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SOVEREIGNS AS SHAREHOLDERS

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This paper considers the increasing impact of sovereign wealth funds as equity investors. Sovereign investment has been viewed with suspicion because sovereign wealth funds, as tools of sovereign entities, could be used for political rather than investment purposes. While this risk is considerable, much of the discussion surrounding sovereign investment ignores or minimizes the mitigating effect of a number of regulatory, economic and political factors. This paper argues that continued care, but not additional regulation, is necessary to ensure that U.S. interests are not jeopardized by sovereign investment in U.S. enterprises. However, while the U.S. is able to protect its interests within its markets, other countries may not have the regulatory structure or political power to adequately defend their interests. Additionally, U.S. interests could be harmed by politically-motivated sovereign investment in other countries. As a result, this paper argues in support of efforts to establish a code of conduct for sovereign investment.

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I. INTRODUCTION

International investment implicates much more than the flow of cash and goods; considerable political issues are often at stake.[1] Commerce sometimes creates issues of national security, and may stoke national pride.[2] In the late 1980s and early 1990s, Japanese investors turned from bidding on U.S. Treasury notes[3] to purchasing iconic U.S. businesses and properties, including movie studio MCA and the Pebble Beach golf course. It was not merely the fact of foreign ownership that caused alarm: the Japanese also operated under a more controlled, top-down form of capitalism that created "not just a clash of cultures but a clash of economic strategies, a competition of ideas."[4] Yet, when the Japanese turned their attention to other markets, especially Asia, the concerns shifted: "Japanese electronic goods and automobiles will not disappear from American shelves or showrooms, but increasingly they will come from factories in Asia, rather than in Japan or the United States. That will mean less job creation in Ohio or Tennessee, as the Japanese start up fewer new ventures in the United States."[5]

So these concerns echo today with the rise of sovereign wealth funds (SWFs). Are SWFs benign, long-term investors that will add stability to global capital markets? Or do SWFs represent a new kind of state capitalism that threatens our national security by allowing our political rivals access and control of our firms and technologies? As the U.S. attempts to protect itself against such political investment, what are the consequences for the U.S. if SWFs turn their attention to other markets?

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[1] "The relationship between international politics and international investment" says British economist John Kay, "is an issue as old as commerce." *Sovereign Wealth Investment Is a Force for Stability*, FINANCIAL TIMES, Feb. 27, 2008, at 11.

[2] As David Hume wrote over 250 ago, "Nothing is more usual, among states which have made some advances in commerce, than to look on the progress of their neighbours with a suspicious eye, to consider all trading states as their rivals, and to suppose that it is impossible for any of them to flourish, but at their expence." DAVID HUME, *Of the Jealousy of Trade, in* POLITICAL DISCOURSES, Part II, para. II.VI.1 (1752).

[3] Japanese investors once purchased approximately 40% or more of all Treasury notes. James Sterngold, *Intractable Trade Issues with Japan*, NEW YORK TIMES, Dec. 4, 1991, at A8.

[4] *Id*.

[5] *Id*.

SWFs have made a number of high-profile acquisitions in recent months. In 2007 alone, China's SWF, China Investment Corp. (CIC), purchased a 10% stake of private equity fund Blackstone for $3 billion[6] as well as $5 billion in convertible securities of investment bank Morgan Stanley.[7] Abu Dhabi's SWF Abu Dhabi Investment Authority (ADIA) acquired $7.5 billion in convertible securities of Citigroup,[8] and Abu Dhabi's Mubadala Development SWF acquired $622 million in AMD stock.[9] Borse Dubai acquired 20% of Nasdaq,[10] and Dubai World purchased $5 billion in MGM stock. Two "strategic investors", one of which was Singapore's SWF, Government of Singapore Investment Corp. (GIC), and the other believed to be a petrodollar SWF, purchased $11.5 billion in convertible securities from Swiss bank UBS.[11]

The list of acquisitions reveals that SWFs are in most cases formed by countries that receive large net capital flows from the United States through investment and trade in goods and commodities such as petroleum. Some of the trade deficit with such countries is remedied through purchases of U.S. Treasury Bills. Nearly 45% of U.S. Treasury Bills are held by foreign investors, with approximately $388 billion held by China and $130 billion held by oil-producing nations.[12] However, China and other SWF sponsor countries have expressed interest in putting their funds into instruments that will produce higher yields.[13]

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[6] Kate Linebaugh, Henny Sender & Andrew Batson, *China Puts Cash to Work in Deal with Blackstone*, WALL ST. J., May 21, 2007, at 1.

[7] Michael J. de la Merced & Keith Bradsher, *Morgan Stanley Posts First Quarterly Loss, and Welcomes Chinese Investor*, INT'L HERALD TRIBUNE, Dec. 19, 2007,

[8] Nick Timiraos, *Will Overseas Funds Be a Juggernaut?*, WALL ST. J., Dec. 1, 2007.

[9] Lina Saigol & Chris Nuttal, *Abu Dhabi's Mubadala Poised to Buy Up 9% Stake in AMD*, FINANCIAL TIMES, November 16, 2007).

[10] Norma Cohen & Robert Anderson, *Exchange Rivalries Usher in a New Era*, FINANCIAL TIMES, Sept. 21, 2007.

[11] Paul Betts, John Burton & Andrew Hill, *Singapore's GIC Set to Steal More of the Limelight*, FINANCIAL TIMES, Dec. 12, 2007.

[12] U.S. Dept. of Treasury, Major Foreign Holders of Treasury Securities (Feb. 29, 2008), http://www.treas.gov/tic/mfh.txt.

[13] *See, e.g.*, *China Takes the Bank*, THE ECONOMIST, July 26, 2007.

As a general matter, SWFs, like other investment funds, have sought return on investment in the assets themselves, and thus far have not made (or through the application of existing regulations, have not been permitted to make) investments in the U.S. for strategic political purposes, such as the acquisition of a company for the purpose of acquiring sensitive technology or of securing for a sovereign access, and perhaps exclusive access, to particular commodities or products. SWFs have thus far refrained from political investments even in countries that do not have legislation comparable to the U.S.'s foreign acquisition regulations. However, a number of features associated with SWFs have raised serious concerns about their activities. While SWFs have existed for decades with little notice or impact, the profile of SWFs has increased markedly in recent years. SWFs are already a significant force in global capital markets. There are approximately 40 sovereign wealth funds in operation today, with 20 of the 40 formed since 2000, and 10 of these 20 formed since 2005.[14] Currently, all these SWFs control, by various estimates, two to three trillion in assets.[15] SWFs are also expected to increase significantly both in number and in the amount of assets under management. Estimates predict that by 2015 SWFs will control approximately $10-15 trillion in assets.[16]

The growth of SWFs in recent years is driven by several factors, all of which suggest a continuing increase in the economic importance of SWFs in the coming years. Standard Chartered, a UK bank that published an influential report on SWFs in 2007, notes that commodities price inflation has been important in the growth of SWFs.[17] Fourteen of the largest 20 funds depend on commodities (and particularly oil) as their main source of income.[18] An excess in foreign currency reserves has also led to growth in a number of SWFs, including China's CIC. China has reserved some $1.43 trillion; Standard Chartered speculates that China believes it needs only $1.1 trillion on reserve "to cope with any external shock",[19] and uses at least some of the excess to fund CIC.

[14] GERARD LYONS, STANDARD CHARTERED BANK, STATE CAPITALISM: THE RISE OF SOVEREIGN WEALTH FUNDS 4 (2007) [hereinafter STATE CAPITALISM].

[15] INTERNATIONAL MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT (2007); STATE CAPITALISM at 4.

[16] STATE CAPITALISM at 4.

[17] *Id.*

[18] *Id.*

[19] *Id*. at 5.

Thus, "[a]s reserves grow, it would be no surprise if additional amounts were used in stages to swell the size of China's SWF to, say, $600 billion within two years!"[20]

Additionally, SWFs will likely grow more quickly relative to other sovereign accounts such as foreign currency reserves simply because they will be invested more aggressively. Another factor that causes SWFs to grow more quickly relative to other sovereign accounts such as foreign currency reserves is that SWFs are invested more aggressively. While currency reserves are invested conservatively in order to insure the availability of funds (for currency stabilization purposes, for example), SWFs are typically designed for growth. The return on investment by SWFs varies widely, but Standard Chartered estimates an average annual return for 2006 at just under 20%.[21]

With the phenomenal growth of SWFs, each new SWF investment seems to raise calls for further regulation of SWFs. This paper, however, evaluates SWF regulation within the broader context of investor regulation and economic and political incentives acting on sovereigns in their role as shareholders, and argues that our current legal framework provides insulation against the negative potential of sovereign investment. However, SWFs remain tools of sovereigns that may act opportunistically in their own best interests. While the U.S. has the ability to protect its interests when SWFs purchase securities in U.S. firms, many other countries do not, and U.S. interests may be harmed through SWF activity outside its jurisdiction.

This paper proceeds as follows. In Part II, the paper defines and discusses the benefits of SWFs, then turns to the various problems they present to investees and host nations. Of particular importance is the potential use of SWF investments as political tools. SWFs also present unique regulatory questions for host nations.

In Part III, the focus shifts to the existing U.S. regulatory framework that works to mitigate many of the potentially negative effects of SWF investment, including possible political activities. The primary statutory protection within this framework is the Exon-Florio provision under the Defense Production Act of 1950, as recently modified through the Foreign Investment and National Security Act of 2007 (FINSA). The Exon-Florio provision is implemented by the Committee on Foreign Investment in the United

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[20] *Id.* at 6. Senator Everett Dirksen is attributed (perhaps apocryphally) the line, "A billion here, a billion there, pretty soon it adds up to real money." *See* The Dirksen Center, *"A Billion Here, A Billion There…"*, http://www.dirksencenter.org/print_emd_billionhere.htm (last visited Mar. 12, 2008). If that is true, what should we call the trillions flowing from SWFs?

[21] STATE CAPITALISM at 5.

States (CFIUS), an inter-agency committee that is chaired by the Secretary of Treasury. CFIUS attempts to balance commercial and security concerns "through thorough reviews that protect national security while maintaining the credibility of our open investment policy and preserving the confidence of foreign investors here and of U.S. investors abroad that they will not be subject to retaliatory discrimination."[22] However, the risk of politicization of the CFIUS process is a significant concern. Indeed, the risk of harmful political activities by SWFs is perhaps less likely than the risk of protectionist application of the CFIUS process; the politicization of the CFIUS process or additional regulations for SWFs will dissuade SWF investment in the United States, and will likely result in investments in competitor (and in some cases, less regulated) markets. Indeed, the risk that sovereigns will use SWFs for harmful political activities is perhaps less likely than the risk that the U.S. will dissuade SWF investment through protectionism or politicization in the CFIUS process or by increasing regulation of SWFs.

While this paper argues that existing regulatory, economic and political factors protect the United States against most of the potential threats posed by SWF activities, SWF investment in other markets may yet pose a danger to U.S. interests. For this reason, Part IV argues in support of a voluntary code of best practices that would serve to provide assurance that SWFs will invest apolitically in any market. In Part V the paper concludes.

