The Treasury

New Zealand Superannuation and Retirement Income Act 2001: Amendment to Section 59 Information Release

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NZ SUPER FUND: CONTROLLING INTEREST IN ENTITIES

First principles policy review of section 59 of the New Zealand Superannuation and Retirement Income Act – July 2021

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1. Purpose of the review: Objectives and Approach

The objective of this review is to undertake a targeted, first principles review of section 59 of the New Zealand Superannuation and Retirement Income Act 2001 (the Act). The intention is to determine if the restriction on the New Zealand Super Fund (NZSF) taking a controlling interest in other entities, that was put in place at the formation the Act in 2001, remains appropriate.

The review builds from the 2011 review of section 59, which brought about section 59A of the Act – the ability to invest in Fund Investment Vehicles. While this report should be seen as a stand-alone product, a deep study of its findings would benefit from also reading the 2011 review.

Our approach has primarily been a desktop review. We have undertaken targeted consultation with the Guardians of New Zealand Superannuation (Guardians), the Accident Compensation Corporation (ACC) and the Infrastructure Commission. However, we have not engaged external stakeholders as there is not yet a statement of Government policy. We are seeking an in-principle decision from Ministers and this advice could be subject to further validation and consultation if the rationale for change is accepted, for example with the New Zealand business community.

Recommendations of this review should ensure the legislation is appropriate now and provide assurance that these settings would be appropriate into the future. With this in mind we have considered:

- Investment opportunities for the NZSF and impact on performance
- The benefits or risks to the New Zealand economy and individual businesses/sectors
- Trends amongst other sovereign wealth funds and benefits they gain from control
- Operational risk and complexity stemming from a potential change
- Benefits and risks to Government

2. Executive summary

The NZSF is currently prohibited from taking controlling interest in companies. Part of the rationale for this was appropriate for the maturity of the fund and the relatively small exposure to Direct Investments within global practice of investment management in 2001.

The Guardians' governance has evolved in line with the NZSF's investment capability to provide effective oversight of complex investment strategies. This governance capability has been validated by the most recent independent review of the Guardians.[1]

Direct investment[2] is a much more common feature of best practice portfolio management than in 2001, or the more recent review of section 59 in 2011. The proportion of fund allocation to

[1] Review of the Guardians of New Zealand Superannuation – July 2019 – prepared by Willis Towers Watson

[2] The reference to Direct Investment in this paper refers to internal capability to invest in private unlisted assets. The term can also have a broader meaning, for example can include investment in listed assets of via managers. The relaxation of the control restriction may enable control deals more broadly.

direct investments may continue to grow into the future and is particularly important for the NZSF to capture domestic investment opportunities, including infrastructure investments.[3]

The expansion of direct investments generally contradicts a third rationale for restricting control of entities. It is no longer meaningful that 'if the Government wished to own a business it would make this choice with a specific policy intention in mind'. Direct investments are a common method to get exposure to unlisted assets and would not significantly expand the Guardians' operating model to move from minority to majority shareholdings.

The final policy rationale for restricting controlling interests is related to avoiding certain obligations through ownership. [36]

The reality is the Guardians' strong governance oversight is likely to be a positive impact that reduces the probability of these issues occurring in the first instance, but the risk of poor public perception and/or political pressure to undertake specific investments remains.

This perception risk sets a tension where we believe it is desirable for the Guardians to have the flexibility of taking a controlling interest in businesses, but governance settings should be for prudent use of this tool. The expansion to the Guardians' toolkit can offer commercial and strategic benefits, both for the NZSF, on a transactional basis, and the New Zealand economy, for market depth of capital and diversification of risk appetite.

We considered a range of implementation options that could enforce prudent use of taking a controlling interest in entities. However, we favour a relatively light touch legislative option to ensure the investment independence of the Board is maintained. Our recommendation is to remove the section 59 control restriction and include a new section 61 investment 'standard, policy or procedure'. This will then require the Board to monitor the policy over time and Ministers can receive assurance on the utilisation of the policy relative to global best practice through the one in five year independent reviews of the Guardians.

3. Recommendations and next steps

We recommend that:

- Ministers provide an in-principle agreement to the relaxation of the Section 59 control restriction of the New Zealand Superannuation and Retirement Income Act 2001 (the Act).
- Subject to further investigation on how this would be implemented, a new 'standard, policy and procedure' could be added to section 61 of the Act, for the Guardians Board to determine the prudent and commercial use of controlling interests.
- This policy would monitor the prudent use of where the New Zealand Super Fund (NZSF) is able to take a controlling interest in entities.
- Section 59A, providing the NZSF with the ability to invest in Fund Investment Vehicles, would not be amended.

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[3] The Guardians letter of expectations has communicated Ministers' desire for the NZSF to consider infrastructure since 2018.

- Subject to Ministers' risk appetite for this change, and the pace of implementation, these findings are validated by an external consultation. This could happen at the same time as a Bill is prepared for the House.

It is assumed that any change to legislation would take a minimum of six months and is dependent on the capacity of the House of Representatives to allocate time to receive this Bill.

The Act also sets out the expectation that the Labour and National parties would consult each other (as well as the Guardians) on any proposed changes to Part 2 of the Act.[4] The findings of this consultation, or informing that a consultation did not take place would be presented in a statement upon introduction of the Bill.

[4] Section 73 of the New Zealand Superannuation and Retirement Income Act 2001.

4. The Case for Change

On balance the opportunities outweigh the risks in justifying the relaxation of the section 59 control restriction. The starting point for assessing key issues is the assessment framework used in the 2011 review. A key part of the framework is an assessment of the likely effect removing section 59 may have on the long-term risk adjusted commercial returns of the NZSF.

An ability to take controlling interests may create a larger opportunity set, enable better investment management and optimise commercial returns. It may also bring about secondary benefits such as domestic investment and economic development. The ability to capitalise on these benefits is dependent on the Guardians' internal investment capability and ability to manage risks.

4.1 Control and a case for optimising commercial returns

Sovereign Wealth Funds (SWFs) are increasingly seeking more direct exposure to private markets.[5] SWFs diversify their holdings in pursuit of a better risk-return profile.[6] To do this they may pursue higher rates of returns by targeting alternative assets such as private equity, and looking towards longer-term objectives particularly in firms they hold direct investments in.

Moreover, SWFs are better placed to capture illiquidity premia due to their longer investment horizons (and in some cases, long-dated or non-existent liabilities).[7]

SWFs entry into the private equity markets is also a function of the perception that there may be significant excess return premia available over the more price efficient public markets. However, there is an alternative view that the diversification benefits may be overstated (and risk may be understated) given that valuations of private markets investments are not mark-to-market.

The Guardians already employs a direct investment strategy for the NZSF. Therefore, we are only assessing whether it is in the public interest that this strategy expands to taking a controlling interest of those assets from time to time.

There appears to be limited (no) quantifiable market-based evidence of the sub-optimal performance impact from the section 59 type restriction. In the absence of empirical evidence, the impact of performance can only be assessed qualitatively.

Some dependencies linked to the Guardians' ability to secure commercial returns include[8]:

- whether the fund has the required resources and organisational structure to be successful in private markets
- monitoring of performance and allocation of risk to direct investments relative to the benchmark asset allocation
- the diversification of risk appetite between the NZSF and other market investors
- idiosyncratic transaction risks due to public knowledge of restrictions on the NZSF to remain within certain limits (including the control restriction)

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[5] http://www.bernardobortolotti.com/wp-content/uploads/2019/08/Sovereign-Wealth-Funds-Approach_LOWRES_V11.pdf

[6] HARRIS, R., JENKINSON, T., & KAPLAN, S. (2014). Private Equity Performance: What Do We Know? *The Journal of Finance, 69*(5), 1851-1882. Retrieved June 22, 2021, from http://www.jstor.org/stable/43612946.

[7] https://www.ifswf.org/what-prompted-members-move-private-markets-investments

[8] https://www.ifswf.org/what-prompted-members-move-private-markets-investments

- the degree to which these limits restrict the ability for the NZSF to respond to emerging opportunities, and
- the degree of opacity in private markets.

A further non-quantifiable risk is the degree to which political or reputation risk would play a role in the GNZS making sub-optimal commercial decisions for the NZSF. Current legislative settings create a high degree of investment independence for the GNZS so we consider this risk to be relatively low.

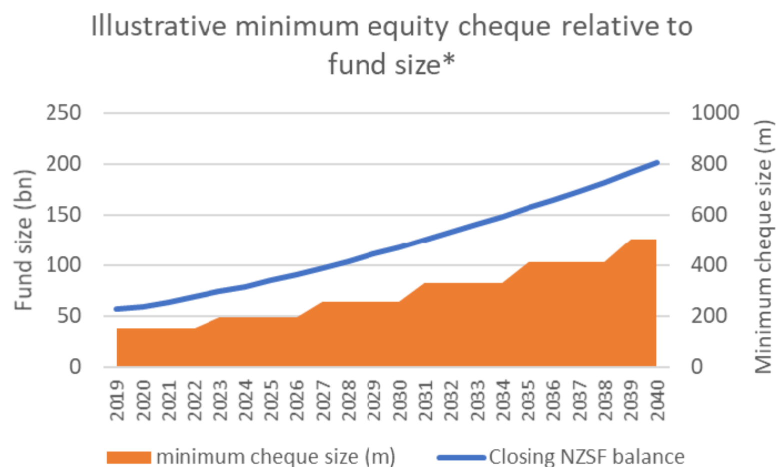
4.2 Control and a case for a larger opportunity set

The potential for a larger addressable market and opportunity set is a key driver for the GNZS advocating for change. The GNZS value proposition to investment partners leverages the NZSF's endowments. Specifically, the NZSF's long-term investment horizon, ability to tolerate a liquidity crunch and its sovereign status.

In current settings the Guardians must seek out investment partners that share similar characteristics, such as Environmental, Social and Governance (ESG) values. The ability to find partners that can invest alongside a minimum ticket size of $200m to $300m has become challenging. This minimum investment size will grow as the NZSF continues to grow, presenting an increasing challenge into the future.

The minimum capital allocation is a self-imposed restriction which effectively caps the maximum number of investee companies, allowing for a focused operating model to mitigate monitoring risk. Under the control restriction, a minimum deal size of $400m will be required for the Fund to participate.[9] This doubles the number of deals precluded, with 75% of the New Zealand deals falling under this size limit.

The graph below shows that overtime, the minimum transaction size rises, relative to the growth of the total fund. This means the potential addressable market/opportunity set in New Zealand declines as the size of the fund grows at a rate faster than the economy.



* Graph assumes constant ratio of minimum cheque size to fund size, adjusted every 5 years.

Finding the right co-investment/partner and opportunities that are big enough to have a material impact on fund performance can be a challenge, particularly in the domestic market. Without

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[25]

any change to the control restriction, this would eventually drive the Guardians to look for direct investment opportunities overseas.

The removal of the control restriction would provide access to a wider group of viable investment partners in New Zealand, enabling more of a principle/minority investor partnership. This could attract institutional investors who are comfortable with the Guardians due diligence practices, deepening capital markets for domestic transactions.

