focuses on the need for a robust legal structure for a sovereign fund, stating the importance of demonstrating "to home and recipient countries, and the international financial markets," that the sovereign fund has been "properly set up and [that] investments are made on an economic and financial basis."[183] The fund's "legal framework . . . should be sound and support its effective operation and the achievement of its stated objective(s)[,]" and the "key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and other state bodies, should be publicly disclosed."[184]

181. UN OFF. ON DRUGS AND CRIME, *supra* note 176, at 12.

182. The "purpose" of the principles is expressed directly in such terms:

> The GAPP aims at supporting the institutional framework, governance, and investment operations of SWFs that are guided by their policy purpose and objectives, and consistent with a sound macroeconomic policy framework. Publication of the GAPP should help improve understanding of SWFs as economically and financially oriented entities in both the home and recipient countries. This understanding aims to contribute to the stability of the global financial system, reduce protectionist pressures, and help maintain an open and stable investment climate. The GAPP would also enable SWFs, especially newly established ones, to develop, review, or strengthen their organization, policies, and investment practices.

SANTIAGO PRINCIPLES, *supra* note 9, at 4.

183. The "guiding objectives" of the Santiago Principles are (1) "[t]o help maintain a stable global financial system and free flow of capital and investment;" (2) to "comply with all applicable regulatory and disclosure requirements in the countries in which they invest;" (3) to invest on the basis of economic and financial risk and return-related considerations;" and (4) "[t]o have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability." *Id.*

184. *Id.* at 7. Disclosure may include a description of "the legal basis and structure of the SWF" to "enhance[] the public understanding and confidence in the mandate to manage public monies." *Id.* at 12. The Santiago Principles argue that

Among other things, these principles mean that "the establishment of the SWF [has been] . . . authorized under domestic law."[185] The fund's source legislation should also provide a "clear mandate for the manager to invest the SWF's assets and conduct all related transactions" and should specify the "beneficial owners" (the sovereign itself, typically, or a ministry or agency) and "legal owners" (the fund entity, for example).[186] While the Santiago Principles allow for considerable flexibility in mandate and operations (and in any event, as soft-law standards, the Santiago Principles have no enforcement mechanism other than low-powered, reputational constraints), the principles assume that "[a]s investment institutions, SWFs operate on a good faith basis, and invest on the basis of economic and financial risk and return-related considerations."[187]

This default financial orientation is expressed most explicitly in the Santiago Principles' GAPP 19, which states that an "SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds."[188] But the flexibility to pursue a multiple-equilibrium approach, such as through the pursuit of social goods that may not be easily quantifiable (including a broad reorientation of a country's market to a more sustainable economic system),[189] is contemplated by subprinciple 19.1. That provision states that "[i]f investment decisions are subject to other than economic and financial considerations, these should

> [c]larity and disclosure of the legal relationship between the SWF and other state bodies (such as the central bank, development banks, other state-owned corporations and enterprises) contributes to a better understanding of the mandated responsibilities of the SWF vis-à-vis other government bodies, and of the SWF's institutional set-up and organization structures to ensure that it is managed professionally.

Id.

185. *Id.*

186. *Id.* The Santiago Principles note that "Such clarity contributes to accountability in the home country, and is often required under the recipient countries' regulations." *Id.*

187. *Id.* at 5.

188. *Id.* at 8.

189. For example, the Kingdom of Saudi Arabia uses its Public Investment Fund (PIF) "as part of the broader effort to drive national economic transformation and achieve positive and sustainable change in Saudi Arabia." SUSTAINABLE DEVELOPMENT GOALS: 1ST VOLUNTARY NATIONAL REVIEW, KINGDOM OF SAUDI ARABIA 87 (2018), https://sustainabledevelopment.un.org/content/documents/20230SDGs_English_Report972018_FINAL.pdf.

be clearly set out in the investment policy and be publicly disclosed."[190] Similarly, GAPP 2 states that "[t]he policy purpose of the SWF should be clearly defined and publicly disclosed[,]" explaining in the commentary that "[a] clearly defined policy purpose facilitates formulation of appropriate investment strategies based on economic and financial objectives . . . . The pursuit of any other types of objectives should be narrowly defined and mandated explicitly."[191]

By relying on overlapping and mutually reinforcing legal frameworks of the level of the strategic fund's sponsor country, its host countries, and international soft law, strategic funds have a greater chance of avoiding the risks of corruption, politicization, and waste that could erode the legitimacy of the fund and its sovereign sponsor. Given the variations in the institutional strength of different sovereign sponsors' legal regimes, as well as in the quality of host-country laws, it is likely that we will see a variation in the quality of strategic fund governance. In cases where sponsor-country and host-country legal frameworks are weaker, additional strength may be needed from international soft-law regimes, such as the Santiago Principles.