II. SOVEREIGN WEALTH FUNDS: DEFINITIONS AND CONCERNS

A. *Defining and Contextualizing Sovereign Investments*

Sovereign wealth funds may be defined and categorized in various ways, but the central and common feature of all SWFs is, of course, their origin as investment vehicles established and controlled by a sovereign political entity. Categorization of SWFs is often based on purpose, investment intent, geographical region, or, most commonly, source of funds. SWFs are created for numerous purposes, including use as stabilization funds, endowment funds, pension reserve funds, development funds, or government holdings management funds. For purposes of this paper, I will use an expansive definition of sovereign wealth funds that includes endowment funds, pension reserve funds and holdings management funds, since these are the funds most likely to invest in global equity markets (while stabilization funds, by contrast, are designed primarily as a

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[22] *See* U.S. DEPT. OF THE TREASURY, COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES, http://www.ustreas.gov/offices/international-affairs/exon-florio/.

risk management device and thus tend to invest in more conservative instruments).[23] SWFs are also categorized based on the source of their funds. The first major category is made up of commodity funds created through commodity exports owned or taxed by the sovereign.[24] Primarily, this category is composed of petrodollar funds, including the funds of Norway, Russia, Kuwait, Qatar, and the Alaska Permanent Fund. A second category is composed of non-commodity funds that are established through transfers of assets from official foreign exchange reserves,[25] including Singapore[26] and China. China's CIC is the largest fund of this type.

In both cases, the funds are typically what might be called "recycling" funds. Funds flow into emerging or commodities-based economies, and for a variety of reasons including a relative scarcity of investment opportunities,[27] the funds held by the sovereign may be redeployed. Increasingly, these funds may be invested in developed nations as equity investments in public companies. Recycling cash flows back to the U.S. is viewed as a positive development; rather than funneling investment returns to fund enterprises in other countries, it allows some recapture of the capital.[28] While equity investments by SWFs raise serious political and economic concerns, the converse problem of no investment from these very wealthy funds may also pose serious long-term threats to sustained economic prosperity. Part of the concern with funds being deployed elsewhere is that there would be less transparency in these investments: deployed funds would not be subject to the type of reporting requirements that monitor publicly-traded entities in established markets.

The size and impact of sovereign wealth funds is best understood through comparison with other major investment vehicles such as traditional institutional funds

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[23] Andrew Rozanov, *Sovereign Wealth Funds: Defining Liabilities* (May 2007), *available at* http://www.ssga.com/library/esps/Soverign_Wealth_Funds_Andre_Rozanov_4.27.07rev2CCRI1182371372.pdf.

[24] *Id*.

[25] *Id*.

[26] STATE CAPITALISM at __.

[27] *China Takes the Bank*. *supra* note 13.

[28] McKinsey Global Institute, *The New Power Brokers: How Oil, Asia, Hedge Funds and Private Equity Are Shaping Global Markets*, 31, October 2007, http://www.mckinsey.com/mgi/publications/The_New_Power_Brokers/ (follow "Launch this report" hyperlink).

(including mutual funds), private equity funds, and hedge funds. Considering total assets under management, sovereign wealth fund assets are a fraction of the funds managed by institutional investors such as mutual funds and pensions, but outstrip private equity and hedge funds investments considerably.

[Insert CHART 1]

The following charts detail the ten largest funds of each type.

[Insert CHARTS 2-5]

Institutional investors such as pension funds and mutual funds are by far the largest players in established international capital markets. However, as noted by the U.S. Treasury, sovereign wealth funds as a whole are larger than either private equity funds or hedge funds, and according to the Treasury, "are set to grow at a much faster pace."[29] As noted above, there are only approximately 40-50 active SWFs, while there are hundreds of institutional investors, private equity funds and hedge funds. Across the market as a whole, the potential footprint of the largest SWFs is second only to the largest institutional funds, and far surpasses the largest hedge funds.[30] The largest SWF, the ADIA fund of the United Arab Emirates, is more than twice as large as the 10 largest hedge funds combined. If Saudi Arabia creates a fund, as it has indicated it might, its SWF will likely "dwarf" ADIA.[31]

B. *Benefits of Sovereign Investment*

Sovereign wealth fund investment has provided and will continue to provide both the sovereign investor and the host countries with a number of beneficial externalities beyond the issuer benefits provided through any specific investments. Significant SWF investment makes the investor nation a partner in the promoting the economic health of

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[29] Under Secretary for International Affairs David H. McCormick, Testimony before the Joint Economic Committee, Feb. 13, 2008, http://www.ustreas.gov/press/releases/hp823.htm.

[30] It is noted that institutional investors of various types may have very different investment strategies, and hedge funds and private equity funds may take larger stakes in companies than many institutional investors would seek. But, as noted above, in some cases SWFs tend to invest more like activist hedge funds (with large, influential stakes) than more passive institutional investors.

[31] Henny Sender, David Wighton & Sundeep Tucker, *Saudi Arabia Aims to Take Lead in Sovereign Wealth Fund Stakes*, FINANCIAL TIMES, Dec. 22, 2007.

the host country.[32] SWF investment may also lead to more open and better-functioning markets within the investor nation. For example, CIC's recent investments in U.S. enterprises may encourage Chinese reciprocity and provide U.S. firms an entry into China's developing markets.[33] Aligning enterprise interests with sovereign interests through SWF investment could also help in areas such as patent and copyright protection. A large investment by CIC in a major media company, for example, would perhaps incentivize China to protect intellectual property rights more effectively.

SWFs are also generally considered to be stable investors. As noted by Deputy Treasury Secretary Robert Kimmitt,

> SWFs are in principle long-term investors which typically do not deviate from their strategic asset allocations in the face of short-term volatility. They are not highly leveraged, and it is difficult to see how they could be forced by regulatory capital requirements or sudden investor withdrawals to liquidate their positions quickly. In this context, SWFs may be considered a force for financial stability—supplying liquidity to the markets, raising asset prices, and lowering buying yields in the countries in which they invest."[34]

C. *Concerns with Sovereign Investment*

Despite these benefits, however, much more attention has been given to the risks of SWF investment. Concerns over sovereign wealth funds are focused on the ways in which their activities may differ from those of other investors, and the ways in which host nations may be limited in their ability to regulate such activities.

1. Political Risk

The primary concern with SWFs is that because they are investment arms of a sovereign entity, a fund's investments may be used for political purposes. Securities &

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[32] This old idea was expressed more eloquently by Montesquieu: "Two nations who traffic with each other become reciprocally dependent; for if one has an interest in buying, the other has an interest in selling; and their union thus is founded on their mutual necessities." 20 BARON DE MONTESQUIEU, *Of the Spirit of Commerce, in* THE SPIRIT OF THE LAWS 316 (Thomas Nugent, trans., Hafner Publishing 1949).

[33] On the other hand, we might also worry that the power to grant market access to an enterprise might encourage rent-seeking by the sovereign, where access is conditioned on preferential treatment over other shareholders.

[34] Robert M. Kimmitt, *Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy*, FOREIGN AFF., Jan./Feb. 2008.

Exchange Commission Chairman Christopher Cox, in a representative comment, said that "[i]nvestors and regulators alike have to ask themselves whether government-controlled companies and investment funds will always direct their affairs in furtherance of investment returns, or rather will use business resources in the pursuit of other government interests."[35] Among these government interests might be the acquisition of sensitive technologies or expertise through, as an example, the purchase of a controlling stake in a company, or the acquisition of a major supplier of a limited natural resource. Economist Lawrence Summers asks "[w]hat about the day when a country joins some "coalition of the willing" and asks the U.S. president to support a tax break for a company in which it has invested? Or when a decision has to be made about whether to bail out a company, much of whose debt is held by an ally's central bank?"[36]

There are also more subtle and less directly-regulated ways in which a SWF may exercise political power. For example, a sovereign might direct a SWF to invest in a company in order to encourage the company (either as a condition to investment or perhaps as a shareholder) to build a manufacturing facility in the country in order to provide jobs, diversify the economy, and strengthen the country's tax base.[37] Perhaps more benignly, a sovereign might also direct SWFs to invest in companies that have created negative externalities or produced products the sovereign finds socially undesirable. Doing so could encourage corporate activities that lessen or eliminate such externalities, or lead to changes in products or modes of production; for example, a SWF could invest in an auto manufacturer in order to influence the automaker to produce vehicles using alternative automotive fuel sources, or could invest in a pharmaceutical company in order to encourage development of certain therapies. Or, a SWF may invest in companies that provide services to the sovereign as a way of recapturing or reducing some of the costs of such services. A sovereign with significant U.S. investments may also use its investment as a bargaining chip with the federal government; consider the Treasury or Federal Reserve Board faced with a threat by a sovereign that unless it adopts

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[35] Speech by Securities & Exchange Commission Chairman Christopher Cox, Keynote Address and Robert R. Glauber Lecture at the John F. Kennedy School of Government, Harvard University, Oct. 24, 2007, http://www.sec.gov/news/speech/2007/spch102407cc.htm.

[36] Lawrence Summers, *Funds that Shake Capitalist Logic*, FINANCIAL TIMES (July 29, 2007), *available at* http://www.ft.com/cms/s/2/bb8f50b8-3dcc-11dc-8f6a-0000779fd2ac.html.

[37] Assuming that such a transaction does not implicate a breach of fiduciary duties or violate antitrust laws, there is no reason why such a transaction could not benefit of the company, the SWF, and the sovereign and its citizens. The concern, however, is that the sovereign will use the SWF to the detriment of the company.

a certain policy, the sovereign's fund may withdraw its billions from U.S. companies.[38] In all these respects, SWFs differ from most other investors because they have the potential to be employed as political or economic tools rather than as investment instruments.

A more nebulous concern is the rise of state capitalism. Capital markets in the U.S. are dominated by private funds, operating under primarily federal government supervision but with limited governmental intervention. Some observers have questioned whether the existing regulatory structure can manage the activity of sovereigns in markets designed for transactions involving predominantly private actors. More generally, the increased involvement of political actors in U.S. capital markets also represents a possible shift from market capitalism to a state capitalism in which commercial motives are mixed with or displaced by political motives. Chairman Cox outlines this concern:

> If the distinction between government and private activity in our capital markets is increasingly blurred, is there a point at which the entire financial activity we today call a free market stops being precisely that, and morphs into something else? The presumption that markets comprise chiefly the activity of private economic actors is embedded within the DNA of the SEC. When the Securities and Exchange Commission was created in 1934, its purpose was to serve as an independent regulator of the profit-seeking activity of self-interested individuals and firms in the securities markets. It was not, however, to supplant the market or directly participate in it. . . . The clear separation between the public sphere of government and the private character of the economy stems also from the Constitution itself. Among its most fundamental features are its explicit guarantees for private property. Our Constitution has enshrined the right to property in repeated and specific guarantees to the individual, which are simultaneously denied to a central government whose powers are enumerated and strictly limited. This legal arrangement, in turn, reflects the presumptions of the culture and legal traditions from which our Constitution arose.[39]

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[38] While such a scenario may not be likely, note that a SWF, as an entity without fiduciaries and without competitors for funds, may not be as sensitive to the losses it would inevitably take by withdrawing funds in a short time through market transactions.

[39] Speech by Securities & Exchange Commission Chairman Christopher Cox, Gauer Distinguished Lecture in Law and Policy at the American Enterprise Institute Legal Center for the Public Interest, Dec. 5, 2007, http://www.sec.gov/news/speech/2007/spch120507cc.htm.

A similar concern was expressed by management scholar Jeffrey Garten, who argues that the rise of state capitalism demonstrates "government efforts to reassert control over their economies and to use this to enhance their global influence . . . While prudent regulation in certain areas is justified, the new zeitgeist is likely to produce too much government intervention, too fast. We can expect less productivity, less innovation and less growth, since governments have many goals that the private sector does not." [40] A limited number of minority positions in publicly-traded companies are not likely to have a large effect on the balance of power between public and private control of the markets, but the challenge even for smaller SWF investments will be to create incentives so that public actors invest and vote proxies like private actors.

