TRADE UNION ADVISORY COMMITTEE
TO THE ORGANISATION FOR ECONOMIC
COOPERATION AND DEVELOPMENT
COMMISSION SYNDICALE CONSULTATIVE
AUPRÈS DE L'ORGANISATION DE COOPÉRATION
ET DE DÉVELOPPEMENT ÉCONOMIQUES

OECD Investment Committee
Consultation on Sovereign Wealth Funds
13 December 2007

Comments by the TUAC

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As outlined in the paper below, TUAC makes the following recommendations to OECD governments, including members of the Investment Committee.

- ***In order to avoid double standards in the policy treatment of un-regulated investors – which also include hedge funds and private equity – the OECD should insert the policy issue of SWF within a broader discussion on international investment and regulation of financial markets.***

- ***The OECD should engage dialogue with SWFs and their home governments on the joint implementation of the OECD Guidelines for Multinational Enterprises, the OECD Guidelines on Corporate Governance of State-Owned Enterprises, as well as relevant pension governance and asset management related OECD Guidelines.***

- ***OECD governments should integrate the role of SWFs in the necessary dialogue with emerging economies on coordination of fiscal and budgetary policies to rebalance growth between world regions.***

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The TUAC welcomes the initiative by the OECD Investment Committee to engage in policy discussion on the role of sovereign wealth funds (SWFs) in the global economy. The number and the diversity of OECD subsidiary bodies that are currently working on SWF issues is indicative of the importance, and of the level of public concern within OECD countries on this issue. Besides the Investment Committee, the issue was raised at recent meetings of the Committee on Financial Markets, the Working Group on Privatisation and State-Owned Assets and the Working Party on Private Pensions.

The rapid growth of SWFs – which is attributable to the persistent trade and financial imbalances between different regions – has changed the landscape of global asset ownership. Just as hedge funds and private equity have become mainstream in the asset management industry, in a short period SWFs have moved up in the global ranking of asset owners and have surpassed long held positions by OECD-based pension funds and other institutional investors. SWFs have also diversified their investments, moving away from treasury bonds to more employment-sensitive assets, including public listed companies and more recently private equity. As with the recent boom in alternative investment assets, the un-regulated nature and the opacity of SWFs have raised public concerns within the OECD economies.

The role of SWFs in the global asset ownership structure

TUAC notes the distinction that is made by the OECD Secretariat between pension-related and non-pension related SWFs:

- SWFs *per se* are government-backed investment entities managing state revenues earned on non-renewable natural resources (such as the Gulf State SWFs) or central bank foreign exchange reserves accumulated by non-commodity exports (such as the Chinese SWFs).

- Pension Reserve Funds (PRFs) are public institutions whose objective is the long-term sustainability of national pay-as-you-go pension systems and are usually regulated under the home country pension or social security jurisdiction; an example is given by the Canada Pension Plan.

This distinction between SWFs and PRFs helps inform on the broader sustainability issues associated with state-owned investment funds, including global imbalances in trade and finance, the management of natural resources, and demographic change. It also brings to light the geopolitics of SWFs: most SWFs are located in non-OECD countries and are dependent on global trade and exchange rates; all PRFs are based within the OECD and are dependent on demographic change and ageing societies.

According to OECD estimates, total SWF pools amount to around USD 2400bn and are expected to grow rapidly in the coming years. PRF pools are estimated at USD 2200bn[1] and should begin to cash out between 2010 (in the case of Sweden) and 2025 (Canada, France) to support national pension systems. In comparison, world assets under management by occupational pension funds are estimated at USD 16000bn. Other than size, SWFs are heavily

[1] Excluding the US Social Security Fund whose investment policy is strictly limited to the non-tradable ownership of US treasury bonds.

concentrated. Unlike PRFs whose investment policies are often regulated – such as the US Social Security Fund – or whose structures are disaggregated into several independent sub-funds – such as the five Swedish AP funds – SWFs are managed centrally under a unique investment entity and have fully liberalized investment policies. By compiling recent OECD figures and other sources on pension fund asset management (see annex) TUAC has found that there are 8 non-OECD SWFs alone in the Top 20 of global asset owners.

The investment policy and accountability of SWFs

Little is known about most SWFs' investment and governance policies other than what is reported in the media. A recent research seminar organised by the OECD Working Party on Private Pensions highlighted the information gap between SWFs and PRFs with regard to the internal governance of the fund, public accountability, the composition of the portfolio and the investment policy. In fact, the exact size of the portfolio under management is a source of uncertainty for several large SWFs[2]. Yet the OECD Secretariat reports a trend among SWFs and PRFs to rapid diversification of investment portfolio toward more investment in equity, less in fix-income government bonds, and a rising share of alternatives classes such as real estate property, private equity and hedge funds.

