Opinion of the European Economic and Social Committee on 'The impact of private equity, hedge and sovereign funds on industrial change in Europe'

(own-initiative opinion)

(2010/C 128/10)

Rapporteur: Mr MORGAN
Co-rapporteur: Mr POP

On 26 February 2009, the European Economic and Social Committee, acting under Article 29(2) of its Rules of Procedure, decided to draw up an own-initiative opinion on

The impact of private equity, hedge and sovereign funds on industrial change in Europe.

The Consultative Commission on Industrial Change, which was responsible for preparing the Committee’s work on the subject, adopted its opinion on 10 September 2009.

At its 457th plenary session, held on 4 and 5 November 2009 (meeting of 5 November), the European Economic and Social Committee adopted the following opinion by 167 votes to one with three abstentions.

1. Conclusions and recommendations

1.1. The purpose of this opinion is to consider the impact on industrial change of Sovereign Wealth funds (SWF), and Alternative Investment Funds (AIF). AIF are Private Equity (PE) and Hedge Funds (HF). The EESC commissioned consultants ‘Wilke Maack and Partner’ (WMP) and they have produced an 87 page report. Readers of this opinion are referred to the report itself for a detailed analysis of the issues. A very different perspective on AIF and SWF will be found in ‘The New Power Brokers’ published on the Mckinsey Global Institute web site.

1.2. The funds examined in this opinion influence industrial change in different ways. SWF are conventional investors, buying and selling in the market. HF buy and sell shares, mostly as traders, although some HF are activist. The PE strategy is hands on. It is not possible to generalise about these three modes of investment. They are quite distinct. A WMP SWOT analysis for each fund is given at the end of sections 3, 4 and 5 respectively.

1.3. Experience and research reveal one very clear common aspect: all the social consequences, including industrial change, will be greatly facilitated by increasing provision and dissemination of information and, above all, transparency. The EESC firmly advocates improving these three elements in all cases.

1.4. PE has three important aspects. It has a positive impact with venture capital and in the financing of turnarounds and reorganisations and the growth of family companies. On the other hand, the recent aggressive financial engineering associated with larger leveraged buy-outs (LBO) may lead to the failure or near failure of many firms with potentially dire consequences for all stakeholders, including employees. There is also an important social dimension, involving both the improvement and deterioration of employment rates, earnings levels and social rights. Because of difficulties with the data, WMP advise that we need to be extremely cautious about concluding that companies backed by PE are treated worse or squeezed harder in the context of the general acceleration of industrial change and restructuring in the last two decades. There are many examples of a worsening of work conditions and labour relations throughout Europe where these funds play no part.

1.5. In general, HF activities do not impact industrial change, but there are important exceptions. HF are large buyers of distressed debt. As such they are buyers of last resort and can play an important role in the rescue and reorganisation of distressed companies. They also get involved on both sides of M&A situations. This creates value, but the impact on industrial change is not always positive. The short term orientation is seen as a potential negative. Other concerns include lack of transparency and the potential for systemic risk, aggravated by leverage.
1.6. There are two important aspects to SWF activities. SWF positives include their pattern of longer term shareholding and their readiness to be the buyer of last resort. Negatives include a lack of transparency and the potential to use their stakes for strategic political purposes.

1.7. The internationalisation of capital markets has been very significant. Investing institutions have assembled world wide equity portfolios and promoted international mergers and acquisitions. Pressure has been put on companies and regulators to transfer voting rights from management to shareholders. The shadow of M&A and the threat of shareholder activism have caused managements in the EU to initiate widespread industrial change. This has to some extent undermined relationships between management and stakeholders and shortened the time horizons of management general. This is the context in which AIF and SWF operate.

1.8. Conventional Institutional Fund Managers (CIFM), those in charge of pension, insurance and mutual funds, are involved with AIFM at every turn. They are major investors in AIF, they sell their investments to PE for LBOs, they buy portfolio companies when PE exits, their investments in companies are in play when activistHF intervene in M&A and they are the shareholders who lend shares to HF so that HF can sell short. They ultimately stand behind whatever environmental, social and governance policies the AIF implement. CIFM are the reciprocal of AIFM.