Because of the size of its economy and its geopolitical footprint, of particular concern to policy-makers is whether the China will be a political investor. China, unlike many countries whose economies are based on petrodollars, may be less dependent on the financial success of the SWFs investment activities. Many petrodollar funds may be attempting to diversify in order to be able to maintain social programs after their petroleum resources no longer provide significant income. China, on the other hand, has a rapidly growing economy that is not dependent on a single resource or industry. China may use funds less conservatively, which creates a heightened concern that they may use their funds for political purposes.

2. Economic and Regulatory Risks

SWFs are increasingly important actors in markets that were not expressly designed with regulations for their participation. Although markets hope that SWFs invest and behave like other investors, the SEC chair and some staff[41] have expressed concern that the SEC may not be able to regulate SWFs as it does other investors. In a speech on the impact of sovereign wealth funds, Chairman Cox stated that:

> Neither international law nor the Foreign Sovereign Immunities Act renders these funds immune from the jurisdiction of U.S. courts in connection with their commercial activity conducted in the United States. But a discussion between the SEC and a foreign government might be

[40] Jeffrey Garten, *The Unsettling Zeitgeist of State Capitalism*, FINANCIAL TIMES, Jan. 15, 2008, at 11.

[41] Linda Chatman Thomsen, Director, Division of Enforcement U.S. Securities & Exchange Commission, Testimony Concerning Sovereign Wealth Funds and Public Disclosure Before the U.S.-China Economic and Security Review Commission, Feb. 7, 2008, http://www.sec.gov/news/testimony/2008/ts020708lct.htm.

> quite different if, instead of seeking cooperation in an enforcement matter in which we were mutually interested, the SEC were pressing claims of insider trading against that very government. . . When a foreign private issuer is suspected of violating U.S. securities laws, our experience working with our overseas regulatory counterparts indicates that we could almost always expect the full support of the foreign government in investigating the matter. But if the same government from whom we sought assistance were also the controlling person behind the entity under investigation, a considerable conflict of interest would arise.[42]

Like many hedge funds and private equity funds, SWFs are, as a group, less transparent relative to more regulated institutional investors such as pension funds and mutual funds. Only a few SWFs publish information on their size, returns, composition of their portfolios, investment objectives, and proxy voting policies. For many SWFs, transparency with respect to investment objectives is limited to statements to the press that the fund's objective is a high return on investment,[43] or, in other words, that the SWF does not have any political motive for the investment. However, even where an investment position is clearly disclosed, the SWF may later decide to alter its objectives concerning a particular investment in pursuit of a political goal. If it does, what should or could be the response of the portfolio company's country of domicile? Additionally, some commentators worry that SWFs may create unique systemic risks. While SWFs may provide needed capital for our markets, they often take large stock positions (in terms of investment value, although typically not in terms of voting power). Large inflows of capital may inflate assets prices. Further, SWFs could cause significant turmoil if, for reasons of national exigency, a SWF must liquidate its positions.

Another concern with SWF size and influence is the potential for abuse of informational disparities. Sovereign wealth funds have particular informational advantages that may not be available to other investors, or, in some cases, even to company insiders. For example, a SWF may receive knowledge of a pending action against a corporation through government channels. Or, the sovereign could be in the position to bring an action against the competitors of one of its investments. Chairman Cox raised the specter of government power being "no longer used solely to police the securities markets at arm's length, but rather ... to ensure the success of the government's

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[42] Cox, *supra* note 35.

[43] *See, e.g,* Steven Weisman, *China Tries to Reassure U.S. About Its Investing Plans*, The NEW YORK TIMES, Feb. 1, 2008.

commercial or investment activities."[44] He suggests the possibility of a world in which governments use "the vast amounts of covert information collection that are available through their national intelligence services"[45] in trading and other market activities, to the disadvantage of private investors.

Using an argument that has been raised in defense of insider trading rules generally, Cox argues that “[i]f ordinary investors—an estimated 100 million retail customers who own more than $10 trillion in equities and stock funds in U.S. markets—come to believe that they are at an informational disadvantage, confidence in our capital markets could collapse, and along with it, the market itself.”[46] So long as sovereigns are using their funds for wealth creation rather than other purposes, such activities would seem to be against their own interests as diversified investors. Again, however, to the extent that sovereigns do engage in manipulative activities, the SEC may be in the difficult position of bringing an action against the SWF and its managers.

Courts may also have difficulty in accommodating SWFs. Because of their diversified investments and relatively large financial stakes in individual companies, SWFs will inevitably invest in companies that will face lawsuits as a result of securities fraud. Under the application of the Private Securities Litigation Reform Act (PSLRA),[47] the presumptive lead plaintiff will be the shareholder with the greatest loss;[48] however, a judge might want to exclude the SWF because of the SWF would arguably not meet the “typicality” requirement of Federal Rule of Civil Procedure 23(a)(3).[49] Should SWFs be considered typical investors under FRCP 23(a)(3)? Consider that competing plaintiffs may challenge the adequacy of the SWF as lead plaintiff and ask for discovery into the

[44] Cox, *supra* note 35.

[45] *Id*.

[46] *Id*.

[47] Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in 15 U.S.C.) (amending Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77z-1 (2000)) and Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78u to -4 (2008))).

[48] *See id*. at sec. 101(a), § 27(a) (amending 15 U.S.C. §§ 77z-1(a)(3)), 101(b), 27D(a) (amending 15 U.S.C. § 78u-4(a)(3)).

[49] FED. R. CIV. P. 23(a)(3).

business of the SWF,[50] which will likely be uncomfortable for many SWFs that might otherwise prefer to serve as lead plaintiff.

III. REGULATION OF SOVEREIGN WEALTH FUNDS

Against this substantial list of the major risks and concerns with SWF investments, this section attempts to address whether our regulatory structures are sufficiently robust to manage such risks. Despite the magnitude of these concerns, an existing framework of federal and state laws, along with crucial political and economic factors, eliminates or mitigates many of the risks.

A. *Political and Economic Factors*

To date, SWFs have generally avoided political activities. In part, this is due to regulatory restraints imposed by host countries. In the U.S., investments that involve sensitive technologies, vital commodities and resources, and other issues that might affect national security are regulated through the vetting process of the Committee on Foreign Investment in the United States ("CFIUS"). A number of other developed economies, including EU economies, have enacted or are considering similar legislation.[51] The significant attention created by SWF investment activities has thus far forced SWFs to invest modestly, and, in some cases, accept conditions to investment that insure that the SWFs remain passive investors. For example, as a condition to its $7.5 billion investment in Citigroup, Abu Dhabi's SWF agreed "not to own more than a 4.9% stake in Citi, and will have no special rights of ownership or control and no role in the management or governance of Citi, including no right to designate a member of the Citi Board of Directors."[52] Indeed, it has been suggested that following a few unofficial rules of investment, largely focused on eliminating the potential for political mischief by either the SWF or the host country, will help SWFs avoid suspicion. Some SWFs are already learning to play by certain rules in order to avoid scrutiny by CFIUS. For example, a reporter observed that SWFs: "buy small stakes, not entire companies; emphasize that board membership, or other control, is not in the game plan; consult in advance with

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[50] James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587 (2006).

[51] Carter Dougherty & Stephen Castle, *EU Warns Against Overreaction on Sovereign Wealth Funds*, INT'L HERALD TRIB., Feb. 25, 2008.

[52] Press Release, Citigroup, Inc., Citi to Sell $7.5 Billion of Equity Units to the Abu Dhabi Investment Authority (Nov. 26, 2007), *available at* http://www.citigroup.com/citigroup/press/2007/071126j.htm.

federal agencies and elected officials likely to be sensitive; and avoid certain sectors, such as energy or government contracting—though if the stake is small enough, it may not be an issue."[53] The voluntary adoption of such policies in recent transactions has helped SWFs avoid some of the missteps of the DP World and CNOOC transactions (discussed in Part III.C, *infra*), that resulted in heightened scrutiny of foreign investment.

There are a number of economic factors that also limit the likelihood that SWF will be used as a political tool. First, there is some evidence that prior attempts at state capitalism through mixed-motive investment—political motivations combined with commercial intentions—have resulted in relatively poor performance. Assessing the economic impact of political investments is not always straight-forward; it may not be possible to evaluate the return on a strategic investment to acquire military technology that may not produce a viable weapon for years and may never be used in an actual conflict, nor is it easy to quantify an investment that is ultimately designed to bolster national pride. However, a conventional assessment of publicly versus privately managed funds shows that private funds fare significantly better and that more political funds tend to fare more poorly;[54] studies of government-managed investment in the 1980s indicates that governments are not more successful at allocating capital than private enterprise, especially when the investment decisions are based at least in part on political objectives.[55]

Another economic factor that limits political activities is that SWFs are widely diversified investors with a limited economic interest in each investment. SWFs are diversified as a result of their size and their deliberate efforts to limit suspicion. However, a decision to engage in political activities with respect to just one such investment would create a cascade of protectionist responses to many if not all of the SWFs existing or planned investments. Most SWFs engage in transactions designed to

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[53] Associated Press, *Foreign Investors Are Taking a Lower Profile, Other Steps to Avoid Political Resistance* (November 28, 2007), http://www.ap.org (Archive Search for "Foreign Investors Are Taking a Lower Profile, Other Steps to Avoid Political Resistance").

[54] Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993). *But see* Annika Sundén & Alicia H. Munnell, *Investment Practices of State and Local Pension Plans, in* THE NEXT CHALLENGE: PENSIONS IN THE PUBLIC SECTOR (The Pension Research Council and University of Pennsylvania Press 1999).

[55] Romano, *supra* note 56.

fall outside CFIUS jurisdiction by limiting their investments to a non-controlling stake.[56] Even SWF investments that do not fall under CFIUS jurisdiction initially, however, may trigger jurisdiction if the SWF directs or perhaps even influences the company to act in a political manner. During the review of the SWF's activities, CFIUS may exercise its broad remedial powers to freeze or unwind a SWF's investment, and would likely scrutinize the SWF's other U.S. investments to determine whether it has attempted similar political activities with other companies. Viewed from this perspective, the size and diversification of SWFs suggests that SWFs would be economically foolish to engage in political activities; SWFs should seek to avoid the uncertainty and potentially huge burdens that would result from a deviation from a default investment posture.

Finally, and most significantly, if SWFs did engage in political activities, perhaps against economic interests, the SWF also risks a political response. While some countries may not possess the economic or political power to defend their interests against more powerful nations, the U.S. is not in such a position. Even in the best case, political uses of SWFs would trigger extensive political and economic negotiations and a deterioration of the relationship between the U.S. and the sovereign. A more likely U.S. result, given political suspicion of SWF activity, is a harsh protectionist response that would create economic strain for all parties. While SWFs have yet to act or been made to act politically, they operate under unique scrutiny. The suspicion surrounding SWFs will likely cause SWFs to act hyper-cautiously. For example, unlike other investors not operating under political suspicion, SWFs may fear that suggesting cost-cutting measures could be viewed as a politically-motivated effort to encourage outsourcing (perhaps to the SWFs home country). Because of fears that the SWF will be used as a political tool of the state, the SWF must consider the potential political effect of any action or statement it or the sovereign makes regarding its investments.