4.3 Control and better investment management

The control restriction adds structural complexity to ownership structures relating to direct investment activities. These limits create transaction complexity and potentially impact the Guardians' ability to respond to investments due to value or liquidity choices where the greatest opportunity to add value exists.

The limitations around managing investments materialises as:

- an inability to avoid or capture a control premium on purchase or exit from the transaction
- narrower choices around exit strategy – must always find a purchaser for a minority holding
- an inability to provide additional capital to support investee companies when they need it most i.e. are in distress
- limitations for influence over key board/shareholder decisions. This include less ability to influence management of ESG issues and deployment of capital over the long-term in like with sustainable finance principles.

'Control' here is not an economic concept. It is possible for the NZSF to expose the Crown to up to 100% of the economic risks associated with an investment without breaching the control threshold. As section 59 online applies to entities NZSF has always been able to hold controlling interest in assets. For example, the Guardians can currently own 100% of certain asset classes i.e. property, forestry and agriculture.[10]

The concept of a control premia is reasonably well established that there is additional value to being able to directly influence decisions. However, it is hard to quantify how removing the control restriction would add to performance.

Majority ownership brings a greater ability to influence the company in terms of risk prevention, the application of sustainable finance principles and how issues are managed when they arise, for example, commercial risks or reputation through responsible investment issues. Despite recent media attention relating to investments in companies linked to alleged human rights violations in the global listed equity portfolio, the NZSF has a reputation for being world leading in ESG integration.

Reputational risks stemming from ESG issues may increase with a controlling interest, but it also provides greater ability to influence. The NZSF is exposed to ESG or business performance risk regardless of size of the investment.

We agree that there is as case for change as under current settings there are constraints around investment management which results in loss of opportunity. A relaxation of section 59 should enable value-add through majority ownership with limited assumed risk.

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4.4 Control for domestic investment and development

There is a potential confluence of interest for the Government and the NZSF where direct investments are focused on the New Zealand economy. The Guardians see New Zealand as a market where it has a competitive advantage. Ministers from both of New Zealand's major political parties have signalled a preference that the NZSF plays a role in domestic economic development by considering ways to increase the allocation to domestic investment.

4.4.1 Ministerial direction

A 2009 Ministerial direction encourages the Guardians to increase allocation of New Zealand assets. We see a continuation of this through the Minister of Finance's most recent 'Letter of Expectations' to the CFIs encouraging them to familiarise themselves with government priorities and consider the confluence of interest in areas of social, sustainable and/or infrastructure investment where this is consistent with the long term investment objectives of the NZSF.

The Guardians have signalled a preference for a domestic focus for direct investment as they believe it to be a long-term source of investment returns and source of competitive advantage for them. Direct investment is seen a key vehicle for delivering on the 2009 Ministerial directive to consider ways of increasing the allocation to New Zealand investment.

Globally there is also an increasing trend of SWFs investing in domestic markets, to promote domestic economic development.[11] However, the purposes and settings of SWFs can be quite varied and it is important to ensure that the primary purpose of the NZSF (to return value to New Zealanders to offset intergenerational/demographic cost pressures) is kept out of scope for this review, (see *'annex: Global Sovereign Wealth Funds'* for additional detail.

The much bigger policy question around purpose and mandate has not been addressed in this report. For now, we consider investment independence of the Board to be a critical success factor for a fund that has a profit maximisation purpose.

4.4.2 Infrastructure investment

Infrastructure is a space the Guardians has targeted due to its potential to offer significant scale and returns that match the NZSF's long-term return profile. The ease of transaction in this sector is greatly simplified if the control restriction were to be removed – i.e. partnerships can be structured appropriate to the nature of the investment and can be adapted pre- or post-procurement to enable more responsive engagement approaches.

Infrastructure is an attractive investment category for NZSF because of its consistent, competitive returns and yields. It also has the potential to deliver the scale required for active investments to be meaningful. Globally, there has been an increasing trend in direct investment in infrastructure by SWFs.[12]

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[11] *Committing to long-term trends*, International Forum of Sovereign Wealth Funds, https://ifswfreview.org/long-term-trends.html

[12] *The Covid-19 Response*, International Forum of Sovereign Wealth Funds, https://ifswfreview.org/covid-response.html

From the Government's perspective, deepening the market to engage in large-scale or strategic infrastructure projects can have multiple benefits. [13] These include attracting international infrastructure partners through the Guardians global outreach and bringing about downward pressure on pricing through increased competition. We don't expect the local capacity constraints for skilled labour to come about, however, as delivery partners would still require a primarily local workforce to subcontract to.

One potential disadvantage of the Guardians bidding for the Crown's significant infrastructure projects is that risk is not transferred outside of the total Crown balance sheet. However, the risk is transferred to a more flexible part of the balance sheet and the expectation is the Guardians would be sophisticated enough to price this risk effectively over time.

Globally, infrastructure investments are not uncommon in SWF portfolios and have shown a strong increase over the last decade.[14] Investments in domestic infrastructure are still limited among most funds, including those in advanced economies. This is because many SWFs have not matured to have strong asset management teams, are distanced geographically from their investments, or struggle with complex investor structures.[15] The most common reason for outsourcing domestic infrastructure investments is the cost of building a dedicated team for a specific market.

4.5 Control and global peer funds

SWFs are a heterogeneous group of institutional investors and are not directly comparable. There is no consistent regulatory approach relating to mandate and/or limits for SWFs.

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[13] Joel MacManus, Major report reveals $75 billion infrastructure deficit, warms of recession risk, September 2020, https://www.stuff.co.nz/national/122771520/major-report-reveals-75-billion-infrastructure-deficit-warns-of-recession-risks

[14] *Sovereign Investors 2020 – A growing force*, PwC, https://www.pwc.com/gx/en/industries/sovereign-wealth-investment-funds/publications/sovereign-investors-2020.html

[15] *Sovereign Investors 2020 – A growing force*, PwC, https://www.pwc.com/gx/en/sovereign-wealth-investment-funds/publications/assets/sovereign-investors-2020.pdf, page 31

However, the Santiago Principles provide global best practice guidelines to achieve good governance, transparency and accountability, while allowing room to reconcile the diverging mandates and regulatory traditions of their signatories. The latest publicly available compliance review of SWF compliance to the Santiago Principles had the NZSF ranked number two – with 92% compliance.[16] See *annex A: Global Sovereign Wealth Funds'* for more detail on the Santiago Principles.

While it is not common for SWFs to have legislated control restrictions, we do not see that holding a controlling stake as the predominant approach to gaining direct investment exposure. As the Guardians have framed it, the option to take a controlling stake in entities is an additional 'tool in the toolbox', rather than the target investment state.

Fund maturity, investment capability and effective management of reputational risk are some critical success factors for SWF controlling investments.

4.5.1 Fund maturity

Since the last review in 2011 the NZSF has grown from $19 billion to $58 billion. This has had a material impact on its investment strategy, which has evolved to include a greater proportion of direct and unlisted investments.

The Guardians access Fund investments in different ways and seeks flexibility accordingly. It contemplates that external managers will be preferred over a direct access point when it is more efficient and offers greater probability of value add (e.g. due to geography, breadth, skills, market knowledge and access).[17] Overtime, as the value of the premia for direct investments to passive equity exposure fluctuates, the Guardians may want optionality to move between markets.

Typically, when a SWF is created in its early stages, third-party fund managers will be used with a high proportion of assets being held in equity and fixed-income securities traded on recognized and liquid public markets. As SWFs mature and develop their internal expertise, more capital is often gradually managed in-house, and exposure to other more complex alternative asset classes is sought, again using third-party fund managers. The final stage of development is often to make direct investments, often initially as sizeable minority positions in publicly quoted companies, then as co-investors in private investments, typically alongside an alternative investment manager, and ultimately as a lead investor.[18]

The maturity here refers to capability, operating model and size. The evolution of NZSF to this highly mature phase aligns with the notion that as the Fund grows and matures it is now seeking more scalable direct investments where its in-house capability can capture a competitive advantage.

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[16] *The Santiago Compliance Index 2013*, GEOECONOMICA, January 2014, https://www.nzsuperfund.nz/assets/documents-sys/Santiago-Compliance-Index-2013-public.pdf

[17] *'Briefing paper – prohibition on control (S59) impact and recent developments'*, 2 September 2020, GUARDIANS

[18] Malan Rietveld and Perrine Toledano, *The New Frontiers of Sovereign Investment*, Columbia University Press, 2017, chapter 4

Key success factors for NZSF to date, have been a singular purpose, commercial independence and separation of power. This review considers the impact of removing/amending the control restriction within the current mandate of NZSF – to invest on a prudent and commercial basis.

4.5.2 Internal capability

There is an accelerating trend to "insource" direct investments to drive higher net of fee returns and encourage a greater alignment of interests between asset owner and third-party managers.[19] Yet, sovereign investors often lack the capacity to manage all strategies in-house. The priority is on maintaining control and alignment around investment decisions, as well as lowering cost.

We note that the Guardians has stated that lower cost is not the key motivation for wanting to take controlling interest, rather it is to remove limits that restrict the ability to respond quickly to emerging opportunities, extract additional value through purchase/exit strategies and a desire to invest more in New Zealand.

We have received assurance that the operating model is not expected to expand, although there is an acknowledgement that capacity could be squeezed in economic uncertainty as multiple businesses may require the Guardians to 'lean in' to resolve issues at the same time. This is likely to be the case for any significant shareholding but the option to move to a controlling stake adds a tool for negotiation where liquidity of businesses is not able to be resolved through primary financial institutions.

This trend towards internalisation appears to have stabilised for several funds, due to the complexity of building internal capabilities. Mid-sized sovereign wealth funds use a combination of external managers and internal oversight.[20] Integrated solutions that aim to build expertise in niche sectors, while selectively outsourcing, can pose discrete organisational and governance risks which should be carefully assessed in advance of implementing in-sourcing strategies.[21]

The Guardians has established a direct investment team to give it the capability to invest in unlisted markets, which is relatively uncommon compared to many SWFs. While this comes at an operating expense, the long-term benefit would be in the accelerated development of in-house capability with sector specialisation to capture a higher proportion of investment returns.

The question over strategy, performance and capability is best managed at the Board level, rather than via legislation. We do consider it important that there is sufficient scrutiny over these strategies and Government is made comfortable that the Board has assessed the appropriateness of management actions on a regular basis.

The Guardians are required by legislation to undergo an independent review every five years to provide the government assurance on how effectively and efficiently it is performing its function.