1.9. Following consideration of the WMP report and the other perspectives included in this opinion, the EESC recommendations fall into three categories: regulation and transparency, amendments to existing social legislation and the responsibilities of CIFM.

1.10. Regulation of AIFM is the subject of a proposed EU Directive on which the EESC will write a separate opinion. From the EESC perspective, it is important to note that the AIF did not cause the crisis but that they have been heavily impacted by it. There remains a good deal of uncertainty about the role played by these funds and there is clearly a case for more transparency through appropriate regulation.

1.11. The EESC endorses the six high level principles for the regulation of HF proposed by the International Organisation of Securities Commissions (IOSCO) in June 2009 and which are outlined in Section 4. The EESC recommends to the Commission that it base itself on these principles and strengthen them for AIFM regulation in the proposed Directive. While IOSCO has completed an analysis of the risks to the financial system posed by PE, no regulatory proposals have yet been made. The EESC recommends that the Commission adapt the IOSCO HF principles to fit the profile of PE.

1.12. As discussed in Section 5, the Santiago principles agreed by the SWF provide a basis for improved SWF transparency and governance. However, much more remains to be done. The EESC urges the Commission to continue to press the SWF International Working Group (IWG) to proceed with the necessary developments.

1.13. Under some legal systems, HF and PE that own and control companies are not regarded as employers and are therefore exempt from employers’ legal obligations. The European Acquired Rights Directive, which protects workers’ terms and conditions in the case of takeovers, does not generally apply in the case of AIF acquisitions due to the fact that they merely take over the shares so that the identity of the employer does not change. The EESC recommends that the Acquired Rights Directive 2001/23/EC (1) be strengthened in the case of HF and PE takeovers in order to

— safeguard the rights of the employees concerned, including the right to be informed and consulted;

— ensure that transfers of undertakings by way of share sale are not excluded from the Directive;

— ensure that these actions respect National and European legislation.

1.14. In order to reflect the situation created by HF and PE, the EESC proposes that Council Directive 94/45/EC (2) on the establishment of European Works Councils and Directive 2002/14/EC (3) establishing a general framework for informing and consulting employees be amended to ensure more effective consultation rights, respecting the position of all parties, before PE deals are finalised, during any restructuring process, and before exit.

1.15. An increasing number of pension funds and insurance companies have holdings in HF and PE and their failure could negatively affect the entitlements of pension scheme members. The EESC asks the Commission to review the Directive 2003/41/EC (4) on the activities and supervision of institutions for occupational retirement provision to ensure that:

— employees and union representatives are consulted about pension investments and the associated risks and that their views are respected.

(1) OJ L 82, 22.3.2001, p. 16.
— Member States use best practice to ensure that company pensions acquired by employees are shielded from bankruptcy.

1.16. The EESC calls on the Commission to set out in the next directive clear, unambiguous rules which will ensure transparent use of funds, not least through direct participation by employees' and businesses' representatives.

1.17. The EESC calls on the Commission to consider Responsible Investment in Private Equity (PRI) in all their dealings with AIFM. The PRI, which address environmental, social and governance (ESG) issues, were drawn up by an institutional investor initiative in partnership with UNEP Finance Initiative and the UN Global Partnership. The EESC recommends that SWF follow the lead of the Norway Pension Fund and also sign up to the PRI.

1.18. In addition, the EESC endorses the principles for ‘Responsible Investment in Private Equity’ published by the PRI Board. The principles are designed to help CIFM investing in PE to discharge their ESG stewardship responsibilities towards the portfolio companies in which they invest. The EESC would welcome the development of a similar set of Principles for HF.

2. Owners, managers and investors

2.1. Most companies in the EU Member States are privately owned by families. When families do ultimately give up control, the company may be acquired by another company (trade sale), sold to a private equity firm (buy out) or converted into a public company via an initial public offering (IPO) on a stock market. The ethos of the family owned business is generally long term, coupled with a proprietorial responsibility for stakeholders, especially the work force.

2.2. Some entrepreneurs seek private equity to support the earliest stages of company development. Seed Capital is financing provided to study, assess and develop an initial concept for a product or service. Start-Up Capital is for product development and initial marketing. The entrepreneur usually has to rely on family and friends for this speculative capital but business angels and venture capital firms may also choose to invest. Expansion Capital supports the growth of a firm. Involvement at this stage is not unusual for venture capital.