B. *State Corporate Laws*

While SWF investments are a relatively novel problem for politicians and regulators, state laws have long dealt with the basic concern presented by SWFs: the potential divergence of interests among shareholders. This problem is regulated or mitigated through a variety of protections. First, U.S. corporate law (despite the trend of recent years) still provides meager power to shareholders. Shareholders are entitled to elect, though generally not select, nominees for the board of directors; shareholders are also entitled to vote on certain major corporate transactions and events; shareholders may

[56] Transactions that are reviewed and approved by CFIUS are typically more secure for SWFs because CFIUS is limited by statute in its review of activities post-approval. Generally, investigations of SWF investments can be reopened only if a mitigation agreement is breached.

also, in limited circumstances, put forward proposals to be included on the company's annual proxy statement. The exercise of voting rights by SWFs in such instances gives no cause for alarm, since SWF investment will almost exclusively result in minority ownership of the corporation and correspondingly limited voting power, and will generally not include the right to representative directors.

Second, the duty of loyalty owed to the company and the shareholders by managers and directors provides some protection against the use of SWFs as a political tool. Absent self-dealing on the part of management or directors, it is difficult to imagine a company pursuing a transaction that would privilege SWFs or their sovereign sponsors at the expense of other shareholders. On the other hand, if the SWF were a controlling shareholder or management or directors were receiving some benefit from a transaction that favored the SWF or sponsoring sovereign at the expense of pother shareholders,[57] the transaction would be voidable under state law unless approved by a majority of disinterested directors, disinterested shareholders, or was found to be fair to the corporation and other shareholders.[58]

Finally, even in the unlikely event that a SWF were permitted to place representative directors on the board, state corporate law holds that the duties of directors run to the corporation and the stockholders as a whole, and not to the entity that by contract or voting power placed the director on the board.[59] Directors owe a duty of care, which typically requires them to manage the affairs of the company in accordance with a

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[57] Besides a state law claim, such a transaction risks Internal Revenue Service scrutiny. A transaction favoring certain stockholders over others may be deemed a constructive dividend, and the corporation would lose the ability to claim it as an expense. *See* JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION § 38 (1997).

[58] *See, e.g.,* DEL. CODE ANN. tit. 8, § 144 (2008); MODEL BUS. CORP. ACT § 8.60 [hereinafter MBCA].

[59] For a discussion of this principle, see R. FRANKLIN BALOTTI & JESSE FINKLESTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 4.38(B) (3d ed.). Note, however, that directors representing minority shareholders face penalties for a breach of fiduciary duties, there is no *respondeat superior* liability for the SWF or the sovereign as there would be for directors of a controlling shareholder.

Note also that if a SWF were able to place a director on the board, CFIUS would likely have jurisdiction and the SWF would likely be required to sign a mitigation agreement (as discussed in Part __, *infra*) that would provide another level of protection against political or mixed-motive decision-making by the SWF and the board.

"prudent man" standard,[60] and a duty of loyalty, which requires them to manage the interest of the company in good faith and in the best interests of the corporation and its stockholders.[61] These fiduciary duties place a liability constraint around SWF-appointed director decision-making. Any decision that would place the interests of the SWF or the sovereign at odds with the rest of the shareholders would require disclosure of the adverse interest of the SWF or sovereign, recusal of the SWF-appointee from the deciding vote, and approval of the decision by a majority of disinterested directors, all of which have fiduciary duties to the corporation and its shareholders.

A more problematic aspect of SWF-appointed directors is that the appointee-directors may pass confidential corporate information to their clients either for use in trading or for political purposes. In both cases, however, existing state statutes and case law police such behavior, and *ex ante* protections could also reduce the risk of violations and misuse of corporate information. Confidential information could not be passed to a sovereign without violating the duty of loyalty; *ex ante*, reasonable boards would be careful to limit the possibility of disclosure by asking that the appointee recuse himself or herself from the discussions. And while federal insider trading laws impose penalties for trading on material, non-public information, the company could also adopt *ex ante* protections. For instance, to mitigate the risk of insider trading and potential difficulties in prosecuting a SWF or a sovereign, the company should adopt an insider trading policy that would prohibit trades by the appointee, SWF or other entity of the sovereign during "blackout" periods.

C. *Federal Regulation*

The regulatory responses to SWF investment by host countries typically have at least one major common feature: the restriction of SWFs to investment activity, rather than political activity. U.S. regulations are typical in this respect. However, concern over political activities must be balanced against protectionism that could ultimately harm U.S. markets and companies. To balance these concerns, two general principles should govern domestic regulation of SWFs. First, SWFs should be allowed fair, non-discriminatory access to U.S. markets. Second, U.S. regulators and markets must have the ability to quickly check political behavior by SWFs. The U.S. must have an open-door policy with respect to its markets, but insure fair but effective regulation for all participants. With some limited exceptions, existing regulations meet these criteria.

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[60] *See, e.g.*, MBCA § 8.30(b).

[61] *See, e.g.*, MBCA § 8.30(a).

1. Securities Regulation

Outside of CFIUS, the most important federal regulations for SWFs are the SEC's disclosure rules under Section 13(d) of the Exchange Act. The SEC's Exchange Act Rule 13D sets out a tripartite disclosure system for disclosure by shareholders. For a shareholder holding less than 5% of the company's outstanding stock, no disclosures are required by the shareholder. The 5% threshold of 13D explains the levels of investment of SWFs, which have been and will almost certainly continue to be in amounts below the 5% level.[62] For passive investors, defined under Rule 13D as persons not seeking to acquire or influence control of the issuer and who own less than 20% of an issuer's outstanding securities,[63] SEC rules mandate a short-form disclosure of identifying information and require certification that "the securities . . . were not acquired and are not held for the purpose of or with the effect of changing or influencing the control of the issuer of the securities and were not acquired and are not held in connection with or as a participant in any transaction having that purpose or effect."[64]

For investors owning more than 5% and not eligible for Schedule 13G, Schedule 13D requires more detailed disclosures by the investor including, among other things, a discussion of "the purpose or purposes of the acquisition of securities."[65] The SEC requirements thus encourage investment under levels that would trigger disclosure requirements. A reasonable reading of the statute would require some of the transparency that SWFs have been asked to provide: SWFs with significant investments that have designs on control would be required to disclose any purposes for the investment, including political purposes, which, as discussed below, should trigger review by CFIUS. It is possible, of course, that a SWF would not disclose political intentions, but nevertheless use its investment for political purposes. Such activity could bring SEC enforcement action, but more importantly would bring heightened political and regulatory scrutiny of all the SWFs investments in the U.S. and probably in every other

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[62] As with Al-waleed bin Talal,the Saudi prince who holds nearly 5% of Citigroup, an investor holding less than 5% may have a significant impact on the governance of a company; however, this is the exception rather than the rule. Prince Al-waleed's influence may be justified by his consistent investment focus over the course of a long investment relationship with Citigroup.

[63] *See* Securities Exchange Act Release No. 34-39538, http://www.sec.gov/rules/final/34-39538.txt.

[64] *See* Schedule 13G, Item 10 (2008).

[65] *See*17 C.F.R. § 240.13d-101,Item 4 (2008).

jurisdiction in which the SWF has invested. Again, for diversified SWFs, the costs of political activity would seem to far outweigh any potential benefits.

2. Committee on Foreign Investment in the United States

The primary federal protection against political use of SWF investments is CFIUS. The CFIUS process in its current form was set out in FINSA, enacted on July 26, 2007. FINSA amended the Exon-Florio process which covers national security review of foreign investments in US entities. The review process is managed by a committee that includes the Secretaries of the Treasury, Homeland Security, Commerce, Defense, State, Energy, Labor,[66] and the Director of National Intelligence and the Attorney General (collectively, the Committee on Foreign Investment in the United States, or “CFIUS”). The FINSA amendments are the result of the controversy arising from CNOOC’s bid for Unocal and the Dubai Ports World deal. A number of “highly intrusive and restrictive”[67] bills were introduced, but after negotiations Congress, the administration and the business community settled on, in the faint praise of a leading law firm, the “’least bad’ option in an environment where some form of legislative overhaul seemed inevitable.”[68]

The CFIUS process governs “any merger, acquisition or takeover that is proposed . . . by or with any foreign person which could result in foreign control of any person engaged in interstate commerce in the United States,”[69] and focuses on investments that may have a security impact on “critical infrastructure.” Currently, CFIUS defines "control" as "the power, direct or indirect, whether or not exercised, and whether or not exercised or exercisable through the ownership of a majority or a dominant minority of the total outstanding voting securities of an issuer, or by proxy voting, contractual arrangements or other means, to determine, direct or decide matters affecting an entity . . . ."[70] Under the CFIUS process, parties to a covered transaction typically file a voluntary notice, often even when it appears that the transaction does not involve a controlling ownership. After notice is received, CFIUS undertakes a 30-day

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[66] The Secretary of Labor is a nonvoting, ex-officio member. 50 U.S.C.S. app. § 2170(a).

[67] Christopher F. Corr, *US Tightens the Screws on Foreign Investors*, July 26, 2007, http://www.whitecase.com/alert_internationaltrade_0707/.

[68] *Id.*

[69] 50 U.S.C.S. app. § 2170(a)(3) (LexisNexis 2008).

[70] 31 C.F.R. § 800.204 (2008).

"National Security Review".[71] Following this review, CFIUS may either allow the transaction to proceed, or may undertake a second, 45-day "National Security Investigation."[72] Certain transactions, however, automatically require the second-stage review, including "foreign government-controlled transactions", which are defined as transactions that "could result in the control of any person engaged in interstate commerce in the United States by a foreign government or an entity controlled or acting on behalf of a foreign government."[73] An exception to this requirement is a finding by senior CFIUS officials that, after review, the transaction will not impair the national security of the United States.[74] CFIUS officials have also developed a practice (though not a rule) of not formally investigating deals involving the acquisition of less than 10%[75] of the company's outstanding stock, provided the acquisition does not bring with it the incidents of control for the investor, such as a seat on the board of directors.

CFIUS, especially after the FINSA amendments, conditions its approval of SWF investments on the signing of "mitigation agreements" that interested government agencies broker between purchasers and sellers. Mitigation agreements may require special security agreements, board resolutions, and proxy and voting agreements. Often these agreements require that the acquiring firm sell certain assets or refrain from exporting certain technologies. In the case of a SWF, a mitigation agreement involving a minority SWF shareholder could reasonably stipulate that the SWF remain a passive shareholder, and prohibit the SWF shareholder from seeking a seat the board of directors. In practice however, SWF investors by design invest in amounts that do not compel investigation by CFIUS. Further, passive investment terms are set by the issuer and the SWF so that the risk of political involvement—not only by the SWF but by U.S. government agencies or members of Congress—is minimized.

The FINSA amendments of 2007 attempt to chart a moderate course with respect to sovereign investment concerns. Some commentators and politicians have expressed

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[71] 50 U.S.C.S. app. § 2170(b)(1) (LexisNexis 2008).

[72] 50 U.S.C.S. app. § 2170(b)(2) (LexisNexis 2008).

[73] 50 U.S.C.S. app. § 2170(a)(4) (LexisNexis 2008).

[74] 50 U.S.C.S. app. § 2170(b)(2)(D) (LexisNexis 2008).

[75] The 10% threshold is not a bright line, but merely a rule of thumb; CFIUS looks at "functional" control. 31 C.F.R. § 800.702 (Appendix to Part 800—Preamble to Regulations on Mergers, Acquisitions, and Takeovers by Foreign Persons). Incidents of control could come at lower levels of ownership than 10%, especially where there is a limited public float of common stock.

concerns that the CFIUS process does not provide sufficient protection. For example, Senator Evan Bayh argues that shareholders such as Prince Al-waleed bin Talal may exercise influence over a company even though they own less than 5% of the outstanding stock of the company. Such transactions may not come within the scope of CFIUS review because they do not involve a controlling stake. However, CFIUS still retains the ability to initiate a review even though it did not earlier conduct a formal 30-day review/45-day investigation. For example, if a SWF that did not acquire control initially later attempts to acquire and exercise control, CFIUS may begin an investigation and suspend or void any politically motivated transactions.