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[19] *Beyond the Market: Reframing Risk in a Dynamic New World*, International Forum of Sovereign Wealth Funds, https://www.ifswf.org/general-news/beyond-market-reframing-risk-dynamic-new-world

[20] *Internal vs External Management: A False Dichotomy*, International Forum of Sovereign Wealth Funds, https://www.ifswf.org/publication/internal-vs-external-management-false-dichotomy

[21] *Beyond the Market: Reframing Risk in a Dynamic New World*, International Forum of Sovereign Wealth Funds, https://www.ifswf.org/general-news/beyond-market-reframing-risk-dynamic-new-world

The latest independent review of the NZSF prepared by Willis Towers Watson noted that the Fund was operating at a global best practice level. The review also noted that[22]:

- The governance model was strong with the Board and management operating at global best-practice levels.
- The investment model was impressive including the approach to risk budgeting, the integrated portfolio construction approach, management of liquidity risk and ability to react dynamically to opportunities.
- The investment model will face some challenges given that peer funds are increasingly competing for the same opportunities, making attractive new investments harder to find.

4.5.3 Management of reputational risk

While reputational risks are a feature of direct investing generally, the magnitude of that risk is increased where control positions are taken. Having control involves greater influence over outcomes and, accordingly, more perceived responsibility for operational matters within the underlying investee.

Even for funds that can take controlling interest, a common reason for not utilising this option is the effort needed to manage reputational risk. For example, [26] has no control restriction yet its threshold for taking controlling interest is high. Its position is due to:

> *'the expectations placed on* [26] *potential reputational implications, time and attention commitments from the relevant teams and the broader organisation are of a different order of magnitude, whether during execution or post-acquisition, in control deals. In particular, the relevant deal team is required to address specific considerations when seeking investment approval e.g. long-term strategic rationale for the deal, reputational risk arising from* [26] *being a controlling shareholder including political, policy, regulatory, financial, operational, people-related and ESG-related risks and specific mitigation plan (if relevant).*[23]

We see a similar approach in New Zealand, as the minimum ticket size targeted by the NZSF ensures that the direct investment opportunities pursued are material enough to justify the effort and risk exposure.

5.6 Conclusion: enabling control provides flexibility that could deliver value

A relaxation of the control restriction would give the Guardians greater access to direct investment opportunities in New Zealand. Investment market trends also suggest that the NZSF may increasingly tilt toward direct investment over time, as the potential for more traditional asset yields might rise and fall. At the end of the day, this is a choice about optionality.

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[22] Review of the Guardians of New Zealand Superannuation – July 2019 – prepared by Willis Towers Watson

[23] '*Peer Investing Fund approaches May 2021'*, May 2021, GUARDIANS

The combination of longer duration and illiquidity of unlisted investments means that a relaxation of section 59 will improve the Guardians' ability to optimise its own shareholding and partnership structures to be responsive to investment opportunities, and provides greater flexibility when undertaking transactions. This flexibility is expected to optimise returns in the long-term, but this must be monitored relative to alternative strategies with different risk and cost-intensity profiles.

5. Reasons for caution

5.1 Parts of the original policy rationale are still relevant

At its inception, the Fund was intended to be a portfolio of financial investments, not an operator of businesses. A proscription on taking controlling interests was not thought to be a significant constraint, as normal practice for private investment funds at the time was to avoid controlling interests. There was also a concern that if the Crown controlled an entity – there could be an implied guarantee by the Crown of the entity's liabilities in the case of financial difficulty. It was also assumed that if it makes good public policy for the Crown to have ownership of a business, it would be better for the Government to make the decision directly. The original policy intention assumed foregone opportunities due to these settings.

Part of the rationale for the control restriction and the risks being mitigated by the restriction are still relevant. For example, the fund is still not intended to be an operator of businesses.

5.2 Assessing whether competitive neutrality issues could arise

Competitive neutrality is a concept that means that a government-owned entity should not have a competitive advantage (or disadvantage) compared to a private entity engaged in a similar business. Due to its size and Crown balance sheet, we have analysed whether the NZSF could operate to an unfair advantage relative to private businesses.

The NZSF is one of the largest institutional investors in New Zealand and has a significant role in New Zealand's capital markets. Due to its size, it will have substantive power within the domestic institutional investor market. Having substantial market power is not illegal. However, it is illegal for a business with a substantial degree of market power to take advantage of that market power for anti-competitive purposes.[24]

Domestic investment by SWFs risks destabilising macroeconomic management and undermining both quality of public investments and the capital maximisation objectives of the Fund. The source of these risks is essentially that the SWF is owned by the same entity – the government – that seeks to promote public investments. These risks may be mitigated but not eliminated.[25]

The Guardians assert that creating a market dominant position is not in its best interest as it would create an illiquid position that is counter to its portfolio construction approach i.e. it is not able to exit transactions from a market dominant position.

The Guardians is subject to competition law, tax law and security market regulations the same way as any private institutional investor. This means that the size of the NZSF is already legislated for in commercial law and it will be subject to normal market conditions.

The perception of preferential treatment due to the sovereign status is a risk that will remain. This can be partially mitigated by transparent procurement processes. Again, reflecting on the

[24] Section 36, Commerce Act 1986. Anti-competitive means: to restrict the entry of another business into any market, to prevent or deter a business from being able to compete effectively and to eliminate a business from any market. This means if the GUARDIANS undertook activity to eliminate another institutional investor from the market or restricted entry there is potential for the Commerce Commission to intervene.

[25] Gelb et al, *Sovereign Wealth Funds and Long-Term Development Finance: Risks and Opportunities*, February 2014, https://elibrary.worldbank.org/doi/pdf/10.1596/1813-9450-6776

quality of governance for the Guardians, which acknowledges that independence and transparency are very much dependent on each other, we are comfortable that this does not present an unreasonable hurdle, but should be monitored for comfort levels within the business community.

An adjacent issue is how a change to the control restriction compares to setting of other CFIs i.e. ACC. ACC's governing legislation does not contain an explicit prohibition on controlling interests, but it has restrictions on the creation and acquisition of subsidiary companies which have a similar effect. The question is should CFIs also be on a somewhat level playing field or are their individual settings dependant on their separate purpose and mandate. This is out of scope for this review but should be picked up through a follow-on question with ACC's Board in due course.

5.3 Capability to take controlling interests

Guardians capability has already been discussed briefly at 4.5.2. The information below is captured from the Guardians' Direct Investment strategy and risk allocation processes, to build assurance for capability to take controlling interest and manage change associated with a relaxation of the control restriction.

5.3.1. Direct investment strategy

Direct investment is one of five ways in which the Guardians seek to capture value add.
[26]

Positive performance of the current portfolio doesn't necessarily mean that the same performance will be replicated with control enabled investments but is indicative of potential value add in the future.

The process through which level of involvement and effort put towards direct investment is shown below.

[25], [34]

The Guardians has proposed that the removal of the control restriction is unlikely to materially change its operating model. This is due to the requirement to monitor investments and select governors for any reasonable stake in an entity.

There is a risk that this position changes in the future – which could result in changes to its operating model and capability needs. Majority may add demands in a crisis. However, it would be largely the role of the business itself to be resilient to economic fluctuations. The risk is small and a key reason why it is important to have prudent use of any flexibility to take a controlling stake as it may be harder to ramp up to manage issues with multiple businesses particularly in times of economic stress.

5.3.2 Risk budgeting

Allocation of risk for direct investment and private assets is integrated into broader governance frameworks of the Guardians' risk budgeting. This is given effect by a "top-down" framework in which the risk management function is integrated into the investment review process ex-ante, then later is tasked with on-going risk monitoring across a variety of key risk factors: liquidity and exit risk, concentration risk, credit risk, interest rate risk, regulatory risk, technology risk, etc.[26]

For the NZSF, the Board sets the overall risk budget. The various investment opportunities with underlying similar drivers are grouped together into risk baskets. The direct investment portfolio is aligned to risk baskets. There are five risk baskets that drive top-down risk allocation and resource focus, as shown below. The direct investment opportunities are currently focused on

[26] *Beyond the Market: Reframing Risk in a Dynamic New World*, International Forum of Sovereign Wealth Funds, https://www.ifswf.org/general-news/beyond-market-reframing-risk-dynamic-new-world

three risk baskets: structural, real assets and asset selection. The Board approves the overall risk budget.

Broad Markets	Arbitrage, Credit & Funding	Structural	Real Assets	Asset Selection
Global Macro	Active Collateral	DM Equity Multifactor	Energy (Alternative)	Active Equities
Strategic Tilting	Convertible Arbitrage	Life Settlements	Growth Capital	Opportunistic NZ
Variance Swaps	Direct Arbitrage	Natural Cat. Reinsurance	Infrastructure (Core)	Buyout
Event Driven Opportunity	Distressed Credit	Rural Land	Infrastructure (Non-Core)	
Dividend Futures	Merger Arbitrage	Timber	Real Estate (Development)	
	Opportunistic Volatility		Real Estate (Prime)	
	Insurance Run-off		Real Estate (Secondary)	

Source: Direct Investment Strategy discussion slides

This process highlights the role of the Board to have clear oversight of the risk allocation to direct investments. There is no expectation that this overarching process would change for a control restriction as the risk on the investment does not fundamentally change. If anything, the risk becomes more controllable, but the external factors that can impact returns performance would look to be assessed no matter the size of the stake in an entity.

The Guardians has signalled that the (proportional) size of the direct investment portfolio is likely to remain the same over time, but there is an expectation to bid for large infrastructure deals. The benefit of allocating risk to this portfolio and away from other portfolios would be assessed on a case by case basis and is best managed at the Board, not via legislation.

6. Our key concerns

6.1 Political pressure

NZSF was set up to smooth the impact on the Crown finances by the increasing demand for superannuation payments. It is a fund set up for profit maximisation purposes rather than economic development or stability purposes, see *annex: context and key conclusions from the 2011 review*, for a brief outline of the fund and its purpose.

Generally, SWFs as large, direct shareholders in firms are can be called onto take a more active investment management approach which creates political concerns.[27] This issue was alluded to in the original policy paper, that a large government-controlled portfolio of financial assets potentially could be used to contribute to active management of the domestic economy. This tendency may grow with the ability to take on a controlling stake in entities, including for strategic infrastructure projects.

The 2011 review found that amending section 59 to allow for substantive controlling interests could weaken the Guardians' commercial independence. The argument is that section 59 helps to prevent a build-up of non-legislative political pressure and helps to keep the political discourse on the NZSF focused on risk-adjusted commercial returns. This in turn helps to keep the political legitimacy of the NZSF, in line with the original policy rationale as a fiscal commitment mechanism and long-term savings vehicle.

Any relaxation of the control restriction should consider ways to bolster the independence provisions to ensure minimal political interference in the Fund's investment activities. This could be done, for example, through a Board controlled policy on application, while keeping the double-arm's length settings and the purpose as it is.

6.2 Reputational risk to the Crown

The Fund is ultimately part of the Crown and should behave accordingly. This is reflected in the clause on 'avoiding prejudice to New Zealand's reputation as a responsible member of the world community'.[28]

The Act prescribes the standards, policies and procedures that must be adopted and monitored. The Board is publicly accountable and is exposed to reputational risk. However, Guardians' sovereign status means the Crown is also exposed to reputational risk by association.

Reputational risk to the Crown will be heightened with controlling interests. However, we consider the current setting of Board accountability with some oversight from Ministers to be appropriate to manage this risk.