2.3. PE invests in private companies via the Buy Out. This may involve an exit for a founding family or it may involve removing a company from the stock market and taking it private. In a Management Buy-Out, the current managers are the buyers, using financial support provided by PE. In this context, private equity funds also finance workers buy outs. Replacement Capital involves the purchase of shares in an existing private company from another PE fund. This type of transaction allows the first fund to extract value in a timely fashion, most PE funds being time limited.

2.4. Mergers and acquisitions (M&A) are a major factor in corporate life. Growing companies make acquisitions which they usually fund with debt or equity. Companies are often acquired because they have valuable assets which the incumbent management is not putting to optimum use.

2.5. When companies begin to show signs of failure and distress they can be saved, but extreme action may be required, accelerating overdue industrial change and impacting the social and economic interests of shareholders, employees and other stakeholders. The outcome may involve a turnaround by new management, a rescue via acquisition, a PE buy-out or even a reorganisation following insolvency.

2.6. Most equity investment is in Public Equity — the shares of companies listed on stock markets. The internationalisation of equity markets has been hugely significant. Public equity investors influence industrial change through the stock market where they buy shares that meet expectations and sell shares that disappoint. CIFM shareholders are not hands on. They make their views known to management and can ask the board to change the management but, ultimately, they influence industrial change by their exits and entrances and by their support or otherwise for mergers and acquisitions and AIF transactions.

2.7. Investment in the equity of companies is a somewhat risky option in the spectrum of investment opportunities. Investors buy shares in the expectation that they will rise in value. While the average value of portfolios does increase over time, both the markets and individual shares tend to move up and down. CIFM trade in and out of cycles in an attempt to optimise the value of their holdings but their funds remain exposed to the vagaries of the stock market.
2.8. CIFM manage pension, insurance and mutual funds. In addition, high net worth individuals (HNWI) have substantial assets, about one third of which are incorporated in the other funds listed below. All conventional investors seek to mitigate the downside of stock market exposure. To do this they turn, inter alia, to AIFM. HNWI support has funded the tremendous expansion of HF.

2.9. Data published by International Financial Services, London, help to put the scale of these funds into perspective. Global assets under management in 2007, in US$ trillions, were estimated as follows:

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Assets (trillions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension Funds</td>
<td>28.2</td>
</tr>
<tr>
<td>Insurance funds</td>
<td>19.9</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>26.2</td>
</tr>
<tr>
<td>HNWI</td>
<td>40.0</td>
</tr>
<tr>
<td>Private Equity Funds</td>
<td>2.3</td>
</tr>
</tbody>
</table>

The relative importance of HF and PE is increased by both concentration and leverage. SWF have broadly the same goals as CIFM so they also invest in PE and HF. An absolute majority of all assets under management by HF globally now come from CIFM and a third of those assets come from pension funds.

2.10. AIFM returns have consistently outperformed conventional stock market investment. They are generally successful in executing high risk/high return strategies. For example, HF managers engage in Short Selling. The HF borrows shares in the target company. These will be obtained for a fee by a broker from an owner of the shares. The HF then sells the shares in the expectation that the price will fall. In due course the HF must repurchase the shares to return them to the owner. If the share price has fallen, the fund will profit, but this is limited to 100% of the sums involved. If the price goes up, there is no limit to the potential loss. Short selling is high risk.

2.11. HF also take positions in M&A transactions, usually buying shares in the target company and selling those of the buyer. Since there is a risk that the transaction may be blocked, HF may become activist to mitigate that risk. As well as intervening in M&A transactions, HF may also take positions in companies with a view to provoking a transaction. This is high risk.

2.12. When companies get into difficulty, CIFM sell their holdings. AIF are particularly interested in Distressed Debt, which tends to be heavily discounted. This then gives AIF the leverage to call the shots during the ensuing negotiations. A fund can often get its money back and more from a liquidation. In a reorganisation, the fund may forgive the company its debt in return for equity which can be profitable if the shares then recover. A reorganisation is good for the company’s stakeholders because it allows the business to carry on. Investment in distressed debt is clearly risky. The funds can profit because they are prepared to get involved when everyone else is leaving.