A SWF may use its investment in a political manner yet still fall outside of the control test that defines CFIUS jurisdiction; however, there seems to be little that a SWF could do that would fall outside of legitimate investment activity and yet fail to trigger CFIUS review because CFIUS defines control broadly as the ability to "determine, direct or decide matters affecting an entity." The mere exercise of voting rights could not enable the SWF to direct the company to reveal sensitive technologies or to invest in the sponsoring sovereign, for example. The SWF would require control to force such transactions, and the act of attempting to acquire control would trigger CFIUS review. But outside of CFIUS' jurisdiction, within the murkier sphere of shareholder influence, protection against political activity decreases. Still, even though CFIUS would no longer apply, other factors would work against political activity so that SWFs should not possess influence greater than other shareholders. Suppose again that a sovereign wishes to pressure a company in its SWF's portfolio to build a factory in one of the sovereign's poorer regions. If the transaction is fair to the company and its shareholders, perhaps the company will agree. But why would a minority ownership by a SWF suggest that the company and sovereign would not negotiate at arms' length? Put another way, what pressure could the sovereign apply that would not create serious political and economic consequences for the sovereign and its SWF? It could not, for example, threaten to foreclose opportunities to the company to do business in the country without having such a decision characterized as politically motivated. Likewise, it could not threaten to sell its shares without a similar result.[76] Even where CFIUS does not reach, other laws,

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[76] Although such subtle pressures would not always be apparent to regulators because they would occur though non-public channels, sovereigns would face the risk that companies would reveal such pressures. Most companies have welcomed SWF investment under the assumption that SWFs are long-term, low-maintenance investors. If SWFs change the rules, it seems unlikely that companies would play along, especially where doing so runs the risk of derivative lawsuits from other shareholders.

economic realties, and political consequences provide assurance against political use of SWFs.

a. Concerns with the CFIUS Process

There remain a number of concerns with the CFIUS process, however, which suggest that the risk of heavy-handed application of CFIUS is greater than the risk of political exploitation of SWFs by sponsoring sovereigns. First, even for transactions that are not reviewed, CFIUS adds significant transaction costs to any significant SWF transaction involving a U.S. entity. Aside from the added costs to the SWF and issuer of legal advisors that help the parties navigate the CFIUS process, CFIUS also creates potentially costly delays if the transaction is reviewed. By requiring officials to affirmatively sign off on a decision not to investigate, FINSA creates pressure to investigate, which will undoubtedly increase the average time for review of SWF deals.[77]

The CFIUS process also raises the possibility of political mischief. The FINSA amendments to the CFIUS process created broad and arguably political tests that may not be directly related to the transaction itself, and which may result in transaction approval being tied to political concerns. For example, CFIUS is required to consider (A) the adherence of the SWF's subject country to nonproliferation control regimes,[78] (B) the relationship of such country with the United States, specifically on its record on cooperating in counter-terrorism efforts;[79] and (C) the potential for transshipment or diversion of technologies with military applications, including an analysis of national export control laws and regulations.[80]

Politicization of the CFIUS process can also result from both private and governmental activities outside of CFIUS. Prior to the FINSA amendments, private parties repeatedly used the CFIUS process to achieve private gains.[81] In 1990, for example, British Tire and Rubber (BTR) attempted a hostile takeover of Massachusetts-based Norton Company. 64% of Norton's shareholders approved the $75-per-share offer.

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[77] Corr, *supra* note 67.

[78] 50 U.S.C.S. app. § 2170(f)(9)(A) (LexisNexis 2008).

[79] 50 U.S.C.S. app. § 2170(f)(9)(B) (LexisNexis 2008).

[80] 50 U.S.C.S. app. § 2170(f)(9)(C) (LexisNexis 2008).

[81] For a more detailed discussion of these transactions, see U.S. NATIONAL SECURITY AND FOREIGN DIRECT INVESTMENT, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS 123-141 (2007).

[82] However, the deal offered little protection for Norton employees, and a coalition established by Norton employees collected 8,300 signatures in opposition to the transaction and placed an ad in the Wall Street Journal. Soon after, the legislature of the Commonwealth of Massachusetts passed a bill blocking BTR from replacing the Norton board at the company's annual meeting. 119 members of Congress then wrote a letter to the president asking for an investigation into the transaction, and stating that BTR's acquisition of Norton would not be "in our economic security or national interest."[83] However, another foreign company, French conglomerate Saint-Gobain, stepped in to make a $90-per-share offer. Norton was more pleased with this offer, and similar objections on economic and national security grounds were not raised. As commentators noted, "It is hard to imagine how a British acquisition of Norton raised national security issues while a French acquisition did not. There were no national security issues with the proposed British acquisition; Norton simply did not want to be acquired by BTR, and used a political campaign toward CFIUS to prevent it."[84]

In 2000, a Dutch company, ASML Holding N.V., made a bid to purchase Silicon Valley Group (SVG), a semiconductor manufacturer. Both ASML and SVG filed with CFIUS in February 2001. The Pentagon was opposed to the transaction because an SVG subsidiary, Tinsley Laboratories, manufactured equipment used in spy satellites.[85] As a condition to CFIUS approval, ASML was prepared to agree to mitigation that would require Tinsley to make its products available to the Pentagon, and would prohibit transfer of Tinsley's technology out of the U.S.[86] The parties believed that CFIUS would approve a transaction on these terms, and that the deal would go through at the end of the 30-day CFIUS initial review. However, another company with competing interests in SVG, Ultratech Stepper, engaged lobbyists to block the transaction. The lobbyists and the U.S. Business and Industrial Council, which received contributions from Ultratech, sent fact sheets and other materials to hundreds of members of Congress in opposition to the transaction. The Pentagon and Congressional opponents of the merger then

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[82] *Saint-Gobain Offers Friendly Merger to Norton*, CERAMIC INDUSTRY, June 1, 1990.

[83] EDWARD M. GRAHAM & DAVID M. MARCHICK, U.S. NATIONAL SECURITY AND FOREIGN DIRECT INVESTMENT 124 (2006).

[84] *Id.*

[85] Glenn Simpson, *Pentagon Moves to Postpone Dutch Deal for Silicon Valley Group*, WALL ST. J., Mar. 8, 2001, at B6.

[86] Peter Spiegel, *Rival Accused After Security Fears Block High-Tech Sale*, FINANCIAL TIMES, Mar. 9, 2001, at 12.

succeeded in pushing the deal to the 45-day investigation stage. Although the deal ultimately went through,[87] ASML was forced to accept a more demanding mitigation agreement, requiring ASML to maintain certain research and development within the United States and to attempt to sell Tinsley Laboratories within six months.[88]

In 2002, ST Telemedia, the second largest telecom in Singapore, offered $250 million for a 61.5 percent stake in Global Crossing. Carl Icahn was also interested in acquiring Global Crossing, and XO Communications, a company chaired by Icahn, sent a letter to Federal Communication Commission requesting that the FCC delay its review of the transaction "to ensure that all interested parties have ample opportunity to assess the public interest implications of the ST Telemedia takeover of Global Crossing by extending the comment cycle in this proceeding until the DOJ and CFIUS have concluded their review."[89] According to an attorney involved in the representation of Global Crossing, Icahn encouraged Congressional opposition to the transaction. Arguing that the transaction was unlikely to pass CFIUS review, Icahn sued to block the transaction and force an auction of bankrupt Global Crossing.[90]

The potential for the politicization of CFIUS is also seen in two recent deals, involving not SWFs but state-owned companies, that catalyzed the FINSA amendments. In June 2005, China National Offshore Oil Company Ltd. (CNOOC), a state-controlled company, made an unsolicited, all-cash, $18.5 billion bid for Unocal Oil Company. The bid followed an accepted $16.5 billion bid in cash and stock by Chevron. The bid

[87] Lobbying for the deal by Intel's Chairman Andy Grove and CEO Craig Barrett helped it gain approval. Grove and Barrett argued that Intel depended on SVG components, that SVG's financial health was in jeopardy, and that ASML would provide SVG with financial stability. Mark LaPedus, *Who loses if Bush blocks ASML-SVG merger? ASML, SVG, and Intel*, EE TIMES, May 2, 2001, http://www.eetimes.com/news/semi/showArticle.jhtml?articleID=10808232.

[88] George Leopold, *U.S. companies line up to buy Tinsley from ASML*, EE TIMES, May 4, 2001, http://www.eetimes.com/showArticle.jhtml?articleID=18305849.

[89] Letter from Brian D. Oliver, Executive Vice President, Strategy and Corporate Development, XO Communications, to Marlene H. Dortch, Secretary, Federal Communications Commission (June 12, 2003), *available at* http://sec.edgar-online.com/2003/06/13/0000950133-03-002164/Section7.asp.

[90] U.S. NATIONAL SECURITY AND FOREIGN DIRECT INVESTMENT, *supra* note 81, at 124 (author David Marchick, then an attorney with Covington & Burling, represented Global Crossing in the transaction).

expectedly raised political concerns.[91] In July, the US House of Representatives voted 398-15[92] for a resolution asking President Bush to block the transaction as a threat to national security. Chevron then sweetened its bid to approximately $17 billion. Unocal asked CNOOC to sweeten its bid to compensate for the inevitable delays as the Bush administration conducted a lengthy review of the acquisition. CNOOC declined to increase its offer unless Unocal agreed to pay the costs of terminating the Chevron transaction and "lobby for the deal in the US Congress."[93] Unocal declined, and CNOOC withdrew its bid.

The second contentious sale occurred with the 2006 takeover of Peninsular and Oriental Steam Navigation Company (P&O), a UK firm, by Dubai Ports World (DP World). Following the takeover, DP World would assume P&O's agreements to manage a number of major U.S. port facilities. In late 2005, DP World approached CFIUS to discuss the transaction. In February 2006, P&O's stockholders approved the transaction, and CFIUS reviewed the transaction and approved the assumption of the port agreements.

Details of the DP World deal soon appeared in the financial press and shortly after became a national press news story as New York Senator Chuck Schumer criticized CFIUS approval of the transaction.[94] He was joined by a bipartisan Congressional coalition that called for a second review of the transaction and possible legislative action to stop or unwind the deal.[95] President Bush threatened to veto any such legislation,

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[91] China's Xinhua News Agency characterized the opposition as "unexpected", and CNOOC complained that "[t]he unprecedented political opposition that followed the announcement of our proposed transaction . . . was regrettable and unjustified." Xinhua News Agency, *CNOOC Withdraws Unocal Bid*, Aug. 3, 2005, http://www.china.org.cn/english/2005/Aug/137165.htm.

[92] H.R. Res. 344, 109th Cong. (2005), *available at* http://thomas.loc.gov/cgi-bin/bdquery/z?d109:h.res.00344: (Follow "Text of Legislation" hyperlink).

[93] Xinhua News Agency, *supra* note 91.

[94] Stephanie Kirchgaessner & Edward Alden, *Dubai Ports Takeover Prompts Backlash*, FINANCIAL TIMES, Feb. 16, 2006.