Portfolio diversification is welcome as long as it helps SWFs focus their investments on the development needs of their home countries and regions, notably in the area of infrastructure, private sector employment creation and sustainable public services. However diversification into listed equity and alternative investment funds such as private equity augments investors' social responsibilities and transparency requirements. The expansion of SWF investments has not been met by comparable changes in their governance. The opacity in which SWFs operate is due to the very un-regulated nature of those funds. Unlike PRFs, SWFs are not subject to close financial supervision in their home country and the board of directors' fiduciary obligations and nomination procedures are rarely spelled out in regulation. In addition, in some of the home countries for large SWFs the public democratic institutions that are necessary so as to ensure appropriate public accountability of SWFs are missing.

The gap between weak governance and accountability of SWFs and their direct or indirect holdings in OECD-based companies has raised concerns in the media about SWF capacity to fulfill investor responsibilities in a way that is consistent with the long-term interest of the invested companies. As their investments in listed equity and in private equity have expanded, so too have their responsibilities as employers across the OECD. TUAC is also aware of the argument that SWFs' investment in strategic industries and national security-sensitive activities may require close governmental scrutiny. At the same time, TUAC believes that the discussion on SWFs' responsibilities as investors needs to be broadened. Given the size of their portfolio, it is assumed that most of SWF holdings are not managed internally but are externalized to asset management intermediaries. While greater attention is needed on the governance of SWFs themselves, equal consideration should be given to the regulation of financial intermediaries that channel their investments into the real economy. It would be a mistake for the OECD to focus exclusively on the non-OECD based SWFs while leaving aside the broader ramifications in the investment chains, including hedge funds and private equity firms (whose general partners are located in the key OECD financial centers).

[2] For example, portfolio estimates of Kuwait Investment Authority vary from USD 500bn to 875bn, those of the Stabilisation Fund of the Russian Federation between USD 32 and 127bn.

SWFs in a context of global trade and financial imbalances

For TUAC, central policy concerns are the relationship between SWFs and their home country macro-economic and budgetary policies and how this relationship affects both the home country's development and the global economy. Some SWFs function as *saving funds* for future generations in which inflows are determined by a fixed share of export revenues or by nominal contribution by the government. Others function as *stabilization funds* the aim of which is to smooth the impact of world prices in commodity and/or energy on government revenues. In both cases, the growth of SWFs is dependent on the current account balance, which in the case of emerging economies has been excessively positive in the past five years.

Recent OECD Secretariat papers for the Committee on Financial Markets have shown how the rise of SWFs has been fuelled by emerging countries' rapid foreign reserve accumulation and their impact on the global asset prices, as seen on commodity markets, and in the rise of private equity deals. *"Given the large size of some SWFs"* it is argued *"changes in the strategic asset allocation, such as a shift from bonds to equities, could have a significant impact on the relative prices of these two asset classes."* The role of SWF becomes crucial in the current context of depressed credit markets within the OECD following the sub-prime crisis, and the investment opportunities created by the on-going restructuring – and downsizing – of the banking sectors within the OECD zone. Since January 2007, SWFs have taken substantial shares in the capital of no less than five OECD banks of global reach[3].

For TUAC however, the macro-economic dimension of SWFs goes beyond the current impact on financial asset price stability. At the last OECD Ministerial Council in May 2007 – prior to the onset of the sub-prime crisis – TUAC raised the urgent need to rebalance growth between world regions and for trade and saving surplus emerging economies to expand their domestic demand faster – including China, Russia, and energy exporters of the Middle East, all of which rank high in terms of SWF ownership.

What OECD governments should do

In our view, the surge of SWF in global asset ownership is a direct consequence of some emerging economies' excessive emphasis on an export-oriented growth model. Undervalued foreign exchange rates and, as seen in the case of China, the suppression of workers' right to obtain low labour cost advantage are distortions to the global economy. While avoiding short-term risks of overheating the home countries' economies, the massive wealth that is accumulated in those state owned funds should be considered in a broader policy discussion between OECD governments and key emerging economies so as to achieve more redistributive domestic demand-oriented and poverty alleviation policies

- ***OECD governments should integrate the role of SWFs in the necessary dialogue with emerging economies on coordination of fiscal and budgetary policies to rebalance growth between world regions.***

[3] Citigroup, UBS, Barclays, Standard Chartered and Fortis.