2.13. A Leveraged Buy-Out (LBO) is a high risk PE transaction. The investment fund makes an acquisition without itself providing much of the capital required for the deal. The transaction is usually funded by bank debt and junk bonds with the assets of the target company used as collateral, all based on the assumption that the cash flows of the target company will cover interest payments and loan repayments. In the present crisis, many such transactions are proving to be flawed.

2.14. This section has put the rationale for AIF into perspective. While the activities typically undertaken by AIFM and SWF are described in the following sections, the funds themselves do not necessarily stick to these categories. PE funds can operate in the HF space, and vice versa. SWF invest in both.

3. Private Equity

3.1. Private equity funds are pools of privately managed capital formed for the purpose of making investments in private companies. They are typically structured as limited partnerships. The investment focus of PE funds is on venture capital, replacement capital, distressed securities and buy-outs. A PE fund will have a seven to ten year life. It seeks to exit profitably by the time the fund closes. The life of a typical investment is three to five years, but may extend to ten. Replacement capital allows a fund to close before all its investments are mature.

3.2. Since PE has a strong bias towards the provision of seed and venture capital as well as acquiring distressed securities and financing buyouts, PE is an important agent of industrial change. The EESC has endorsed the role of venture capital in a recent opinion (5). The sharp increase in private equity fundraising between 2004 and 2007 also had a significant impact on industrial change in Europe, in particular by providing capital for leveraged buyouts, acquiring and acquisitions and the purchase of distressed securities.

3.3. Buy-outs are the main sphere of PE activity. There are many methodological problems in assessing the impact of PE buy-outs on industrial change. As WMP have pointed out, there is ‘the question of the counterfactual’. What would have happened to the company concerned in the absence of PE involvement? Where we have data on company performance, against what benchmark should it be measured? How do we account for the fact that companies taken over by PE are far from a random sample?

3.4. It is conventional to compare the impact of a PE buy-out against a peer group of companies which were not bought out. However, the valid comparison would be with a peer group of companies subject to corporate acquisition. It would be surprising if the corporate acquisition resulted in industrial change much less radical than a PE buyout, since the purpose of a corporate acquisition is always to enhance the earnings of the acquirer. Similarly, radical industrial change would also be expected in a conventional turn around, following the introduction of new management.

3.5. 2005 to 2007 was the era of the mega LBO. Banks were lending with the lightest of covenants. Historically, the debt portion of an LBO ranges between 60 % and 90 %. This leverage was applied to the balance sheets of PE portfolio companies rather than to the PE funds themselves. Thus the leverage is widely distributed and does not represent any systemic risk per se. However, IOSCO has identified the likelihood that many highly leveraged PE portfolio companies may fail, affecting lenders, purchasers of the debt and the PE partners such as pension funds. From the industrial change perspective, the biggest threat is to the stakeholders in the companies affected. As far as possible the reorganization and reconstruction of these companies should be carried out with the consent of the stakeholders.

3.6. WMP has examined the evidence relating to five aspects of the impact of PE on industrial change at the company level. They have been unable to arrive at definitive conclusions due to methodological problems and other limitations to the analysis.

3.7. In respect of firm performance, profits and value creation, the outcome is clearly positive. However, a major conclusion with regard to survey results on PE effects on average value added to target firms is that the results do not explain to what extent the value creation monitored is arising from ‘genuine’ creation processes rather than from ‘value appropriation’.

3.8. In respect of employment, the impact on staffing levels in the target firms is the most controversial issue of the current debate about PE. There are a multitude of contradictory studies from both the PE industry and the trade union perspective. A study by Harvard for the World Economic Forum, quoted by WMP, found that PE investments experienced larger job losses than the control group. However, since PE funds often take over weaker companies whose previous employment situation was probably not sustainable, restructuring and redundancies might any way have been necessary.

3.9. The Harvard study also found that PE controlled companies were prone to ‘creative destruction’ where the rate of acquisitions, sales, new plants and closures were twice as high as in other companies. In the two years following a PE takeover, 24 % of employees will have been impacted by this activity. This is not surprising where restructuring and reorganisation are involved.