[95] Press Release, Senator Charles Schumer, Strong Bipartisan Push To Pass Emergency Legislation Suspending Dubai Port Deal Continues (Feb. 26, 2006), *available at* http://schumer.senate.gov/SchumerWebsite/pressroom/press_releases/2006/PR72.Senate.022406.html.

claiming that "it would send a terrible signal to friends and allies not to let this transaction go through."[96]

On March 8, 2006, a House Panel overwhelmingly voted to block the deal.[97] The following day, DP World released a statement saying that "[b]ecause of the strong relationship between the United Arab Emirates and the United States and to preserve this relationship . . . DP World will transfer fully the U.S. operations of P&O Ports North America, Inc. to a United States entity."[98] DP World eventually sold P&O's U.S. ports operations to an American International Group subsidiary.[99]

As made clear in the foregoing examples, the key to success of private efforts to exploit the CFIUS process is the encouragement of Congressional involvement, which was enhanced through the FINSA amendments. CFIUS provides for congressional oversight, requiring CFIUS to report to (i) the majority and minority leaders of the House and Senate, (ii) the chair and ranking members of the Senate Banking Committee and the House Financial Services Committee, (iii) any House or Senate committee having oversight over the lead agency in the CFIUS review, (iv) Senators and Members of Congress from the district concerned, and implicitly (v) governors whose states "interact" with the critical infrastructure involved. As practitioners have argued, "[s]uch broad ranging, transaction-by-transaction Congressional involvement in the potentially explosive issue of foreign investment can only raise the risk of political mischief, particularly where US constituents have an interest in opposing a competing foreign investor or have an ax to grind against an investor's home country."[100] The danger in the CFIUS process is that political abuse of the CFIUS process is easily masked as "the furtherance of a legitimate task,"[101] and the protection of national security. The risk of political or protectionist measures, however, is less investment for the United States. The

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[96] Press Release, White House, President Discusses Port Security (Feb. 21, 2006), *available at* http://www.whitehouse.gov/news/releases/2006/02/20060221-2.html.

[97] Ports Deal News Tracker, Wall Street Journal Online, Mar. 15, 2006, http://online.wsj.com/public/article/SB114071649414581503-6cMsd79X0W1Po8sqVlrCDNtfFrg_20070417.html.

[98] Press Release, DP World (Mar. 9, 2006) (on file with author).

[99] Neil King Jr. & Greg Hitt, *Dubai Ports World Sells U.S. Assets*, WALL ST. J., Dec. 12, 2006, at A2.

[100] Corr, *supra* note 67.

[101] *Id*.

head of China Investment Corp. warned that his $200 billion sovereign wealth fund will avoid investing in countries that use national security as an excuse for protectionism: "If an economy will use national security as a criteria [sic] for entry of sovereign wealth funds, we will be reluctant to tap the market because you are not sure what will happen. National security should not be an excuse for protectionism."[102]

FINSA provided some assurance that CFIUS would not be used politically *after* a transaction is approved by tailoring the CFIUS "evergreen" provision which allows CFIUS to reopen an investigation and stop or unwind a previously cleared transaction. Rather than allowing for an arbitrary reopening of an investigation into an existing and approved investment, the CFIUS evergreen provision has two firm triggers that provide some certainty to SWFs with investment intentions. First, a transaction investigation may be reopened "if any party to the transaction submitted false or misleading material information to the Committee in connection with the review or investigation or omitted material information, including material documents, from information submitted to the Committee."[103] Second, CFIUS may reopen an investigation if any party to the transaction or the entity resulting from consummation of the transaction intentionally materially breaches a mitigation agreement, if the breach is certified to the Committee by the lead department or agency monitoring and enforcing such agreement or condition as an intentional material breach, and if CFIUS determines that there are no other remedies or enforcement tools available to address such breach.[104] The challenge for CFIUS is to satisfy its Congressional reporting mandate while also protecting itself from political pressures. Ironically, the mitigation against political risk may be one-sided—dangers against foreign political activity are mitigated, but increased Congressional oversight and involvement creates political risks for SWFs.

FINSA will certainly discourage political investment. However, FINSA will also discourage active sovereign investors and perhaps even some passive sovereign investors, unless experience with the CFIUS process eases SWF concerns that CFIUS will be politicized. Investors crave certainty from their regulatory regime, and if we can't provide it they will go elsewhere. Happily, some of our major competitors are likely to be more restrictive than the U.S. The UK is perhaps the exception, and has suggested

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[102] Leonora Walet, Thomson Financial News Limited, *China Investment Corp Warns Western Governments Against Protectionism – Report*, Forbes.com, News (Dec. 10, 2007), *available at* http://www.forbes.com/markets/feeds/afx/2007/12/10/afx4424545.html.

[103] 50 U.S.C.S. app. § 2170(b)(1)(D)(ii) (LexisNexis 2008).

[104] 50 U.S.C.S. app. § 2170(b)(1)(D)(iii) (LexisNexis 2008).

that it would welcome both sovereign investment[105] and SWFs setting up investment shops in London.[106]

The FINSA amendments have already had a pronounced effect on deals, with CFIUS and firms acting in accordance with FINSA even before the effective date of the legislation. Law firms handling these matters note that notifications to CFIUS in 2006 were 74% higher than 2005, and that "CFIUS is receiving filings at a pace that, if maintained, would reach approximately 150 cases for 2007, substantially exceeding the 113 filed in 2006." While filings have increased, some argue that actual SWF investment has not.[107] The U.S. Treasury reports a year-over-year decrease from 2006 to 2007 in the amount of "foreign official institutions" purchases of U.S. companies' stock.[108] 2006 and 2007 also saw significant increases in the number of deals escalated to the 45-day investigation stage, the number of deals that in which CFIUS required mitigation, and in "informally blocked" deals wherein investors simply pulled out of the CFIUS review process.[109]

The Treasury Department recognizes SWF concerns about U.S. politicization of the CFIUS process, and it is likely that the regulations promulgated in response to FINSA will address the potential for political activity from both SWFs and interested U.S. parties. For example, CFIUS could be made less susceptible to politicization by making clear that "critical infrastructure" will be read narrowly so that valid concerns for national security are not exploited. Congress also demonstrated awareness of this potential when

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[105] *See, e.g., City Minister Welcomes Sovereign Wealth Funds*, UK Trade & Investment, Mar. 12, 2008, http://www.ukinvest.gov.uk/OurWorld/4019411/de-DE.html (UK Minister Kitty Ussher assuring SWFs that "We welcome Sovereign Wealth Funds using London as a base to keep close to the world's financial markets – open and international as it always has been - and London will continue to welcome commercial investment from around the world."). .

[106] Many SWFs are engaged in significant hiring of outside expertise. The Emirates are hiring many highly-experienced managers, and these managers will undoubtedly require a large support staff. DIC hired former Sony CEO Nobuyuki Idei to join the advisory board of its global strategic equities fund just three days after a significant investment in Sony. The former head of BMW, Helmut Panke, and the former head of GSK, Jean-Pierre Garnier, have also signed on.

[107] Corr, *supra* note 67.

[108] U.S. DEPT. OF THE TREASURY, NET PURCHASES OF U.S. EQUITIES BY MAJOR FOREIGN SECTOR: FOREIGN OFFICIAL INSTITUTIONS, OTHER FOREIGNERS, AND INTERNATIONAL & REGIONAL ORGANIZATIONS, http://www.treas.gov/tic/stksect.txt.

[109] Corr, *supra* note 67.

it opted for a more limited scope of CFIUS review. The final FINSA draft defines "critical infrastructure" as systems or assets "so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security." Earlier drafts included much broader language that would have allowed critical infrastructure to include "national economic security and national public health or safety," broad terms that could be held to cover a very wide range of benign investments. However, even the limitation to "national security" is still broad enough to invite mischief. As Attorney David Marchick has noted,

> "there are certain areas of "critical infrastructure," broadly defined, that in the ordinary course simply should not raise national security concerns. For example, there has been great controversy in certain states regarding the privatization of toll roads. While that debate is understandable, it would be far more difficult to see how foreign ownership of a toll road would raise national security issues. The same logic applies to most investments in agriculture and food. Ben and Jerry's is owned by a Dutch company, and Häagen-Dazs is owned by Diageo, a British company. I can think of many great ways to describe Cherry Garcia, but central to national security isn't one of them."[110]

To insure that protectionism does not replace true concern for national security, the Treasury Department will need to clarify that the term "national security" is read to cover concerns that are truly national, rather than relating to a particular congressional district or a particular firm, and concerns that are, in fact, related to security. CFIUS, because of its committee structure, will tend to be internally conflicted in its analysis, because of the different objectives of the various departments with a seat on CFIUS. The intelligence agencies, for example, may be less concerned with the economic effect of barriers to entry than the Treasury Department; no agency, however, wants to be responsible for letting military secrets slip through our borders because of an investment by a rival sovereign.

D. *Expectations of Sovereign Wealth Funds as Shareholders*

This paper has thus far argued that existing regulations compel passivity for SWFs, and thus minimize the threat that equity investments will be used as political tools.

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[110] Testimony of David Marchick before the House Committee on Homeland Security Subcommittee on Transportation Security and Infrastructure Protection on "The Impact of Foreign Ownership and Foreign Investment on the Security of Our Nation's Critical Infrastructure" (May 16, 2007), *available at* http://216.109.139.51/Files/12421_Marchick%20Testimony.pdf.

Aggressive use of the CFIUS process may create risks, however, including loss of investment. Further, the passivity compelled by existing regulations may not always be desirable. The term “passivity” in the context of investor behavior is often equivocated. When regulators and politicians expect SWFs to invest passively, there are at least two senses in which the term may be used. There is, first, a less expansive definition of passive which reflects the SEC’s definition. Under Exchange Act Rule 13D, passive investors are investors that “have not acquired and do not hold the securities for the purpose of or with the effect of changing or influencing the control of the issuers of the securities."[111]

The second definition is not limited only to those investors that do not intend to exercise control, but also those who are “passive shareholders” with the term “passive” serving as an antonym to “activist.” In a representative definition, Bernard Black describes shareholder activism as “proactive efforts to change firm behavior or governance rules.”[112] Thus, in contrast to this definition of activism, a passive shareholder is not only disinterested in control, but is also not involved in any activities that may affect firm behavior or decision-making. While practically all investors fall within such a definition, there are a number of reasons why SWFs should not be expected or required to assume such a role. One disadvantage of passive investment is that the SWF may be unwilling to engage with management; as noted by the Financial Times, “the reason the sovereign funds have been given the opportunity to invest in Wall Street's financial groups is precisely because of misjudgments by managements that were either ignorant of risks and contingent liabilities or tolerant of them.”[113] However, because of the risk of political backlash, SWFs may not encourage needed reforms, as might other investors such as pension funds, hedge funds or private equity firms. For very large portfolio firms such as many of the largest financial institutions, the kind of investor activism pursued by private equity firms and hedge funds is not possible. As explained by Blackstone chief executive Stephen Schwarzman, "the scale of these companies dwarfs our ability to make a meaningful contribution. We can't finance them with our limited resources."[114] As discussed above, hedge funds and private equity firms control only a fraction of the wealth of SWFs. The Financial Times also notes another advantage

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[111] 17 C.F.R. § 240.13d-101 (2008) (Exchange Act Rule 13D).

[112] BERNARD BLACK, *Shareholder Activism and Corporate Governance in the United States, in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (Peter Newman, ed. 1997)

[113] Henny Sender, *Silence not golden for sovereign funds*, FINANCIAL TIMES, Jan. 17, 2008.