Several OECD governments have taken steps to protect strategic industries from the governance and accountability uncertainties created by SWFs. For TUAC these initiatives should be judged upon societal goals such as promoting quality and security of employment, access to technology and to knowledge at home, promoting industrial policies and territorial development. Beyond that, and as noted in the OECD Secretariat background papers, there is little space for OECD governments to single out SWFs in regulation given the commitments under the OECD Investment Declaration and various regional and bilateral investment treaties.

On the other hand, many of the corporate governance and market integrity issues raised by SWFs are common to other un-regulated investment classes, including hedge funds and private equity. These should not be treated separately. As noted in the Investment Committee background papers, some countries such as Germany and the Netherlands have taken steps in 2007 to curb short-termist shareholder activism by lowering the threshold of share ownership above which compulsory disclosure of holdings is required. Much more could be done to align regulation with the emergence of new alternative investment funds and to prevent the regulatory gaps and loopholes of benefit to private equity and hedge funds that appear to be favoured by SWFs. On November 12, the TUAC organised a seminar on the regulation of private equity and recent regulatory initiatives which main findings are reproduced in annex and may inform on the discussions on SWF investment policy.

- ***In order to avoid double standards in the policy treatment of un-regulated investors – which also include hedge funds and private equity – the OECD should insert the policy issue of SWF within a broader discussion on international investment and regulation of financial markets.***

The OECD should further engage policy dialogue on best practices on corporate governance and responsible business conduct among state-owned and state-backed financial institutions. In the above comparison between SWFs and PRFs, the former could take aim at the latter group's recognized commitment to responsible investment. PRFs such as the Norwegian *Government Pension Fund – Global*, the French *Fonds de réserve des retraites*, and the Swedish *AP Funds* have all active socially responsible investment policies which cover part or the totality of their investment mandates. Scandinavian PRFs in particular have engagement policies with the management of invested companies with regards to compliance with ILO core labour standards and international human rights. Some Swedish AP funds apply negative screening[4]. Just recently, the Swedish government announced that all state-owned enterprises would produce sustainability reporting.

The OECD has the instruments and the expertise to facilitate that dialogue. The OECD Guidelines for Multinational Enterprises, which have been endorsed by several PRFs, provide for the adequate framework for dialogue with SWFs on responsible business conduct. Similarly the OECD Guidelines on Corporate Governance of State-Owned Enterprises (the SOE Guidelines) address most of the governance and transparency concerns that have been

[4] For example in 2006 AP2 excluded Wal Mart of its portfolio for discrimination against women in Guatemala and anti-union action and labour legislation violations in the United States. AP1 had "targeted ethical engagement" with that company as well as with BHP Billiton (Anti-union action in Australia), Chevron Texaco (Human rights violations in Nigeria), L-3 Com (Human rights violations in Iraq), Marathon Oil (Corruption in Equatorial Guinea), Total (Human rights violations in Burma), Thales (Corruption in South Africa), Toyota (Anti-union action in the Philippines) and Yahoo! (Actions curbing freedom of expression in China).

raised with regard to SWFs. In addition the SOE Guidelines enhance societal responsibilities of state-owned enterprises, requiring SOEs' codes of ethics to "*include a commitment to comply with the OECD Guidelines for Multinational Enterprises*"[5]. Some elements of the OECD Guidelines on Pension Fund Governance and Guidelines on Pension Fund Asset Management could also provide helpful guidance on SWF transparency and accountability.

- ***The OECD should engage dialogue with SWFs and their home governments on the joint implementation of the OECD Guidelines for Multinational Enterprises, the OECD Guidelines on Corporate Governance of State-Owned Enterprises, as well as relevant pension governance and asset management related OECD Guidelines.***

Source

- OECD Investment Committee: Sovereign Wealth Funds and the International Investment landscape (DAF/INV/WD(2007)15/ADD1)
- OECD Committee on Financial Markets: Sovereign Wealth and Pension Fund issues, DAF/CMF(2007)16/PART1
- OECD Working Party on Private Pensions: Pension Markets in Focus, November 2007, Issue 4
- OECD Working Party on Private Pensions: The Governance of Sovereign and Pension Reserve Funds, OECD Secretariat room document, December 2007.
- IPE.com and Pensionfundsonline.com

[5] Guideline IV.C in particular specifies that "*The board of SOEs should be required to develop […] codes of ethics [...] in conformity with international commitments and apply to the company and its subsidiaries.*" In its annotations, the Guideline acknowledge the specific corporate social responsibilities that fall on SOEs as a result of their "*important role in setting the business tone of the country*" and their exposure to undue political influence.