3.10. In respect to the evolution of wages and working conditions, the impact of PE is again highly controversial. There is evidence on both sides of the argument, but WMP have not arrived at a definitive conclusion due to the lack of systematic data collection.

3.11. In respect of social dialogue, information and consultation at the firm level, there has been hardly any significant research. Empirical evidence shows that in some cases existing arrangements and trade union relationships are respected while in others they are not. A major issue is that relevant EU social Directives do not always apply in PE takeovers.

3.12. In respect of management practice, corporate culture and governance there is again a Harvard input. WMP conclude from it that the major impact of PE is to heighten monitoring of performance and to remove employees and plants that do not reach performance benchmarks. WMP also quote the European Trade Union Institute that PE, with its narrow focus on obtaining operating goals is neither ideological nor sentimental in its approach to such issues as collective bargaining and worker participation.

3.13. The following is a SWOT analysis of PE, annotated by the rapporteur
4. **Hedge Funds**

4.1. HF are limited partnerships. The portfolio is managed by an investment manager; other activities are delegated to the Prime Broker (PB) and the Administrator. Many funds are established in offshore financial centres such as the Cayman Islands so that the growth in the value of the funds is untaxed. Investors are taxed on their profits in their home countries. Investment managers, mostly based in the USA or London, pay taxes on their considerable fees in the countries where they are based.

4.2. An article in the Economic Review of the Sveriges Riksbank, Volume 1, 2009 (ERSV) describes the growth of the HF market from 1996 when there were 2 000 funds world wide managing assets of approximately US$ 135 billion to the end of 2007 when there were 10 000 funds managing US$ 2 000 billion.

4.3. Prime brokerage is the generic name for services offered by investment banks and securities firms without which HF could not operate. It includes global custody of the fund’s assets, securities lending for short selling, financing to provide leverage and technology services. Given the central role of PB in the HF market, many observers believe that data needed for the supervision of systemic risk would be better obtained from the limited number of PB than from each individual HF.

4.4. About twenty PB cover 90% of the global HF industry. 30-40% of global PB is based in London. HF are located 60% in the USA, 20% in London and 20% in the rest of the world. London is home to between 80 and 90% of the EU HF industry. AIF Managers in London are regulated by the UK Financial Services Authority (FSA).

4.5. HF offer absolute investment returns with relatively low volatility which are largely unrelated to whether a particular investment market is going up or down. They achieve this by hedging. They implement their strategies by the use of derivative contracts and they usually leverage their returns by borrowing additional funds to invest.

4.6. They embrace a wide variety of skills and strategies from the most prosaic to the most risky. They use a variety of strategies to take global positions on the direction of markets, currencies, commodities, interest rates, etc. These create a great deal of volume on exchanges without impacting industrial change directly. Some deploy superior research and stock picking skills to buy the best ideas and then short those they believe will perform less well. Others use computer systems to calculate the ‘fair’ value of one asset relative to another and then short the one and buy the other.

4.7. Short selling is thus integral to the operation of HF. The UK FSA said in September 2008 that short selling is a ‘legitimate investment technique in normal market conditions’. Short sellers are economic agents. They often point out an uncomfortable truth about the financial position of the companies whose shares they are selling – that they are not as valuable as people think they are. In this respect they are the financial equivalent of the boy who pointed out that the emperor had no clothes. In certain circumstances it is possible that short selling might intensify what would otherwise be just short term difficulties faced by sound companies and so, as a result, cause the company to undertake industrial restructuring. It might also aggravate stock exchange crises with systemic consequences because of the effect of the mark to market rule. The authorities imposed a ban on short selling of banks shares as the financial crisis unfolded. The imposition of a ban remains a policy option for regulators when they consider that market conditions are abnormal.
4.8. It is with Event-driven strategies that HF can and do have a major impact on industrial change. HF seek out investment opportunities surrounding corporate events. The holding period in such situations is typically one to three years. One example is to arbitrage the shares of merging companies. Sometimes the HF will become proactive and take a small speculative stake to provoke an event, as happened with ABN AMRO. Where the investment is sizeable and the fund is activist, it will inevitably lead to accelerated industrial change. While there is considerable evidence that HF investment increases the value of the target company, there is little or no research on the employment and social impacts. HF are the largest buyers of distressed securities, another event driven opportunity.