CONCLUSION

The domestic shift in sovereign funds reflects the turn to nationalism in other areas of international relations, trade, and economic policy. And although strategic funds represent an important domestic turn for sovereign funds, this turn should not be taken as an argument that sovereign wealth funds are no longer a viable policy choice. Sovereign wealth funds will still be created as needed to respond to the same macroeconomic concerns that have traditionally justified their creation, such as large inflows of cash from natural resource extraction and sale. As noted above,

190. SANTIAGO PRINCIPLES, *supra* note 9, at 8 (italics omitted).

191. *Id.* at 7, 12. Linking to the overarching purpose of the Santiago Principles as a kind of reassurance and credible commitment device, the commentary also notes that

> A clearly defined policy purpose will also ensure that the operational management of the SWF will conduct itself professionally and ensure that the SWF undertakes investments without any intention or obligation to fulfill, directly or indirectly, any geopolitical agenda of the government. Public disclosure of the SWF's policy purpose provides a better understanding of what the SWF seeks to achieve and whether its behavior is consistent with the specified purpose.

Id.

most sovereign wealth funds are designed to solve macroeconomic policy concerns, such as budget stabilization or exchange rate stabilization,[192] though some also play a role as vehicles for intergenerational wealth transfer. These concerns are likely to continue to exist even if cross-border economic activity contracts as a result of nationalistic trade and economic policies. So long as these problems persist, countries—particularly resource-rich countries—can use sovereign wealth funds to alleviate them.

For better and for worse, the international economic order has created tremendous wealth, while also leading to inequalities, pollution, and a host of other disruptions and dislocations. I have argued here that strategic funds should be considered to be both responses and remedies to some of these negative effects. The ironic promise of strategic funds is that many governments use the standard forms of wealth-maximizing entities, such as private equity fund structures, to achieve these goals. Rather than break away from the capital markets and seek to shift all the burden of remediation back to the state, strategic funds seek to co-invest with wealth-maximizing entities in providing public goods through a new and vast form of public-private partnership.

Operating at the intersection of the public and the private economic spheres, strategic funds share governance challenges with both. As a form of sovereign fund, strategic funds present risks to other sovereigns, as they have the possibility to be used as tools of mercantilism. But the greatest risks are within the sovereign's borders. Because of the type and depth of their market investments, strategic funds present acute political, economic, and

192. With respect to the fiscal stabilization role, Shields and Villafuerte summarize:

> In practice, SWFs have been established for a variety of reasons and in a variety of circumstances. Many were initially created for fiscal stabilization, that is, to help smooth the impact on government spending of revenues that were large and volatile, particularly revenue from the export of natural resources. Safety buffers were built up when revenues were high so that spending could be protected when times turned bad. Other SWFs were focused more specifically on protecting high revenues from being raided through populist pressures for sharp increases in spending that might prove unsustainable. But behind these motivations were often broader concerns about management of the economy as a whole. The intention was then more specifically one of macroeconomic stabilization, and in particular, of avoiding excessive pressures on the productive capacity of the economy and hence on inflation.

Jon Shields & Mauricio Villafuerte, *Sovereign Wealth Funds and Economic Policy at Home*, *in* ECONOMICS OF SOVEREIGN WEALTH FUNDS, 43, 44 (italics omitted).

governance risks, including corruption, the crowding out of private enterprise, and legitimacy concerns. The legal principles and frameworks described here can help to manage and mitigate these risks, but simply importing a robust framework does not ensure success. The implementation of that framework will often require the dedicated work of a host of knowledgeable and experienced professionals and intermediaries; the governance gap is typically not merely a gap in legal structure, but it is also a gap in legal personnel.

This Article has argued that strategic funds are an economic response to a political problem—in particular, rising distress over the effects of globalization—, but I do not suggest that the resulting policy efforts should be taken as a cynical, short-term response. In many cases, the tenor of the investments will stretch across generations. Strategic sovereign investment is not a temporary attempt at populist appeasement so much as an effort to effect long-term political and economic stability. Whether the funds will achieve this stability depends greatly on the quality of their legal and governance structures.