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[27] *The Rise of Collaborative Investing – Sovereign Wealth Funds' New Strategies in Private Markets*, BCG – Sovereign Investment Lab joint report, http://www.bernardobortolotti.com/wp-content/uploads/2019/08/Sovereign-Wealth-Funds-Approach_LOWRES_V11.pdf

[28] Section 58, New Zealand Superannuation and Retirement Income Act 2001.

6.3 Bail out expectations

Linked to the issue of political pressure and reputational risk, another important governance related problem is the investment policies of SWFs being used to bail out under performing firms or industries.

One of the original policy intents behind imposing the restriction include a concern that there could be an implied guarantee by the Crown of the entity's liabilities in case of financial difficultly. [36]

The concern here is the hypothetical situation where the Guardians may choose not to support a failing company due to commercial reasons – but the government is pressurised to support or bail out the company due to political reasons or to avoiding reputation risks. [34]

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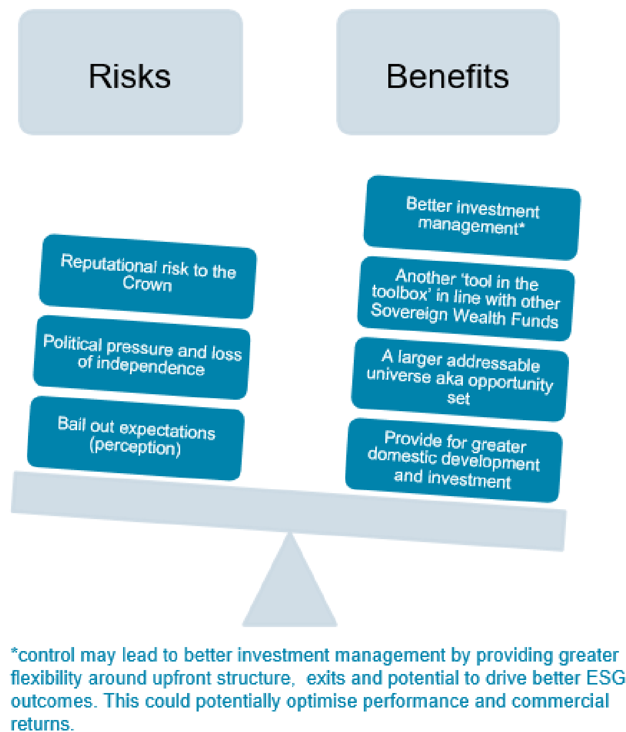
This isn't a new risk but one that could be heightened with controlling interests.

[29] Section 49 Public Finance Act 1989

[30] Ruth V Aguilera, Javier Capape, Javier Santiso, *Sovereign Wealth Funds: A strategic governance overview*, Academy of Management Perspectives, volume 30, 2016, https://web.northeastern.edu/ruthaguilera/wp-content/uploads/2017/02/46.-Aguilera-Capape-Santiso-2016-AMP.pdf

7. Conclusion – potential risks are lower than the benefits of removing the control restriction, but oversight should consider prudent use of this option

Relaxing or removing the control restriction will widen the investible universe for the NZSF, which may bring performance and competitive advantages. However, there are fundamental reasons why we do not see it advantageous for the Guardians to be significant owners and operators of businesses, chiefly the potential for heightened reputation risk and public pressure to act when not in the best interests of the Fund.



*control may lead to better investment management by providing greater flexibility around upfront structure, exits and potential to drive better ESG outcomes. This could potentially optimise performance and commercial returns.

We have considered whether there would be an advantage to modifying relative to removing the control restriction; i.e. still maintaining a legislative hurdle through the use of carve outs e.g. by time period or by sector of investment. However, we do not consider that setting out specific parameters in legislation is viable, as the consideration of where there is a strategic advantage to using this flexibility is highly operational and may change over time.

Our assessment of a long list of potential carve outs is included in *annex B: long list of options.* However, our recommendation is to implement in line with existing legislation, which sets out the purpose for investment and requires the Board to operate a set of policies, standards and procedures to ensure visibility of how the Guardians mandate is given effect.

A complete removal of the control restriction needs to be designed in a way to reemphasise commercial independence and prudent investment practices by strengthening/clarifying the wording in the NZSRI or inserting a requirement to have a policy around governance of controlling interests into section 61[31] of the NZSRI.

[31] Section 61 of the NZSRI prescribes the contents that must be covered, (but not limited to) in the statements of investment policies, standards and procedures.

The Treasury supports a full removal of the control restriction, with appropriate safeguards incorporated into the existing Statement of Investment Policies, Standards and Procedures, (SIPSP), under section 61 of the NZSRI, which is overseen by the Guardians' Board. This will then be included in the five yearly independent review process.

The Guardians' feedback is that the alternative options set out in Annex B are, for various reasons, not practicable or workable. In its view, it would be preferable to retain the status quo rather than to implement any such option.

8. Annexes

We have included a set of annexes for completeness. These sections need not be read but are included for additional assurance on the legal, accounting and policy considerations that have been summarised in this report.

Annex A: Global Sovereign Wealth Funds

Sovereign Wealth Funds (global trends)

Sovereign Wealth Funds (SWFs) are a very heterogeneous group of institutional investors. There are over 131 SWFs around the world.[32] These funds are not directly comparable due to size, location, objective, political and regulatory environments. This makes a comparative peer fund analysis problematic as we are not comparing like for like. For the purpose of this review have taken a broad view and defined it as 'a pool of assets owned and managed directly or indirectly by governments to achieve national objectives'.[33]

The 2011 review considered OECD countries and pension funds/regulation to conclude that majority of countries do not impose control restrictions. NZSF is not strictly a pension fund. Recipients of New Zealand Superannuation, whether current or future, have no special claim over those assets. The Crown is the legal and beneficial owner of the Fund. This means that, while there may well be many issues of pension fund management that are relevant when thinking about the NZSF, not all aspects of pension fund management will carry over automatically.

The framework below groups SWFs into three board categories: capital maximisation, stabilisation and economic development. These categories can be further divided into specific policy objectives.

[32] SWFinstitue, https://www.swfinstitute.org/profiles/sovereign-wealth-fund

[33] *Sovereign Investors 2020 – A growing force*, PwC, https://www.pwc.com/gx/en/sovereign-wealth-investment-funds/publications/assets/sovereign-investors-2020.pdf

A taxonomy illustrating the differences between Sovereign Investors

Economic Objectives	Specific Objectives	Description	Examples
Capital maximisation Building a risk-adjusted capital base for the growth and preservation of national wealth	Balancing intergenerational wealth	Investing to create intergenerational equity e.g. transforming non-renewable assets into diversified financial assets for future generations	NBIM, Kuwait Investment Authority
	Funding future liabilities	Growing and preserving the real value of capital to meet future liabilities, such as contingent liabilities like pensions	Australia Future Fund, New Zealand Super Fund
	Investing reserves	Investing excess reserves in potentially higher-yielding assets via financial strategies aiming at higher long-term returns, and reducing the negative carry costs of holding reserves	China Investment Corporation Korea Investment Corporation
Stabilisation Macroeconomic management and economic smoothing	Facilitating fiscal stability	Using counter-cyclical fiscal tools to insulate the economy from internal and /or external shocks, e.g. changes in commodity prices to smooth consumption	Chile Economic and Social Stabilisation Fund
	Stabilising the exchange rate	Using the fund's resources to balance large capital inflows and outflows in the short term (which may be caused by commodity price volatility) to prevent asset price bubbles and reduce price volatility	Russia Reserve Fund
		Using the fund to manage the amount of capital entering the domestic economy over the long run to ensure the exchange rate is maintained at a level that allows for other export activities, e.g. to prevent Dutch Disease	Mexico Oil Income Stabilisation Fund
Economic development Investment to boost a country's long-term productivity	Investing in hard infrastructure	Domestic development in capital assets, including but not limited to transport, energy, water management and communications	Nigeria Infrastructure Fund
	Investing in social infrastructure	Domestic development in soft infrastructure: human capital and the institutions that cultivate it. This includes socio-economic projects such as education and health	Mubadala Development Company
	Pursuing industrial policy	Creating a diversified economy in order to reduce dependency on one resource or source of funding. Official, strategic efforts by governments to boost productivity in specific sectors	Temasek, BPI (France)

Source: PwC

NZSF is an investment fund with a goal of capital maximisation set up to grow and preserve the real value of capital to help meet future liabilities i.e. superannuation payments.

Holding a controlling stake is viewed as a 'tool in the toolbox' and is not the most common approach to direct investment. Even for funds that are able to take controlling interest, a common reason for avoiding controlling interest is reputational risk. [26]
for example, has no control restriction yet its threshold for taking controlling interest is high.

The following are key themes emerging from our literature review of global SWFs.

<u>Control restrictions</u>

It is common for public asset managers to invest in a broad range of domestic asset classes and many do not have legislated restrictions on specific asset classes.[34] Even though most

[34] Malan Rietveld and Perrine Toledano, *The New Frontiers of Sovereign Wealth Funds*, Domestic Investment Practices of Sovereign Wealth Funds – Chapter 7

funds do not have specific domestic asset class restrictions, some of the funds (located in advanced economies) have other general restrictions that apply to domestic investments.[35]

Globally, most pension investments are not subject to an ownership concentration limit. According to the Organization for Economic Co-operation and Development (OECD), of the seven member countries whose institutions hold 90 per cent of pension assets, Canada is the only country with an ownership concentration limit.[36] This doesn't include New Zealand, as the NZSF is not a pension fund.

The risk appetite and the ability to manage reputational risk is also dependant on the political environment and how democracy functions within a nation state (if it is a democracy).

Domestic development

Several large SWFs have started to focus on domestic economic development.[37]

When investing directly abroad, SWFs tend to evenly split deals between solo investments and equity partnerships. At home, instead they have a much stronger preference for direct solo investments. This behaviour can be attributed to better access to information and investment opportunities in the local market.[38] We can see this trend emerging in New Zealand with the Guardians signalling a preference for domestic direct investment over international due to origination advantage.

Established SWFs with domestic investment mandates were typically founded for different reasons and took different evolutionary paths to their current status as important investors in their domestic economies.[39]

For example, [26] is a well-established as an institution holding companies to improve management of government shares in domestic firms rather than as managers of capital funded from the country's fiscal surpluses or the excess of foreign exchange reserves. [26] in many respects, is comparable to the private equity funds that assume an active role in reforming and managing domestic companies.[40]

Asset allocation

It is estimated that over the next five years, we are likely to see continuation of the trend of increasing allocations to alternative investments accessed through private markets – namely

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[35] https://image-src.bcg.com/Images/SWF-Quarterly-Newsletter_tcm9-210656.pdf

[36] https://www.canada.ca/en/department-finance/programs/consultations/2016/pension-plan-investment-canada-30-per-cent-rule.html#_ftnref1

[37] https://image-src.bcg.com/Images/SWF-Quarterly-Newsletter_tcm9-210656.pdf

[38] http://www.bernardobortolotti.com/wp-content/uploads/2019/08/Sovereign-Wealth-Funds-Approach_LOWRES_V11.pdf

[39] Do Malan Rietveld and Perrine Toledano, *The New Frontiers of Sovereign Wealth Funds*, Domestic Investment Practices of Sovereign Wealth Funds – Chapter 7

[40] Malan Rietveld and Perrine Toledano, *The New Frontiers of Sovereign Wealth Funds*, Domestic Investment Practices of Sovereign Wealth Funds – Chapter 7.