[114] *Id.*

of SWFs: "because they do not depend on borrowed money nearly as much as private equity firms do to finance their stakes, the companies in which they invest do not become loaded with debt. 'The sovereign funds are safer and less risky owners than private equity because they can live with lower leverage and lower returns,' says a senior banker in New York."[115]

The rise of sovereign wealth funds comes in an era of increased institutional investor activism. Institutional investors generally have grown in importance both as a function of their relative size in the market and because proxy advisors and other corporate governance industry firms enable institutional investors institutional investors to overcome many of the collective action problems which in the past made greater investor activism infeasible.[116] Institutional investor activism has significantly affected corporate governance in the U.S. in recent years, most notably in removing anti-takeover protections and requiring majority voting for election of directors.[117]

Like institutional investors, it should be expected that many, if not most funds, will want to use this environment to their advantage and take an active governance role, at least in the sense of engaging with management and the board and exercising shareholder voting rights. Sovereign wealth funds have not and are not likely to behave according to a single paradigm. Rather, some SWFs may invest like socially-conscious pension or mutual funds, some may invest aggressively like some hedge funds, and some may invest passively like many mutual funds. SWFs may be voluntarily passive for several reasons. A SWF may determine to remain a passive investor for the same reason that many investors remain passive: it is economically rational to remain passive when activism is unlikely to result in any appreciable economic benefit for the SWF, perhaps because the investment is relatively small and significant expenditure of resources would result in insignificant gains. Like other investors, SWFs will vote on corporate matters. SWFs may also attempt to place proposals on a portfolio company's proxy (although apparently this has yet to occur). However, with most other investors the calculation of gains versus corporate governance efforts is relatively simple; with SWFs the issues are considerably more complex because SWFs operate as an asset of a sovereign that may not view return on investment of the SWF as the sole or even primary purpose of the fund.

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[115] *Id*.

[116] *See* Paul Rose, *The Corporate Governance Industry*, 32 J. Corp. L. 887 (2007).

[117] *See* GEORGESON, 2007 ANNUAL CORPORATE GOVERNANCE REVIEW, http://www.georgeson.com/usa/download/acgr/acgr2007.pdf.

An expectation of this broader form of passivity by SWF will undoubtedly deter legitimate investments. To require such passivity as an implicit condition to investment negates the essential nature of equity investment.[118] On the other hand, an active role in governance (presumably by the professional managers of SWFs, who are typically drawn from the ranks of fiduciary institutional investor firms) may prove beneficial. Active minority shareholders are often of significant benefit to their portfolio companies. One such example is Nelson Peltz, who holds minority positions in, among many firms, Heinz and Wendy's. Peltz has pushed through a number of changes at both companies, and both companies appear to have benefited significantly as a result.[119]

Likewise, Saudi Prince Al-waleed Bin Talal's Kingdom Holding Company (KHC) is cited as a model minority shareholder. One of KHC's investment philosophies is "a strategy for long-term investments, [seeking] businesses with strong management teams that are capable of delivering sustained growth and continuously strong returns. [KHC] intends to continue to support management teams while seeking to be an active investor taking investment positions large enough to give KHC a voice in the strategic management of its portfolio companies." Prince Al-waleed owns approximately 4.3% of Citibank, yet made front-page news when in early 2007 he publicly called on Citigroup to "take draconian measures to control the costs".[120] After Al-waleed spoke out, Citigroup accelerated cost-cutting measures.[121] While Prince Al-waleed's role in the cost-cutting decision and the effect of the decision are debatable, a more important measure of his influence as an investor is seen later in 2007. In an interview with Fortune magazine, Prince Al-waleed stated that he spoke to then-CEO Charles Prince regularly, and during the subprime crisis they spoke "almost every two or three days. Four or five calls over the

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[118] Such a requirement is nearly converse to the practice of empty voting; both practices separate economic interest from activism, with empty voting retaining voting power and no economic interest, and passive shareholding retaining economic interest but avoiding any form of activism. For a discussion of the practice of empty voting, see Bernard Black & Henry Hu, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPREN. BUS. L.J. 1 (2006).

[119] Julie Jargon, *Peltz Uses "Common Sense" to Reshape Food Industry*, WALL ST. J., Nov. 11, 2007.

[120] David Wighton, *Alwaleed Warns Citigroup over Expenses,* FINANCIAL TIMES, July 19, 2006, at 1.

[121] *Cracks in the Edifice*, THE ECONOMIST, Nov. 8, 2007.

past 10 days."[122] Prince Al-waleed was later thought to have influenced the ouster of Charles Prince when he withdrew his support of Prince after Citi acknowledged $11 billion in losses related to the subprime crisis.[123]

While SWFs may raise concerns over investment intent, engaged SWFs would likely be better co-shareholders from the perspective of other long-term investors than highly-leveraged, activist hedge funds and private equity firms, and may be able to make investments that such firms cannot. Markets have tended to react positively to SWF investments, suggesting that shareholders are not overly concerned with the possibility of political activity by SWFs. Further, shareholders may recognize that by welcoming an investment by SWF, companies are more likely to be welcome in the SWF sponsor country.[124] The benefits attributable to a large, stable shareholder may be part of the explanation for the surge in Sony stock price following a large investment by Dubai's SWF.[125] In Tokyo, Sony stock closed up 4.6%.[126] After CIC's announcement that it would invest in Morgan Stanley, Morgan Stanley's shares rose nearly 6% (versus a 1.67% gain by the S&P 500 on the same day). In the case of Mubadala's investment in AMD, the share price performed as well as the sector overall; in Dubai's investment in Citigroup, the share price underperformed the market but outperformed its sector.

[Insert CHART 6]

In some cases, SWFs already act like other large institutional investors.[127] A number of the largest SWFs, including Norway's Government Pension Fund-Global,

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[122] Andy Serwer & Barney Gimbel, *Prince Alwaleed: Why Chuck Had to Go*, FORTUNE, Nov. 16 2007).

[123] Stephen Taub, *Citi Dweller*, ALPHA MAGAZINE, Nov. 20, 2007, *available at* http://www.alphamagazine.com/Article.aspx?ArticleID=1697572&PositionID=85296.

[124] While such quid pro quo activities may not result in the most efficient allocation of resources, shareholders would hardly sell off the stock of a company that may receive a preferential treatment by virtue of welcoming SWF investment.

[125] Peter Sayer, IDG News Service, *Dubai Investment Fund Buys Stake in Sony*, Nov. 27, 2007, http://www.pcworld.com/businesscenter/article/139929/dubai_investment_fund_buys_stake_in_sony.html.

[126] *Id*.

[127] One money manager speculates that SWFs will behave like pension plans in terms of asset allocation, with portfolios of approximately 60% equities, 30% bonds and 10% alternatives. *See* George Hoguet, *Market insight: Sovereign Funds Should Be Watched with Caution*, FINANCIAL TIMES (December 12, 2007), *available at*

Singapore's Temasek fund, and Alaska's Permanent Fund, provide information on size, results and portfolio composition. SWFs may signal how they will exercise their votes as shareholders by disclosing proxy voting policies, as Alaska does, or by signing on to a set of governance guidelines such as the UN's Principles for Responsible Investment (PRI), as Norway does. Others, however, do not operate openly, and have instead resisted calls for greater transparency.

Some SWFs, especially Western SWFs, will likely seek to be activist in ways similar to pension funds. For example, like pension funds concerned with the detrimental effects of certain products on their pensioners, SWFs may determine to avoid investment in tobacco companies because a significant portion of the country's health expenditures are related to diseases associated with tobacco usage. Norway's SWF recently announced that it was initiating a review of such problematic investments. Finance Minister Kristin Halvorsen said the fund would report to parliament on its investments in 2008, and that "[p]roduction of tobacco, gambling for instance, nations that break human rights ... the sex industry—these are entirely concrete issues" that the fund would consider. [128] Norway's sovereign wealth fund has already signed on[129] to the UN's "Principle for Responsible Investment" (PRI),[130] a set of non-binding best practices. Funds publicly indicate their acceptance of the best practices by becoming signatories to the PRI via a UN website. Among other things, PRI signatories pledge to incorporate environmental, social and governance (ESG) issues into investment analysis and decision-making processes through investment policy statements, support for ESG-related tools, metrics, and analyses, encouragement of the adoption of ESG measures by financial analysts, consultants, brokers, research firms, or rating companies. PRI

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http://search.ft.com/ftArticle?queryText=sovereign&aje=true&id=071212000557&ct=0&papa=6. If all SFWs were to index 60% of their assets to, as an example, the FTSE Global All Cap index, they would collectively own around 4.6% of the 7,805 companies in the index. However, note that these numbers may not hold true for SWFs controlled by Islamic states, since certain forms of lending may violate Shariah law. For a discussion of the asset allocation of petrodollar SWFs, see McKinsey Global Institute, *supra* note 28, at 53.

[128] John Acher, *Tobacco, Gambling, Sex Face Norway Oil Fund Test*, Reuters (Jan. 16, 2008) *available at* http://uk.reuters.com/article/oilRpt/idUKL1623708420080116. Norway has already divested its fund of holdings in companies that make nuclear weapons and cluster bomb components. Associated Press, *Norway's Global Pension Fund Drops 3 Weapon Producers Over Ethics Concerns* (Jan. 11, 2008), *available at* http://biz.yahoo.com/ap/080111/norway_oil_fund_ethics.html?.v=1.

[129] *Signatories to the Principles for Responsible Investment*, http://unpri.org./signatories/.

[130] http://UNPRI.org.

signatories also pledge to be active owners by creating and exercising shareholder rights in accordance with a disclosed ESG policy.

It is unlikely that many SWFs will join Norway as active ESG investors, either through the UN's PRI or through their own ESG criteria (although one might suspect the number will not be significant, at least in the near future). A more likely general trend will be adherence to a corporate governance policy that ultimately emphasizes share value maximization. Of the funds that have disclosed voting policies, Alaska's Permanent Fund has indicated a policy of engagement and support for greater shareholder rights, but the ultimate goal of its policies is "the best financial interest of the Fund",[131] rather than a set of social policies.

Existing U.S. regulations already promote the right kind of passivity—a non-controlling minority stake, with the ability of CFIUS to counteract most political activity. Complete passivity, however, is not necessary for the protection of U.S. interests. Further, imposing passivity on SWFs might merely push SWFs to invest in other jurisdictions with lax standards for investment or political impotence to protect themselves against opportunistic SWF activities. In such jurisdictions, SWFs could operate without the reporting and corporate governance restraints imposed by U.S. law. Certainly, even SWFs in search of benign, diversified investment opportunities will invest in jurisdictions outside the United States. Legislators and regulators should be wary of any changes that would accelerate a shift in SWF investments away from the U.S. and other developed nations because other jurisdictions may be less regulated and because the investment funds will not be recycled back into our economy.

IV. INTERNATIONAL STANDARDS FOR SOVEREIGN INVESTMENT

Taken with the trends in the manner in which SWFs invest in U.S. enterprises, the data suggest that, at present investment levels, there is limited risk that SWFs will use equity investment as a political tool. To the extent that SWFs engage in political investment, it will likely not involve visible investments in highly regulated enterprises or sensitive industries in entities domiciled in jurisdictions that, like the U.S., have enacted legislation such as FINSA. Instead, the most significant political investment may concern less-monitored, less-regulated investments in emerging economies. For example, China has committed funds to many regional investments in Asia and Africa. While such investments almost certainly involve financial concerns, there are likely

[131] ALASKA PERMANENT FUND CORPORATION, RESOLUTION 05-05, RESOLUTION OF THE BOARD OF TRUSTEES SETTING OUT INVESTMENT POLICIES RELATING TO EQUITY SECURITIES, *available at* http://www.apfc.org/resolutions/pdf/Res05_05.pdf.

political advantages to such investments. Some investments might provide insurance that certain natural and strategic resources will continue to flow to China exclusively or at preferential prices. Other regional investments may be valuable because they create ties with other sovereigns or regions within another sovereign. However, such investments could pose serious risks to the U.S. It is in the best interests of the U.S. and other host countries to ensure that SWFs will act apolitically and transparently wherever they choose to invest.