4.9. The rescue of LTCM in 1998 for the reason that it was 'too big to fail' has caused HF to be viewed as a potential systemic risk even though, in retrospect, the rescue by the Fed is considered to have been ill advised. Since then, PB have been mindful of the risks involved in their HF relationships and, in the event, it was the failure of Lehman Bros., a regulated bank, which caused the meltdown. HF were not nearly as highly leveraged as the regulated banks.

4.10. The ERSV article (op cit) examines the role that HF play in financial crises and, in particular, the idea that they act in concert to create waves. No evidence of this behaviour was found in the European Currencies crisis (1992), the Asian crisis (1997) or the IT Bubble (2002). With respect to the current crisis, it has affected the funds more than the funds have affected the crisis.

4.11. The analysis also examined whether HF constitute a greater threat to financial stability than other investors. It found that the influence of individual funds on the entire market is limited, not least because HF assets are distributed amongst 10 000 funds. It is, however, likely that they played a role in the development of the crisis, along with all of the other institutional investors.

4.12. While the impact of HF on industrial change is less marked than that of PE, there remains concern about their potential impact, not least because of the lack of transparency in their strategies, their investments and their domicile. Accordingly the EESC endorses the six high level principles detailed in the recent IOSCO report on hedge funds oversight (June 2009), which was prepared in support of the G20 initiative. The principles are:

- mandatory registration of HF managers/advisors;
- regulatory requirements covering organisational standards, conflicts of interest, disclosure and prudential regulation;
- mandatory registration, regulation and supervision of PB;
- provision by HF/PB of relevant information for systemic risk purposes;
- best practice guidance by regulators;
- international cooperation between regulators.

The advantage of an international agreement is that it discourages regulatory arbitrage.

4.13. The following is the WMP SWOT analysis for HF, annotated by the rapporteur

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Value increase of listed companies</td>
<td>— Short-term orientation</td>
</tr>
<tr>
<td>— Orientation towards efficient markets</td>
<td>— ‘Herd mentality’/‘herding’ behaviour</td>
</tr>
<tr>
<td>— Buyer of ‘last resort’</td>
<td>— Transparency of risks</td>
</tr>
<tr>
<td>— Purchase of risky assets / distressed securities</td>
<td>— Externalsities</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Threats</th>
</tr>
</thead>
<tbody>
<tr>
<td>— Liquidity in financial markets</td>
<td>— Leverage/system risks</td>
</tr>
<tr>
<td>— Overcoming market failures (in the case of active investors)</td>
<td>— not proven</td>
</tr>
<tr>
<td>— Financial innovations</td>
<td>— Manipulation of markets</td>
</tr>
<tr>
<td></td>
<td>— Absolutely not</td>
</tr>
<tr>
<td></td>
<td>— Exhaustion of financial reserves</td>
</tr>
<tr>
<td></td>
<td>More a PE concern</td>
</tr>
<tr>
<td></td>
<td>— Focus on financial engineering</td>
</tr>
<tr>
<td></td>
<td>— High risk strategy – with high reward</td>
</tr>
</tbody>
</table>
5. Sovereign Wealth Funds

5.1. An SWF is not an AIF. It is a state-owned pool of money that is invested in a portfolio of financial assets. Its primary function is to stabilise the country's economy through diversification and to generate wealth for future generations. There are now 20 major funds with an estimated total holding of over $3 trillion in assets. SWF are generally financed by either profits from commodity sales such as oil and gas in the Middle East or by current account surpluses as in the case of China. Taking a macro view of the global economy, SWF clearly fulfil two important roles. They transfer funds back to OECD economies, thus correcting global imbalances and by keeping their surpluses out of the domestic economy, they reduce the danger of domestic inflation.