Private Equity (PE), Real Estate (RE) and infrastructure, as well as multi asset and/or unconstrained managers.[41]

Changes to asset allocations are likely to be most pronounced and visible for capital maximisation funds. They are the most unconstrained and risk-seeking of Sovereign investors. This group includes funds that do not have strictly defined liability profiles.[42] NZSF falls into this category of a capital maximising fund.

Multiple objectives could be achieved through appropriate strategic asset allocation within one fund, or the assets could be separated into separate funds with distinct characteristics. [43]

Infrastructure

SWF's recent shift towards a domestic economic development focus means an increased allocation to private infrastructure. Infrastructure investments are also not uncommon in SWF portfolios. The motivation for the vast bulk of these investments has been commercial.[44]

The long-term horizon and stable cash flows of infrastructure investments are very well aligned with the mandate of SWFs. A survey of SWFs, endowments and pension plans conducted by the Sovereign Wealth Fund Institute in September 2018 found that 40% of the participants noted that they will increase their asset allocation to private infrastructure. This was more than any other asset class.[45]

SWFs invest 3.30% of their portfolios in infrastructure assets and these account for 12% of development funds. These infrastructure investments have shown a strong increase over the last decade.[46]

Direct infrastructure acquisitions represented 10% of all SWF deals during the period 2009-2014 (versus 6% during the period 2003-2008).[47]

The Guardians has also signalled an appetite towards more infrastructure investment.[48] It states that infrastructure is an attractive investment category for NZSF because of its consistent, competitive returns and yields, defensible characteristics and diversification benefits. It also has the potential to deliver the scale required for active investments to be meaningful.

The Guardians claim that, infrastructure is a scalable way in which they can deliver on the direction from the Minister of Finance in 2009, to consider opportunities to increase the allocation of domestic assets.

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[41] *Sovereign Investors 2020 – A growing force*, PwC, https://www.pwc.com/gx/en/industries/sovereign-wealth-investment-funds/publications/sovereign-investors-2020.html

[42] *Sovereign Investors 2020 – A growing force*, PwC, https://www.pwc.com/gx/en/industries/sovereign-wealth-investment-funds/publications/sovereign-investors-2020.html

[43] Gelb et al, *Sovereign Wealth Funds and Long-Term Development Finance: Risks and Opportunities*, The World Bank, February 2014, https://openknowledge.worldbank.org/handle/10986/17313

[44] Gelb et al, *Sovereign Wealth Funds and Long-Term Development Finance: Risks and Opportunities*, The World Bank, February 2014, https://openknowledge.worldbank.org/handle/10986/17313

[45] *https://image-src.bcg.com/Images/SWF-Quarterly-Newsletter_tcm9-210656.pdf*

[46] *Sovereign Investors 2020 – A growing force*, PwC, https://www.pwc.com/gx/en/industries/sovereign-wealth-investment-funds/publications/sovereign-investors-2020.html

[47] *Sovereign Investors 2020 – A growing force*, PwC, https://www.pwc.com/gx/en/industries/sovereign-wealth-investment-funds/publications/sovereign-investors-2020.html

[48] GUARDIANS -BIM 2020

Direct investments in domestic infrastructure are still limited among most funds, including those in advanced economies. For SWFs the most common reason reported for outsourcing domestic infrastructure investments is the cost of building a dedicated team for a specific market.

Santiago principles

The rise of SWF activity has caused some degree of unease among global investors and regulators. The concerns are primarily around the concept of state capitalism, national security and economic competitiveness. The Santiago Principles were created in response to these concerns in 2008 as a voluntary code of conduct for SWFs – aimed at promoting transparency, good governance and accountability standards.

Critics saw SWFs as promoting a new concept of state capitalism at the expense of global free market principles. Governments were suggested to act not merely as providers of stable institutions for markets to operate efficiently, but through their SWFs to engage as powerful, distinct, and, as the term suggests, sovereign market participants themselves. Stronger critics argued that SWFs posed a threat to national security and to the economic competitiveness interests of those countries in whose assets they invested.[49]

The principles commit their signatories to basic and consistent standards of good governance, transparency and accountability, while allowing room to reconcile the diverging mandates and regulatory traditions of their signatories. They constitute a voluntary code of principles and as such are not legally binding under national or international law. They are rather part of a growing international body of "soft norms" around which the expectations of financial market participants and regulators converge. The Santiago Principles leave substantial room for interpretation.

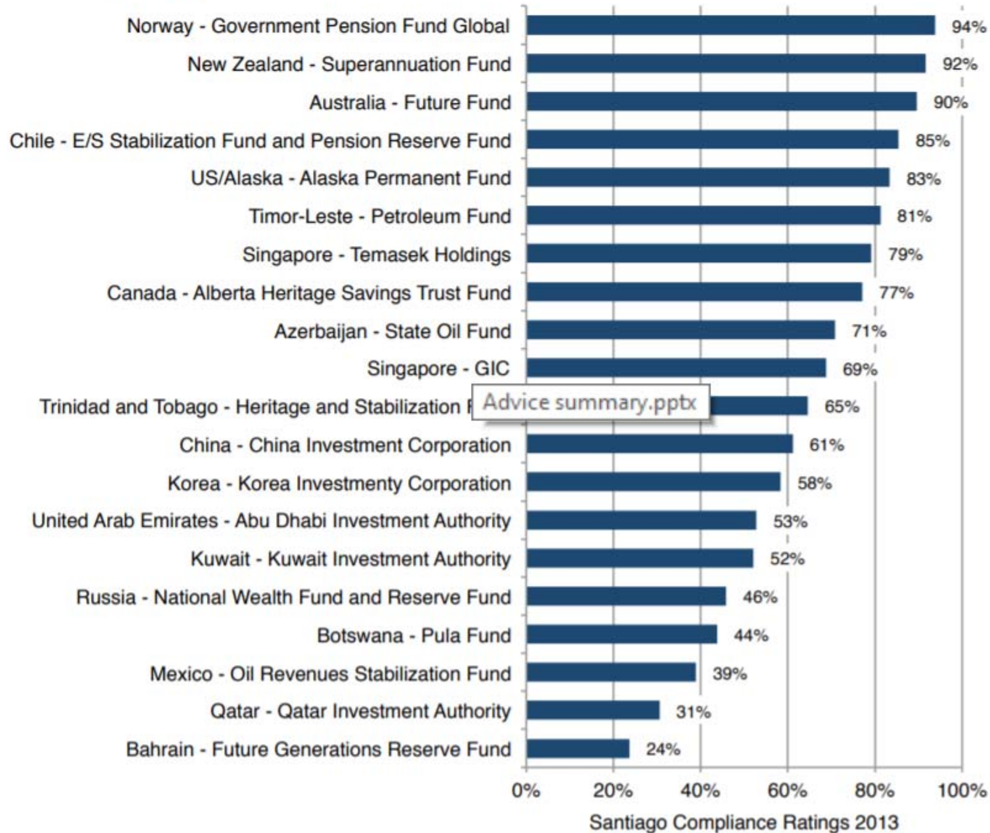
Implementation of the principles are however not consistent across SWFs.

A small group of SWFs, predominantly from democratic countries, shows a high degree of commitment to the principles. [34]

The latest publicly available compliance review of the Santiago Principles had the NZSF ranked number two – with 92% compliance.[50]

[49] Sven Behrendt, *Sovereign Wealth Funds and Santiago Principles – Where Do They Stand*, Carnegie Endowment for International Peace, May 2010, https://www.jstor.org/stable/pdf/resrep13033.pdf?refreqid=excelsior%3Aa592916aa52108260dc6ef2ead3bb54f

[50] *The Santiago Compliance Index 2013*, GEOECONOMICA, January 2014, https://www.nzsuperfund.nz/assets/documents-sys/Santiago-Compliance-Index-2013-public.pdf



The Santiago Principles do not provide guidance on controlling investments or restrictions however they do provide best practice guidance on addressing key issues which are relevant to taking controlling interests i.e. transparency, governance and domestic macroeconomic implications. The Santiago Principles leave a substantial room for interpretation – as they do not consider information that is not in the public sphere – hence global peer analysis is problematic.

The Guardians performs a self-assessment against the Santiago Principles annually. This shows some commitment to global best practice.

Annex B: The long list options analysis

Possible option	What does control offer?	Risks
1. No change	• Avoid any unintended consequences.	• Continuation of the opportunities foregone – as claimed by the GNZS. Less of a risk more of a 'con'.
2. Sector based	• Potential sector development – i.e. infrastructure • Increase opportunity set • Increased flexibility – speed at which they could enter into transactions • Better partner choice • More control and choices around upfront structuring	• Defining the sector can be complicated and bring about lack of clarity to the (legislative) setting • In the context of infrastructure - the market for infrastructure investment is underdeveloped in NZ. The GNZS operating in the market with the ability to take controlling interests could potentially hinder the development of the market if they dominate the area due to being deep pocketed institutional investors with a sovereign status. • Targeting a sector may lead to unintended consequences, the intended outcome may not align with the intention of the carve out. • Unknown implications on performance • GNZS's expertise in certain sectors is untested • Concentration risk - if GNZS are incentivised to investment into select sectors • Political risk – i.e. by being lobbied to be involved in projects • Reduced political independence (real or perceived) as government could be seen as providing a limited carve-out direct at its investment priorities. • Sovereign status could lead to actual and perceived preferential/ treatment – which could dampen competition in the market.