Annex 1 : Indicative ranking of top 20 Global asset owners

(excluding the US Social Security Trust Fund)

Based on OECD sources, IPE.com and Pensionfundsonline.com

Largest asset-owners	top 100	top 20
Sovereign Wealth Funds (SWF)	**16**	**8**
Of which OECD based	*2*	*0*
Of which non-OECD	*14*	*8*
Pension Reserve Funds (PRF)	**10**	**4**
Of which OECD	*8*	*4*
Of which non-OECD	*2*	*0*
Occupational Pension Funds (PF)	**71**	**8**
Of which OECD	*67*	*8*
Of which non-OECD	*4*	*0*
Other institutions	**3**	**0**

	Country	Membership	Name	AUM* (US$bn.)	status
1	**Japan**	**OECD**	National reserve Funds	1 217	PRF
2	**UA Emirates**	**non-OECD**	Abu Dhabi Investment Authority	688	**SWF**
3	**Norway**	**OECD**	Government Pension Fund – Global	278	PRF
4	**Netherlands**	**OECD**	ABP	271	PF
5	**Saudi Arabia**	**non-OECD**	Saudi Arabian Monetary Authority	225	**SWF**
6	**United States**	**OECD**	California Public Employees' Retirement Systems	224	PF
7	**Singapore**	**non-OECD**	Government of Singapore Investment Corporation	215	**SWF**
8	**Kuwait**	**non-OECD**	Kuwait Investment Authority	200	**SWF**
9	**China**	**non-OECD**	China Investment Corporation	200	**SWF**
10	**Korea**	**OECD**	National Pension Fund	191	PRF
11	**United States**	**OECD**	Federal Retirement Thrift Investment Board	181	PF
12	**Kuwait**	**non-OECD**	Future Generations Fund	174	**SWF**
13	**United States**	**OECD**	New York State Common Retirement Fund	146	PF
14	**United States**	**OECD**	California State Teachers Retirement System	140	PF
15	**Russia**	**non-OECD**	Stabilisation Fund of the Russian Federation	122	**SWF**
16	**United States**	**OECD**	Florida State Board of Administration	122	PF
17	**Netherlands**	**OECD**	PGGM	122	PF
18	**Sweden**	**OECD**	National Pension Funds AP-AP4&AP6	117	PRF
19	**United States**	**OECD**	New York City Employees Retirement Systems	109	PF
20	**Singapore**	**non-OECD**	Temasek Holdings	108	**SWF**

<u>Annex 2 : Outcome of the TUAC meeting on private equity, 12 November 2007</u>

Joint OECD – TUAC Labour Management Programme Meeting "Financialisation of the economy: regulating private equity"

Paris, 12 November 2007
9.30 – 17.00
Room G, OECD Headquarters,
2 rue André-Pascal, Paris 16

Summary report by the TUAC Secretariat

The TUAC meeting on "Financialisation of the Economy: Regulating Private Equity" on 12 November 2007 gathered over 50 participants from TUAC affiliates, European Trade Union Confederation and its research institute the ETUI, Global Union Federations and the International Trade Union Confederation. The meeting was chaired by Ron Blackwell, Chief economist of the AFL-CIO, and chair of the TUAC Working Group on Economic Policy, and followed a previous TUAC meeting on private equity (PE) organised for Global Unions in March 2007. The objective was to take stock of regulatory and parliamentary initiatives that had taken place across the OECD since the March meeting. The open session in the morning included participation of a senior advisor to the US House Committee on Financial Services and representatives of the OECD Secretariat Directorate for Financial and Enterprise Affairs.

Overview

The review of recent parliamentary initiatives on PE prepared by the TUAC Secretariat for the meeting (PAC/AFF/LMP(2007)5) shows a high degree of parliamentary activism across the OECD in the past six months. Parliamentary discussions covered most, and in some cases all of the four key PE policy areas that were identified in March:

- <u>Labour issues and public interest</u> (information & consultation of workers, impact on employment and social equity, impact on public services);
- <u>Financial sustainability of the LBO financing</u> (impact on the portfolio company, spill-over effects, protection of creditors, responsibility of institutional investors);
- <u>Taxation</u> (tax treatment of PE general managers' carried interests, of deductibility of debt, of PE firms and offshore transactions);
- <u>Corporate governance</u> (worker participation, transparency of the portfolio company, Prevention of conflict of interests in buy-out transactions and in PE fund management).