5.2. According to WMP, the major SWF are:

<table>
<thead>
<tr>
<th>Country</th>
<th>Fund</th>
<th>Assets US $ billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abu Dhabi</td>
<td>Abu Dhabi Investment Authority</td>
<td>627</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>SAMA Foreign Holdings</td>
<td>431</td>
</tr>
<tr>
<td>China</td>
<td>SAFE Investment Company</td>
<td>347</td>
</tr>
<tr>
<td>Norway</td>
<td>Gov't Pension Fund Global</td>
<td>326</td>
</tr>
<tr>
<td>Singapore</td>
<td>Gov't Investment Corporation</td>
<td>248</td>
</tr>
<tr>
<td>Russia</td>
<td>National Welfare Fund</td>
<td>220</td>
</tr>
<tr>
<td>Kuwait</td>
<td>Kuwait Investment Authority</td>
<td>203</td>
</tr>
</tbody>
</table>

5.3. Their investment horizons are long and, in most cases, unleveraged. They tend to have a higher risk tolerance and to expect higher returns than traditional official reserves managed by monetary authorities. They are generally passive investors but they can be influential. For example, investments by the Norway Pension Fund are subject to an ethical screening in line with the PRI.

5.4. The rise of SWF is a manifestation of a larger shift in the structure of global finance. IMF projections indicate that the total wealth of SWF will reach $6-10 trillion within 5 years. SWF made a series of major investments in troubled financial institutions during the crisis. The emergence of these funds is a central factor in international investing and, as and when the regulatory questions are resolved, they will play a major role in shaping the global economy.

5.5. Many OECD governments have stressed the importance of monitoring and possibly regulating SWF. There is a concern that SWF investments are a threat to national security and their lack of transparency has fuelled this controversy. In turn, this provokes protectionism and economic nationalism amongst recipient countries. A further concern is the lack of accountability which could cause SWF to distort or destabilise financial markets. This concern would be alleviated by governance disclosures.

Creating a method of disclosures that is transparent, credible and reliable would decrease most of the concerns.

5.6. There is no substantive evidence that SWF make investments for political or strategic motives.

Strategic action by some developing countries appears to be taken by their state owned enterprises rather than by SWF. Gazprom’s acquisitions are a case in point, as was the abortive bid by Chinalco to take an interest in Rio Tinto. China is making a push to lock up energy reserves across the globe by offering credit to governments via its two policy banks – China Development Bank and Export-Import Bank of China.

5.7. Since 2008 there has been a twin track international initiative to regularise the relationships between the funds and OECD countries. The OECD has developed guidelines for recipient countries while the IMF has worked with the IWG to develop the Santiago principles which relate to

- the legal framework and fund objectives;
- the institutional framework and governance structure;
- the investment and risk management framework.

5.8. For SWF investment to play a full part in OECD economies, they must enhance transparency and disclosure, especially in respect of governance, strategy and investment objectives. They will need to reaffirm their commitment to the market economy which allows them the freedom to invest. Their governments need to be prepared to accept reciprocal investments from OECD economies.

5.9. At the Kuwait meeting of the IWG in April 2009 SWF set up a permanent representative forum to carry forward the work of the group. While the principles are an important step forward, more will need to be done in respect of

- recipient country relationships;
- disclosure requirements and standards;
- compliance standards, measurements and sanctions.

Without this further transparency, SWF could be a destabilising factor in the macro economy.

5.10. At the level of the company, SWF are not direct agents of industrial change although indirectly they are important investors in AIF. However, with their increasing economic power, they are becoming significant shareholders in leading companies. Accordingly, the EESC would like SWF to follow the Norway fund and sign up to the PRI.
5.11. The following is the WMP SWOT analysis for SWF, annotated by the rapporteur

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term orientation</td>
<td>Lack of autonomy of national stakeholders</td>
</tr>
<tr>
<td>Buyer of ‘last resort’</td>
<td>Lack of transparency</td>
</tr>
<tr>
<td>Increase in financial resources</td>
<td>Both issues to be addressed by Santiago principles</td>
</tr>
<tr>
<td>Strengthening the link to industrial markets</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Opportunities</th>
<th>Threats</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stakeholder orientation</td>
<td>Focus on political objectives - uncertain long-term intentions</td>
</tr>
<tr>
<td>Sound financial engineering</td>
<td>Wealth concentration outside democratic control</td>
</tr>
<tr>
<td>Entrance to new markets</td>
<td>Addressed in part by Santiago principles</td>
</tr>
<tr>
<td>Potential influence on AIF</td>
<td></td>
</tr>
</tbody>
</table>

Brussels, 5 November 2009.

The President of the European Economic and Social Committee
Mario SEPI