3. Domicile/jurisdiction based i.e. Australia and New Zealand	• Potential domestic development • Increased opportunity set • Increased flexibility – speed at which they could enter the transaction • Able to make better use of their competitive advantage • Easier management of regulatory risk – compared to investing further afield.	• Unknown implications on performance • Sovereign status could lead to actual and perceived preferential/ treatment – which could dampen competition in the market. • Difficult to define New Zealand and Australian entities i.e. a New Zealand incorporate company with its operations offshore (or vice versa) or there could be expansion of a business into other jurisdictions (i.e. Lanzatech)
4. Time bound	• Increased opportunity set • Increased flexibility – speed at which they could enter the transaction • In line with the policy rationale. GNZS get exposure to assets but in the long run GNZS is deterred from being an owner and operator of businesses • Greater great flexibility than the current settings	• Limits options around exit timing • A strength of SWFs is their ability to hold investments over the long term to generate illiquidity premia over their risk-adjusted returns achieved in public market. GNZS would lose this advantage if they didn't have flexibility over exit • Complexity around structuring may remain • Creates commercial uncertainty particularly in relation to third parties
5. Control size bound i.e. max 75 %	• Increased opportunity set • Increased flexibility – speed at which they could enter into the transaction	• Somewhat arbitrary – it may be getting into the investment decisions and there is a question around who is better placed to make these decisions • Unclear how this could address key risks – the exposure around political, reputation risks etc still remains
6. Exemptions approved by Ministers on a case by case basis	• Increased opportunity set • Provides an avenue to seek exemptions for situations that are not foreseen during the policy process • Provides more options • Provides flexibility and increases opportunity set but enables additional	• Risk of politicising Fund's activities • Slower decision making • There is a question around who is best place to make this decision – what is the decision being made on, if the decision is made on a political or a public policy ground then there is the risk of the erosion of the current purpose and mandate • Lobbying

	governance – around risks highlighted around control • Creates a space to raise situations that are not anticipated in the policy process. Future proofs any amendment by service as a catch up all back-end options.	
7. Investment size bound	• Increases opportunity set • Provides some flexibility	• Who is better placed to make the judgement? • Absolute dollar amount may not be meaningful – particularly as the fund size grows
8. Complete removal - tension bought in via risk budgeting or adding in added policy to section 61 of NZSRI	• Provides flexibility • Increases opportunity set	• Governance and monitoring will need to also match the risks • Implementation/how it may work in practice is untested • Political risk • Perceptions/expectations around government bail out
9. Any amendment to the control restriction could have a date at which it will need to be reviewed for impact on economy, market and marker participant to consider whether further changes settings are required.	• Will increase the opportunity set and provide flexibility • Force a review of the control restriction and the impact of a relaxation/removal at a later point in time.	• Added administration costs (time and money) for review

Annex C: Context and key conclusions from the 2011 review

New Zealand Superannuation

New Zealand Superannuation is a universal age-related benefit, retaining substantially the current provisions indefinitely. The NZ Super Fund (NZSF) was set up to smooth the impact on the Crown finances cause by the increasing demand for superannuation payments.

Under current modelling, the government will begin to withdraw money from the Fund in 2035/36, with full disbursements to begin in the mid-2050s. Based on current projections, capital withdrawals from the Fund will meet 10% of the net cost of Superannuation cost by 2066, peaking at 12.80% in 2078, and averaging 11.20% for the 50 years from 2060-2110. The Fund will also be paying tax to the New Zealand government in addition to the capital withdrawals

The Guardians of New Zealand Superannuation and the NZ Super Fund

The New Zealand Superannuation and Retirement Income Act 2001 (NZSRI) established the NZSF; a pool of assets on the Crown's balance sheet and the Guardians of New Zealand Superannuation (GNZS), a Crown entity charged with managing and administering the NZSF.

The NZSF was set up to be a clearly defined portfolio of Crown financial resources managed by an independent governing body with explicit commercial investment objectives and clear accountability. The purpose of NZSF was set up to smooth the impact on the Crown finance cause by the increasing demand for superannuation payments. The NZSF was not designed to ever fully finance the cost of New Zealand Superannuation.

Key design elements of the governance framework for the NZSF are: clear definition of the Fund purpose; an appropriate level of independence around the governing body; explicit legislated commercial investment objectives; and a robust accountability framework.

NZSF is not a pension fund. Recipients of New Zealand Superannuation, whether current or future, have no special claim over those assets. The Crown is the legal and beneficial owner of the Fund. This means that, while there may well be many issues of pension fund management that are relevant when thinking about the NZSF, not all aspects of pension fund management will carry over automatically. Both the scope of responsibilities and the fiduciary duties of members of the Fund's governing body are somewhat different than those of trustees of a typical pension fund. Rather NZSF is an investment fund. The assets of the Fund are a well-defined subset of the property of the Crown. NZSF does not administer the benefits payment system, it has no responsibility for determining the levels neither of benefits nor of the Crown's capital contributions or withdrawals, and it does not administer any other funds.

GNZS invests government contributions and returns generated from investments in New Zealand and internationally, in order to grow the size of the Fund over the long term. The projected growth and size of the Fund means that even relatively small efficiency losses could have a significant negative effect on national welfare.

Since 2003, government has contributed $19 billion to the NZSF which, as at 31 May 2021, was worth $57.6 billion. Since inception the GNZS have, on a before NZ tax/after costs basis added an estimated $28 billion to the NZSF, compared to the Treasury Bill return and added an estimated $8 billion in value to the NZSF compared to a market “Reference Portfolio” return.

From 2035/36, the government is expected to withdraw money from the Fund to pay for New Zealand Superannuation. The Fund is projected to grow until it peaks in size in 2070s.The NZSF is expected to continue to grow until it peaks in size as a percentage of GDP in the 2070s. After that time, it will continue to grow in nominal terms, but will reduce in size relative to New Zealand’s GDP.

The NZSF has just over NZD$7.2 billion invested in New Zealand, or 18.4% of its total investments by value[51]. The fund invests in four areas: listed equities, growth capital, rural land and direct investments. Direct investments are: (opportunistic, large scale direct investments, managed by the in-house team). This portfolio includes sizeable investments in Kaingaroa Timberlands, Fidelity Life, Datacom, Kiwibank, hotels & property.

Mandate and Mission

A key purpose of NZSRI is to assist the Crown in meeting New Zealand Superannuation payments. In fulfilling this purpose, the GNZS Board must invest the Fund on a prudent, commercial basis and in doing so manage and administer the Fund in a manner that is consistent with:

- best practice portfolio management
- maximising returns without undue risk to the Fund as a whole; and
- avowing prejudice to New Zealand’s reputation as a responsible member of the global community.

While the legislative mandate provides the GNZS with considerable freedom to invest the Fund how they see fit there are some constraints in place. These include:

- A restriction on the kind of directions the Minister can provide. The Minister cannot give a direction that is inconsistent with the NZSF’ duty to invest the NZSF on a prudent, commercial basis, and cannot direct the GNZS in regard to the NZSF on any other matter.
- Constraints on the ability of the NZSF to borrow money
- Constraint on the NZSF’s ability to take control of companies.

There are no constraints – neither maxima nor minima – over domestic investment. The NZSF is subject to the same taxation regime as other privately owned entities.

The Board also must have regard to the fact that the Fund is owned by the Crown and the Crown bears the risks arising from the activities of the Fund to both its finances and its reputation. The Board approves investment policies that provide further controls on Fund management.

Control restriction and domestic investment

[51] GUARDIANS BIM 2020

GNZS cannot hold a controlling interest in an operating company. The control restriction is imposed by section 59 of the NZSRI which prohibits the GNZS from holding substantive controlling investments. The definition of control is broad, encompassing subsidiaries, effective control as defined by accounting standards, and the ability to control the composition of an entity's board.

In 2009 the GNZS received a Direction from the Minister of Finance relating to investment in New Zealand. In summary, it required that GNZS "identify and consider opportunities" to "increase the allocation of New Zealand assets in the Fund", subject to its duty to invest on a prudent, commercial basis. The letter accompanying the Direction further stated that the Government's expectation that the fund increases its domestic investments to 40% of the total portfolio.

The GNZS considered the request at odds with the Fund's mandate to maximize return over a long-term horizon without undue risk, and consistent with best practice portfolio management. It was noted that in order "to guarantee an increase to a prescribed percentage would require a modification to the Fund's commercial objectives" in the relevant legislation. The GNZS concluded that while local investment activities may produce positive benefits (externalities) in assisting developing New Zealand's capital markets, they cannot take these externalities directly into account when making an investment decision under the NZSRI.

The GNZS believe this constraint limits investment opportunities, particularly in markets like New Zealand where investments tend to be smaller scale and believe it to be unnecessary. According to the GNZS, the control restriction places constraints on direct investment activities. The GNZS see direct investment as the primary vehicle for delivering the 2009 Ministerial Directive to consider New Zealand investments.

Key conclusions and outcomes from the 2011 review

The 2011 review recommended changing the law to allow GZNS to structure and hold investments within passive holding subsidiaries. This led to amendments to NZSRI which enabled the use of Fund Investment Vehicles (FIV) but didn't extend to the fund being able to control other entities such as operating businesses.

The amendments enabled the GNZS to control FIVs, being an entity that is formed or controlled by GNZS for the purpose of holding, facilitating or managing investments of NZSF. The primary control restriction continued to apply.

On the issue of the substantive controlling investments, the 2011 review concluded that was no strong evidence that substantive controlling investments can deliver superior risk adjusted commercial returns to an investor of the size and nature of GNZS.

Substantive controlling investments were not common within global peer funds. The prohibition on control of entities was seen to provide freedom to make investment decisions free from political interference and without a requirement to take wider public policy considerations into account.

The GNZS disagreed with the Treasury position, on the basis that the risks that control may bring can be mitigated through the GNZS' investment mandate and legislated practices. GNZS held the view that the Board of the GNZS are best placed to determine the investment policies in respect of the NZSF (including concentration, liquidity, ownership limits). In setting these

policies the Board must be satisfied that the GNZS meets its investment obligations. The Board will be held publicly accountable if it fails to discharge its obligations, which is where the reputational risk sits.

Annex D: Investment market trends

At the inception of the NZSF, owning controlling interests in non-financial (operating) assets was not seen to be a significant constraint on the Fund's behaviour or performance. It was also normal practice for SWFs to avoid controlling interests. Since the 2011 review, a number of secular trends have shaped the investment markets. The key macro trends that have and are continuing to shape the funds management industry include:

- The availability and growth of low fee passive index funds. This has seen the proportion of passive funds under management grow and active, higher fee rate funds under management shrink.[52] This makes is increasingly attractive to the GNZS to utilise fund managers internationally when viewed through their existing legislative mandate on a cost / benefit basis.

- A steady and continuing decline in asset yields due to declining interest rates and quantitative easing. Declining asset returns incentivises the GNZS to optimise / maximise the returns from its Direct Investment portfolio and allocate increasing proportions to this higher risk / return asset class.

- The growth in PE funds directed towards direct investments - in conjunction with leverage to boost the return on investment (ROI). Unlike PE funds, the GNZS has a specific regulatory framework for borrowing in respect of the NZSF, which puts it at a comparative disadvantage when bidding for assets or in their reported annual returns.

- A steady decline in the fee rate charged by fund managers (margin compression) as a consequence of the relativity between gross and net returns. The logical consequence of this would be to internalise the management contracts for property asset-based investments.

- A decline in new listings world-wide (except China) as PE funds outbid the IPO sale alternative for private investors looking to crystallise the value of their investment.

- Interestingly despite the rising activity levels of Sovereign Wealth Funds over the past decade, they have largely avoided direct investment in the Public equity markets and Public to Private transactions (Takeovers).