The TUAC parliamentary review shows that PE is a cross-cutting 'horizontal' issue and it was argued that it should be treated as such by the OECD. The PE Industry benefits from numerous regulatory exemptions and gaps in each of these four policy areas that are not, or would need to be justified in the public debates. Further to a letter of John Sweeney President of the TUAC and the AFL-CIO to the OECD General Secretary in August 2007, the TUAC will continue advocating for the OECD to adopt a horizontal approach to PE. In 2008 the TUAC Secretariat will monitor OECD work on PE and other alternative investment funds.

Key issues

The following specific conclusions emerged from the meeting discussions.

- Financialisation: the rapid transformation of the private equity industry over the past five years from a niche to a mainstream business should be considered in the broader context of financialisation of the economy. Private equity is only one aspect of the phenomenal growth of financial products, transactions, and institutions in the past years. This has not been matched by comparable changes in national regulations and international cooperation, and has left the real economy and its workers facing increasing pressure because of financial short termism. Large regulatory gaps and loopholes have appeared and have of benefit to the growth and success of PE managers and to un-regulated markets such as the derivative credit markets. There is further evidence that financialisation is a cause of the observed rise in income inequalities and the decreasing share of wages in national income across the OECD in the past two decades.

- Workers' rights: traditional collective bargaining does not function properly under PE regime because decision making centres are rarely located at the level of portfolio companies. Current European legislations on workers' rights to information and consultation prior to a takeover – such as the European Acquired Rights Directive – are not adapted to the PE model. However, when local unions are powerful enough to influence the takeover bid process PE takeovers can create opportunities for extensive unionisation of the target companies. (Workers' rights to information, consultation and representation were further discussed at an ETUI meeting on corporate governance hosted by the TUAC the day following the meeting on 13 November.)

- Transparency and corporate governance: There remain serious problems of data and information availability on the Industry. The suggestion that is made in some OECD countries that this problem could be solved by self-declaratory initiatives, such as in the UK, misses the point about the un-regulated nature of PE. Voluntary codes of conduct cannot substitute to regulation-backed disclosure requirements. In some countries, corporate governance regimes, including the duties of directors, need to be reviewed to take account of the transformation of the PE model into viable and credible alternative to stock exchange listing.

- Systemic financial risks: the PE Industry and its portfolio companies are particularly exposed to the fallouts of the current sub-prime financial crisis, as the LBO financing model has strong similarities with the credit derivative markets. Like the sub-prime market, it is widely assumed that investors and creditors that invest in LBO transactions do not understand what they are buying, cannot measure appropriately their risk exposure to PE, and accordingly are adopting excessive risk appetite behaviour. Central banks and other national and international supervisory authorities have also failed to prevent or to foresee the crisis that was looming. Investor risk management and private equity asset pricing are major complications for supervisory authorities.

- Regulatory and tax arbitrage: A main attraction of PE lies in its widespread use of offshore entities and transactions. A majority of PE firms and funds are located in offshore centres to avoid tax and/or transparency requirements that apply under the jurisdictions of the portfolio companies. The importance of the regulatory and tax arbitrage in PE are major obstacles to advancing discussions on strengthening PE regulation. These are invariably confronted with the perceived threat of capital and foreign investment flight overseas. The Danish tax reform that was introduced in June to limit deductibility of debt from the corporate income tax base of the portfolio company – a key aspect of LBO financing – is particularly instructive on the ways governments can resolve tax arbitrage. However tax treatment of PE should be considered carefully so as to avoid un-intended consequences on corporate financing of the economy at large.

- Public services and spill over effects: there are serious concerns with the impact of PE in sectors that ensure public service deliveries, and on corporate behaviour of listed non-PE companies. The case of PE investments in the nursing home industry in the US is emblematic in this regard. The LBO financing requirements have pushed PE-owned nursing companies to implement short-termist cost cutting programmes which resulted in a fall in the quality of nursing care services in the US. PE-owned nursing companies influence the standards for the industry that have pushed non-PE nursing companies to adopt similar short-termist management behaviour.

- Views of the OECD corporate and financial affairs divisions: for the OECD Secretariat, private equity does not necessitate new legislation but should require particular attention on enforcement and implementation of laws. Specific problems may arise in PE takeover bids, such as market abuse and conflicts of interest, and in market reporting and disclosure. Private equity is nevertheless a powerful means to strengthen capital market efficiencies and enhance the availability of risk capital in the economy.