- A clear trend towards internalisation of investment teams over the past 5 years particularly in equities, private equity and infrastructure.[53]

- Lengthening time horizons (from 6.9 to 9.4 years).[54]

- The proportion of Private Equity continued to rise over the past 5 years more than doubling to 7.1%.[55]

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[52] Passive Attack: are active managers losing market share?, NBR 22 March 2021, https://www.nbr.co.nz/analysis/passive-attack-are-active-managers-shedding-market-share

[53] Invesco Global Sovereign Asset Management Study (2020) and NZSF response to Treasury May 2020

[54] Invesco Global Sovereign Asset Management Study (2020)

[55] Invesco Global Sovereign Asset Management Study (2020)

These trends in combination suggest that the NZSF will increasingly tilt toward Direct Investment as they increase portfolio risk to compensate them for the secular fall in asset yields. However, the combination of longer duration and illiquidity of this asset class means that a relaxation of s59 will improve its ability to create and manage the shareholding levels of its investment partners.

SWFs, like most institutional investors, commonly build an alternative investment portfolio by committing capital to private-equity-style funds managed externally by General Partners (GPs). However, due to high management fees and the heterogeneity of fund performance SWFs are looking to developed new ways to tap into alternative assets through a combination of direct equity and collaborative investing.[56]

Initially, SWFs participated in direct equity investments (non-financial) via a Limited Partnership (LP) and through General Partner selection. Direct equity investment requires different competences to financial portfolio management (which are "Fund of Funds"). In order to effectively execute Private Equity investment directly, SWFs internal staff require competency in M&A transaction related activities, including valuation, deal structuring, due diligence, and on-going operational monitoring capabilities that are outside the traditional LP skill set. Sourcing a team with the requisite skill set is a significant organisational challenge, entailing additional costs and new risks. That is why, as SWFs move away from full delegation models, they have adopted a partnering strategy with other funds to pool capabilities and skills with strategic investment partners. In this evolutionary process direct private equity investing becomes a rational response to net yield compression.

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[56] *The Rise of Collaborative Investing – Sovereign Wealth Funds' New Strategies in Private Markets*, BCG – Sovereign Investment Lab joint report, http://www.bernardobortolotti.com/wp-content/uploads/2019/08/Sovereign-Wealth-Funds-Approach_LOWRES_V11.pdf

Annex E: the Guardians' Direct Investment Strategy

NZSF commenced its Direct Investment Strategy in 2009. The Strategy was initially based on long term ability to harvest risk adjusted returns, capitalise on competitive advantages in New Zealand and cost efficiencies of internal management over external. The Guardians target unlisted transactions that create value by accessing diversifiers, illiquidity, development and country risk premiums, active governance and partnership to realise risk adjusted returns.

Direct Investment is one of five ways the Guardians seek to capture value add. Some of the reasons why direct investment might be preferred include considerations of cost, capabilities, ability to form strong partnerships and alignment to endowments and beliefs.

[26], [34]

The Guardians currently target investments with a ticket size of $NZD 200-300 million and are largely New Zealand focused. The ticket size required will grow with the Fund. This is a self-imposed constraint – to justify the added effort and risk involved in assessing a direct opportunity. The Guardians aims to scale Direct Investments proportionally with the Fund to maintain materiality of contributions to the Fund's returns. As they scale up, finding investments of scale in New Zealand will get harder and opportunistic leads will likely reduce. This will mean international expansions to find suitable partners.

The Guardians has a desire to focus on domestic investments and believe it will be a long-term source of alpha.[57] The self-imposed ticket size restriction and the section 59 control restriction combined will reduce the opportunity set available in New Zealand, particularly as the fund grows. Finding suitable investment partners (domestically) will become a challenge as the fund grows.

The Guardians believes that it has a core origination advantage in New Zealand and other areas of particular knowledge or expertise for international direct investment. Its competitive advantage in New Zealand is primarily due to its size and maturity.

The Guardians accesses direct investment through engagement with private shareholders and co-investment partners. In the longer term, it aspires to lead transactions and/or work with partners to create investment opportunities. Partnerships are a key part of the direct investment strategy. It is a way to bring in sector specific/operational capability. As the Fund grows the pool of domestic partners also reduce which will increase their reliance on foreign partners and limit ability to bring in smaller domestic partners e.g. iwi

The Guardians aims to optimise return from direct investments is via input into strategy and selective involvement in operations through the Board to enable better performance. It claims that section 59 restricts its ability to do this as it restricts its investments to non-controlling stakes and hence influence to that of a minority shareholder.

[57] Alpha is the difference between the return generated from the asset portfolio and the reference portfolio

The Guardians state that its current portfolio is less than 10% direct [26], [34]

Under this assumption the impact on operating structure or capabilities is likely to remain minimal.

[26], [34]

This may change over time – particularly as the size of the Fund grows – hence the operating risks will also change with any changes to the direct investment strategy.

Material from the Guardians:

[26]

Annex F: Original policy rationale vs 2021 review findings

	Original rationale (2001)[58]	2021 review conclusion
1.	The Fund was intended to be a ***portfolio of financial investments***, not an operator of businesses.	• **No change to original policy intention**. We are working under the assumption that the fund is not intended to be an operator of businesses.
2.	There is a ***range of legislation that applies specifically to Crown*** and the entities under its control i.e. the Public Finance Act 1989, Public Audit Act 2001 and the Official Information Act 1982. Further under accounting principles, all entities controlled by the Crown must be included in the Crown Financial Statements.	• [36] • The Guardians' general position appears to be that (should controlling interests be permitted), any controlled investments should be subject to a similar legal regime as FIVs. • The accounting standard on consolidation has changed since 2001. The removal of the control restriction is unlikely to result in material changes in accounting treatment, as long as the Guardians can demonstrate exit strategy and investment earnings from the entities it has a greater than 50% stake in. • See annexes on Legal and Accounting implications for additional detail.
3.	If the Crown controlled an entity, there could be an ***implied guarantee*** by the Crown of the entity's liabilities in case of financial difficulty.	• [36]
4.	It was ***normal practice*** for private investment funds to avoid controlling interests	The 2011 review found: • evidence of commercial benefits of substantive controlling investments unconvincing. • companies managed by private equity fund managers were run better. • no consensus amongst OECD sovereign wealth or pension funds that substantive controlling investments can deliver superior risk-adjusted commercial returns. The 2021 review found: • No consistent approach to control restrictions among sovereign wealth funds • There is no quantifiable market-based evidence of the sub-optimal performance impact from the section 59 type restriction. In the absence of empirical evidence, the impact of performance is an unknown. • Due to high management fees and the heterogeneity of fund performance SWFs are looking to developed new ways to tap into alternative assets through a combination of direct equity and collaborative investing.[60]

[58] https://nzsuperfund.nz/assets/documents-sys/Governance-of-Public-Pension-Funds-NZSF-2003.pdf

note another source to track down is the Hansard documents

[59] Section 49 Public Finance Act 1989

[60] http://www.bernardobortolotti.com/wp-content/uploads/2019/08/Sovereign-Wealth-Funds-Approach_LOWRES_V11.pdf

		• Holding a controlling stake is viewed as a 'tool in the toolbox' and is not the most common approach to direct investment. • As SWFs mature and develop their internal expertise, more capital is often gradually managed in-house, and exposure to other more complex alternative asset classes is sought, again using third-party fund. The final stage of development is to make direct investments, often initially as minority positions, then as co-investors, typically alongside an alternative investment manager, and ultimately as a lead investor.[61] See annex: Global Sovereign Wealth Fund and Investment Market trends.
5.	Holding a controlling interest in a business limits the ***liquidity*** of the investment	The 2011 review found that: • The Guardians had a wide range of illiquid asset investment options that are not constrained by the prohibition on substantive controlling investments, (with the exception of the New Zealand market). • Most of the NZSF's comparator funds within the OECD have an exposure to illiquid assets in the range of 5-30%, primarily through non-controlling investments in externally managed unlisted funds. • Allowing passive holding subsidiaries would also give the Guardians more flexibility to co-invest in illiquid assets with other long-term investors and/or specialised external asset managers. Our 2021 position is that: • Whilst holding controlling interest may limit the short-term liquidity of the asset, sovereign investors have a greater tolerance for illiquidity and leverage their 'patient capital' to general illiquidity premia over the risk-adjusted returns achieved in public markets. [62] • Due to the Guardians' long-term investment horizon they are better suited to break illiquidity risk • A key motivator for the Guardians advocating for the removal of section 59 is to increase flexibility and options around investing in New Zealand. So whilst they may have wide range of illiquid asset investment options in a global context – options are limited in the New Zealand market. •
6.	The controlling owner inevitably gets drawn into ***strategic management issues*** that require closer operational involvement than that usually sought by a portfolio investor	• **The original policy intention remains valid** in the context of the fund's current purpose and mandate – in that the Fund isn't intended to be an operator businesses. • The Guardians target direct investments with a ticket of $200m to $300m. This is a self-imposed ticket size restriction which effectively caps the maximum number of investee companies, allowing for greater focus and mitigates monitoring risk. This

[61] Malan Rietveld and Perrine Toledano, *The New Frontiers of Sovereign Investment*, Columbia University Press, 2017, chapter 4

[62] *The Rise of Collaborative Investing - Sovereign Wealth Funds' New Strategies in Private Markets*, BCG – Sovereign Investment Lab, http://www.bernardobortolotti.com/wp-content/uploads/2019/08/Sovereign-Wealth-Funds-Approach_LOWRES_V11.pdf

		self-imposed restriction aligned to the policy intent that the fund was not set up to be an operator of businesses – as it limits the transactions to ones are likely to have a material impact on performance. • The risk of getting pulled into strategic management issues is likely to get pronounced with controlling interests and one that needs to be continually managed.
7.	If it makes good public policy (including economic, social and/or environmental policy) for the Crown to have ownership control of a business, it would be better for the for the Government to make the decision directly. Focusing on policy outcomes for the domestic economy may compromise the primary objective of financing New Zealand Superannuation. Other, more transparent instruments are available to the Government pursue these outcomes.	• **No change to original policy intention**. We are working under the assumption that the purpose and mandate of the Fund remains unchanged. This means a decision to have a controlling interest in a company will need to stand on its own merit under the Fund's commercial mandate. • The Guardians have signalled a desire focus further on domestic investments – in line with the 2009 ministerial direction however the expectation is that this is still done under a prudent commercial basis, using best practice portfolio management to maximise return without undue risk.
8.	Limiting control over companies conceivably could result in the board having to forego a commercial investment opportunity that required taking control of a company. In the context of a large, widely diversified fund, this was not seen as a significant problem.	• The fact that the Crown would likely bear some net opportunity cost was anticipated and accepted when the fund was established. Quantifying net opportunity cost, additional risk and agency cost is difficult. • The removal of the restriction may provide the Guardians with a slightly bigger investable universe and provide greater flexibility in terms of upfront structuring.
9.	A large government-controlled portfolio of financial assets potentially could be used to contribute to active management of the domestic economy. The investment objectives could be designed to enable a host of economic variables to be affected, including exchange rates, interest rates, levels of investment in the domestic economy generally, or in specific sectors, domestic market depth and liquidity.	• **No change to original policy intention.** Sections below on 'size of the fund and market power' assess potential impact on the domestic economy. • The concerns around the Fund being used to actively manage the domestic economy stem from its size and sovereign status. The key policy issues, include: o Competitive neutrality - does a change give rise to an advantage or disadvantage to the Guardians compared to a private institutional investor in New Zealand? o Market power and capital markets - what is the impact on the level of investment in the domestic economy and specific sectors and the risk of capturing the domestic listed and unlisted private market through material concentration? See annex: other policy consideration for more detailed analysis

[36]

[63] Section 35, NZSRI Act

[64] Section 40, NZSRI Act

[36]

Annex H: Accounting implications

The original policy intention included a caution around accounting implications.

Accounting principles, at the inception of the Fund and the last review of section 59, in 2011, required that all entities controlled by the Crown must be included in the Crown Financial Statements. There was a concern that if the Crown controlled an entity that there would be an implied guarantee by the Crown of the entity's liabilities in the case of financial difficulty.

The general rule is that all controlled entities should be line-by-line consolidated, that is, the assets and liabilities of controlled entities should be shown as assets and liabilities of the group.

The accounting standard on consolidation has changed since the 2011 review

A new accounting standard came into effect from 1 July 2019. This recognised that if an entity holds investments for the sole purpose of capital appreciation or investment income (such as dividends or interest) then the most useful information is the fair value of the investments. In such cases it was accepted that requiring consolidated financial statements may hinder users' ability to assess an investment entity's financial position and results, because it emphasises the financial position, operations and cash flows of the investee, rather than those of the investment entity.

As a consequence, the NZSF now reports and is consolidated as an "investment entity" rather than on the previous line-by-line basis in accordance with PBE IPSAS 35 Consolidated Financial Statements. Therefore, any controlling interest the NZSF has invested in are reported on a fair value basis and shown in in single line item Investments in controlled enterprises in the Government's statement of financial position. The exception only applies where NZSF has investments in controlled enterprises, the Government consolidates the rest of the fund on a line-by-line basis.

NZSF must meet certain criteria to be considered an investment entity for them (and the Government) to be able to use the exemption to line-by-line consolidation. Investment entities are entities that obtain funds from investors for the purpose to provide those investors with investment management services; to invest funds solely for returns from capital appreciation, investment revenue, or both; and which evaluates the performance of substantially all of their investments on a fair value basis.

If the Guardians has additional objectives that are inconsistent with the purpose of an investment entity, they will not meet the definition of an investment entity. Examples of when this may occur include:

- An investor whose objective is to jointly develop, produce or market products with its investees. The entity will earn returns from the development, production or marketing activity as well as from its investments.

- An investor whose objectives require it to be aligned with the economic, social or environmental policies of another entity. For example, if an entity is required to align its

investment policies with other objectives such as owning certain businesses or improving employment outcomes in a jurisdiction; and

- an investor whose individual investment decisions have to be ratified or approved by a controlling entity or which is required to follow the direction of a controlling entity. Such ratifications, approvals or decisions are likely to be inconsistent with the purpose of an investment entity.

Provided the Guardians does not have any other objectives beyond investment activity and operate within its current mandate – it is likely to meet the definition of an investment entity. The Guardians will need to check in on this every year considering any changes in circumstances, and re-confirm with the auditors

Removal of the control restriction is unlikely to result in material changes in accounting treatment

The accounting implications are likely to be immaterial as long as the Guardians can demonstrate an exit strategy and investment earnings from the entities it has a greater than 50% stake in.

Note, the Government's approach to accounting for Kiwibank, which will continue to be line-by-line consolidated, as this is controlled through other government-owned entities.

The accounting implications and outcome should be considered again at implementation and legislative design, if the case for change is accepted and there is a relaxation of the control restriction

Annex I: Other policy considerations

Competitive neutrality

Government businesses compete with the private sector in several ways and in a variety of markets. Government ownership in a business may result in advantages to that business which are not available to the private sector, impeding the ability of the private sector to complete on equal terms

Competitive neutrality is a concept that means that a government-owned entity should not have a competitive advantage (or disadvantage) compared to a private entity engaged in a similar business. This covers a broad area of regulation (e.g., government-owned businesses must meet the same regulatory standards as private businesses).

A similar business is a competitor who can offer the same or similar goods or service to the customer.[65] 'In a similar business' in the context of the section 59 review captures Institutional investors in the New Zealand market – this includes private investment funds – i.e. PE funds, other Crown Financial Institutions and other sovereign wealth funds that could invest in New Zealand.

Advantages could look like: tax exemptions, cheaper debt financing, the absence of any requirement to make a commercial rate of return of return on assets and exemptions from regulatory constraints or costs.

In the context of the Guardians, it is subject to the same tax regime as other privately owned entities.

A relaxation of section 59 doesn't have an impact on the Guardians' ability to access debt. Constraints have been placed over the Fund's ability to borrow money. There are various types of transaction that it might be sensible for the Fund to undertake as part of a prudent commercial investment strategy that are technically borrowing and involve incurring liabilities or contingencies. The Guardians require approval of the Minister of Finance for debt financing.

NZSF is subject to competition law and security market regulations the same way any private institutional investor in New Zealand.

However, an adjacent issue is how any compares to the potential investment activities of other Crown Financial Institutions i.e. ACC. ACC's governing legislation does not contain an explicit prohibition on controlling interests, but it has restrictions on the creation and acquisition of subsidiary companies which have a similar effect, in practice.

Section 266 of the Accident Compensation Act 2001 ("AC Act") provides a subsidiary entity must be wholly owned by ACC and its principal objective is to be to operate as a successful business. Section 266 further notes that the subsidiary will be a Crown Entity subsidiary for the purposes of the Crown Entities Act 2004 and it does not get the benefit of ACC's exemption from income tax.

Section 272 of the Accident Compensation Act additionally requires that the statement of intent must set out—

[65] *What is a competitor*, Commerce Commission, https://comcom.govt.nz/business/avoiding-anti-competitive-behaviour/what-is-a-competitor

(a) matters relating to the relationship between the Corporation and any Crown entity subsidiary:
(c) the extent to which the Corporation may form and register Crown entity subsidiaries:
(d) matters relating to the allocation of any returns generated by any Crown entity subsidiary:

It is clear from the scheme of the legislation that the subsidiary provisions are aimed at subsidiaries ACC may wish to establish to deliver services rather than for investment purposes but the legislation applies to the investment function nonetheless and makes establishing or acquiring subsidiaries impractical. [36]

Market power and the domestic economy

Governments can affect the way markets function sometimes to the detriment of free competition. A large government-controlled fund has the potential influence the domestic economy due to the perceived or actual market power due to its size and sovereign status.

[36]

The Commerce Commission (CC) is the government agency and regulator tasked with enforcing legislation that relates to competition, economic regulation and consumer protection. When assessing if a business is taking advantage of its market power, the CC considers whether the business would behave the same way if it did not have substantial market power but was in otherwise in similar circumstances.

Loss of independence and bail out expectations

From the outset it was recognised that there was need for strong governance arrangements around the large pool of Crown financial assets.[66] The governance arrangements were designed with an aim to minimise the influence of government on investment policies, as this has been shown to have had a negative impact on commercial returns.[67] A key risk is the direction of funds to further economic or development objectives (known as "economically-targeted investments" or ETIs).

[66] (McCulloch & Frances, 2003)

[67] (Iglesias & Palacios, 2000)

As the Guardians shifts to direct equity investments in New Zealand, politically motivated investments may become an issue. The risk of political interference and influence may become more pronounced with the ability to take controlling interests in private New Zealand companies.

The Fund is projected to grow significantly over the next few decades, which means even relatively small efficiency losses could have a significant negative effect on national welfare. The Guardians cannot be compelled to take an action, under current legislative settings. This was tested in 2009 when the Guardians received a Direction from the Minister of Finance relating to investment in New Zealand. In summary, it required that the Guardians “identify and consider opportunities" to “increase the allocation of New Zealand assets in the Fund”, subject to its duty to invest on a prudent, commercial basis. The Direction further stated that the Government’s expectation that the fund increases its domestic investments to 40% of the total portfolio.

The Guardians considered the request at odds with the Fund’s mandate to maximize return over a long-term horizon without undue risk, and consistent with best practice portfolio management. If allocation to New Zealand assets were to substantially increase beyond the then current 18 percent share of the total portfolio, the Fund would run the “risks associated with asset concentration, the relative illiquidity of New Zealand assets, and other relevant idiosyncratic risks associated with investing in any single location.” Consequently, the Guardians did not offer “an assurance as to how much, if at all, the Fund’s New Zealand assets will increase” based on “the unpredictable nature of future commercial, prudent, investment opportunities”. It was noted that in order “to guarantee an increase to a prescribed percentage would require a modification to the Fund’s commercial objectives” in the relevant legislation. The Guardians concluded that “while local investment activities may produce positive benefits (externalities) in assisting developing New Zealand’s capital markets, we cannot take these externalities directly into account when making an investment decision under our current Act”.

The Guardians’ response to the direction show that even if there is political pressure to invest in a certain way, the current legislative and governance setting means that the Guardians are able to assert their independence.

Removing section 59 doesn’t create the risk of pollical pressure it may increase the risk.

Environmental, social and governance (ESG) risks and opportunities

The Guardians in recent years has been exposed to reputational damage due to ESG/Responsible Investing (RI) related matters. The latest is media attention accusing the NZSF of holding shares in companies, (through their global listed equity portfolio) that are linked with the Myanmar military.[68] Another example is attention around investments in Chinese companies linked to alleged human rights violations.[69]

NZSF recently also withdrew investments in five Israeli banks due to their funding of settlement construction in West Bank and the Gaza strip (the Occupied Palestinian Territories). The Guardians claim that whilst Board representation remains the formal route for addressing environmental, social and governance (ESG) issues, majority control would give them additional

[68] Katie Scotcher, *NZ Super Fund holds shares worth 100m in companies linked to Myanmar*, May 2021, https://www.rnz.co.nz/news/political/442353/nz-super-fund-holds-shares-worth-100m-in-companies-linked-to-myanmar

[69] Louisa Cleave and Paula Penfold, *Super Fund money invested in Chinese companies linked to human rights violates*, April 2021, https://www.stuff.co.nz/national/stuff-circuit/300278880/super-fund-money-invested-in-chinese-companies-linked-to-human-rights-violations

leverage to raise the bar on ESG management and performance expectations for investee companies.

The Guardians claim that majority of controversial ESG/RI issues, which has received media attention recently over the last few years have been related to small minority holdings in listed companies. They are unlikely to seek control investments in businesses with significant ESG risk profiles.

Further the Guardians is exposed to EGS risk regardless of size of the investment. However, the reputational risks stemming from ESG issues, will only increase with a controlling interest. The counter argument is that it also providers greatest ability to influence – to mitigate ESG risks.

Best practice is to attempt to change a company behaviour first by engaging with them. Exclusions are a last resort measure when engagement is deemed to be unsuccessful. The Guardians has a reputation of being world leading in this space. A recent independent review of the Guardians found their approach to ESG integration and stewardship to be 'impressive'.[70]

[70] file:///C:/Users/gnanakumargo/Downloads/Willis-Towers-Watson-Review-of-the-Guardians-of-New-Zealand-2019-summary.pdf

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