A. *Individual Country Responses*

There are a variety of approaches that other governments have attempted in dealing with sovereign investment. The UK, for example, has a provision that allows the government to intervene in mergers that affect national security.[132] The German government is redrafting a set of foreign investment rules similar to the CFIUS process. Currently, the only restrictions on foreign investment are transactions dealing with the defense industry and cryptography firms. Under the proposed legislation, German officials could prohibit transactions that could threaten "public order or security."[133] As with CFIUS, such legislation protects against external political influence at the expense of potential internal political mischief. Germany is perhaps chiefly concerned with Russian influence. In 2006, Russian state-controlled bank OAO Vneshtorgbank acquired a 5% stake in European Aeronautic Defence & Space Co. (EADS), a parent of Airbus. In a move similar to U.S. responses to SWF investments, EADS informed the bank that despite the relatively large stake it would not consider allowing the bank a seat on the board, nor would it allow it to influence corporate governance.[134] Unlike many SWFs, however, the Russians were more likely pursuing defined political goals, evidenced by a comment from Sergei Prikhodko, an aide to Russian President Vladimir Putin, stating that “A holding by the state makes sense when we can take decisions or have an influence . . . . If the question is posed under this angle, if we see an economic interest as well, then

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[132] In response to concerns over SWF investments, UK Chancellor Alistair Darling stated: “If it became clear that a company was not acting in a commercial way, or we had reason to believe it was going to make an investment in this country where there were issues of national security, for example, then we have powers under the existing Enterprise Act to take action.” Sumeet Desai, *Darling Says Sovereign Funds Need to Follow Rules*, REUTERS, Oct. 22, 2007, http://uk.reuters.com/article/fundsNews/idUKNOA22927320071022.

[133] Marcus Walker, *Germany Tinkers With Foreign-Takeovers Plan*, WALL ST. J., Jan. 14, 2008, at A2.

[134] Kevin Done & Catherine Belton, *Vneshtorgbank Considers Selling EADS Stake*, FINANCIAL TIMES, July 12, 2007.

we will insist on having a stake, thanks to which we would have at least a blocking minority."[135]

France has also expressed concern with SWF investment, with French president Nicolas Sarkozy declaring that "In the face of the increasing power of extremely aggressive speculative funds and sovereign funds which do not obey economic logic [France is taking] the political and strategic choice to protect its companies, to give them the means to defend and develop themselves."[136] Australia has developed perhaps the most protectionist response to SWFs by reviewing foreign investment through a six-factor analysis: 1) the investor's independence from the relevant foreign government; 2) the investor's behavior under the law and "common standards of business behaviour"; 3) the impact of the investment on competition; 4) the impact on government revenue and policies, including tax; 5) national security; and 6) whether "an investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community".[137]

In the developing world, Indian Finance Minister P. Chidambaram declared that "It is important for developing countries to avoid shocks. Regulation must stay one step ahead of innovation."[138] Under Indian law, foreign investors must be registered with the state securities regulator, SEBI, and are allowed to invest only through proprietary notes. New rules would impose a limitation on "proprietary notes" investments, and SEBI would control registration renewals. As a caution against such protectionist measures, note that the Indian stock market dropped 9% after the announcement of the new rules, just as Malaysia's stock market declined after the imposition of capital controls following the Asian currency crisis of 1997.

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[135] AFX News Limited, *Russia Could Seek Blocking Minority Stake in EADS Eventually - Putin Advisor*, (Sept. 12, 2006), *available at* http://www.forbes.com/markets/feeds/afx/2006/09/12/afx3010667.html.

[136] Helen Beresford, Thomson Financial News Limited, *Sarkozy to Use CDC to Defend French Cos Against 'Aggressive' Speculators* (Jan. 8, 2008), *available at* http://www.forbes.com/afxnewslimited/feeds/afx/2008/01/08/afx4505120.html.

[137] Marc Moncrief, *Swan Gives Foreign Governments a Peek at FIRB Guidelines*, BUSINESS DAY, Feb. 18, 2008.

[138] Associated Press, *Paulson Pushes India to Open Its Markets*, Oct. 30, 2007, http://news.moneycentral.msn.com/category/topicarticle.aspx?feed=AP&Date=20071030&ID=7709096&topic=TOPIC_INTEREST_RATES&isub=3.

Thailand has also determined to implement investment restrictions. New regulations require that some foreign investors must sell holdings or voting rights exceeding 50% of the outstanding stock of Thai companies.[139] The restrictions arose as a result of the sale by former Prime Minister Thaksin to Temasek of a majority stake in the Thai telecom company Shin. As noted above, the acquisition "galvanized public protests against Thaksin [majority owner and former prime minister], eventually culminating in the September coup. The military leaders who staged the coup are intent on showing that the Shin sale was illegitimate to justify removing Thaksin."[140] After the negative reaction, however, Temasek determined to avoid sensitive investments. The chairman of Temasek stated that Temasek would avoid investing in "iconic" companies overseas, instead opting for minority stakes in future investments and seeking local partners in acquisitions, such as through joint venture agreements: "We've got to take various factors into account, such as whether the company or the activity is iconic for that country, whether it will arouse all kinds of emotional sentiments."[141]

The problem for host nations concerned with SWF investment is that imposing strict foreign investment rules may put them at a competitive disadvantage to countries not adopting or enforcing such rules. There are two possible solutions to this problem. The first is the creation of a common set of regulations (such as through a multi-national treaty), and the second is the creation of "soft law"—a set of voluntary best practices that will guide SWF sponsor nations.

In either case, this paper argues that dealing with SWFs requires two steps: First, host nations should (as the U.S. has) create clear, enforceable regulations that will protect national security and politically sensitive assets as well as provide a clear framework for SWFs undertaking investment in a given country. However, countries will have different standards for investment and acceptable disclosure, and some countries may not have the political power to enforce against undesirable SWF behavior or the political will to prevent SWF investments in their country from being used as political tools against other countries. As a second level of regulation, international agreements or voluntary codes of best practices would provide a common set of rules that, while not providing a host nation the ability to enforce its own regulations on SWFs, nevertheless fill gaps in

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[139] Thomas Fuller & Wayne Arnold, *Thailand Threatens Fresh restrictions on Foreign Investors*, INT'L HERALD TRIB., Jan. 9, 2007.

[140] *Id*.

[141] Reuters, *Temasek to avoid politically sensitive investments*, Nov. 23, 2007, http://asia.news.yahoo.com/071123/3/3be57.html.

individual country regulation and thereby provide additional certainty for SWFs transactions to the benefit of both the sovereign and the host nation.

B. *Multilateral Agreements*

Multilateral agreements such as a treaty negotiated through the WTO provide an attractive solution to the risks associated with SWF investment because, in contrast to best practices, the agreement would be enforceable by the country through WTO dispute resolution proceedings. The difficulty in setting up a multilateral agreement for SWFs, however, is demonstrated by the number of unsuccessful attempts have been made in the recent past to develop a multilateral framework for foreign direct investment. In 1995, members of the OECD, led by France, engaged in discussions on a possible Multilateral Agreement on Investment (MAI). The objective of the MAI was "to provide a broad multilateral framework for international investment with high standards for the liberalisation of investment regimes and investment protection and with effective dispute settlement procedures, open to non-Members."[142] However, the inability of OECD members to come to terms combined with increasingly high-profile protests against the MAI ended discussions by 1998.[143]

The World Trade Organization also put a Multilateral Investment Agreement (MIA) on the agenda for the Doha round of trade talks,[144] but developed and developing countries failed to reach a consensus on the MIA. A particular sticking point was the requirement of transparency for member countries (which was essentially a requirement that developing countries operate transparently).[145] Ultimately, the issue of foreign investment was dropped from the Doha agenda in 2004.[146]

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[142] ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, MULTILATERAL AGREEMENT ON INVESTMENT, http://www.oecd.org/document/35/0,2340,en_2649_201185_1894819_1_1_1_1,00.html.

[143] *See generally*, Edward Graham, FIGHTING THE WRONG ENEMY: ANTIGLOBAL ACTIVISTS AND MULTINATIONAL ENTERPRISES, International Institute of Economics (2000).

[144] World Trade Organization, Ministerial Declaration of 14 November 2001, WT/MIN(01)/DEC/1,.41 I.L.M. 746 (2002).

[145] *Members Divided Over Transparency, Definition at WTO Investment Talks*, BRIDGES WKLY. TRADE NEWS DIG., April 2002, Vol. 6 No. 15 (April 2002).

[146] World Trade Organization, Doha Work Programme: Decision Adopted by the General Council on 1 August 2004, WT/L/579 (04-3297).

Trade talks involving SWFs would also face the same difficulties as multilateral foreign investment agreements. There would first be difficulties in achieving a consensus among countries accepting sovereign investment because the political risks associated with sovereign investment differ by country and by sovereign investor. For example, Germany may be more concerned with investment from Russia than investment by Abu Dhabi. On the other hand, the wide gulf between the interests of developed and developing nations that proved insurmountable in earlier foreign investment talks may narrow somewhat when it comes to SWFs. Many SWFs are sponsored by sovereigns that accept significant foreign and sovereign investment, and so might be expected to have an interest in a balanced approach to SWF regulation. Further, there are fewer nations that have SWFs close to the top of their trade agendas: a couple of dozen major sovereign investors and the G7 economies. Thus, one might envision a simpler trade process than the Doha trade negotiations. Wall Street Journal columnist Bob Davis describes how such a SWF trade discussion could work:

> First, the U.S., Europe and Canada, which have common interests, would work out common positions on the most pressing questions, such as whether government funds should be limited to minority stakes, whether certain companies, such as defense and media companies should be off-limits to any investment, and whether countries whose funds invest in certain sectors—say, financial services—should be required to open those same sectors at home to foreign investment. Unless the U.S. and European Union coordinate their policies, argues Professor Garten, investment funds could play one country against another to attract investment, like auto makers play one state in the U.S. against another to get a richer package of tax cuts.
>
> In a second round, the governments of the funds would participate. Their interest: maintaining the freest possible access to invest in the world's richest markets. If the countries don't reach a deal, the U.S. and Europe could impose their rules unilaterally. Negotiations could start with the dozen countries with the biggest funds to keep the talks manageable, unlike the endlessly deadlocked Doha trade talks, which involve 150 nations.[147]

While a trade agreement may be preferable in the long-term because of enforceability, there are disadvantages as well. First, assuming even host nations (or

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[147] Bob Davis, *How Trade Talks Could Tame Sovereign-Wealth Funds*, WALL ST. J., Oct. 29, 2007, at A2.

even a smaller group of host nations, as Davis posits) could come to common terms on the content of such an agreement, such a process could take years. Finalizing an agreement with sovereign investors would likely be an even longer process. But SWFs are already investing now, and SWFs are rapidly increasing in size. The glacial pace of trade negotiations is ill-suited to deal with the pressing concerns of global capital flows in the near term. Further, some sovereign investors such as China have strongly resisted calls for further regulation of SWFs, essentially threatening to take their ball and play elsewhere if Western nations decide to change the rules.

Because of these concerns, to date both the U.S. and the European Union have promoted the adoption of best practices or codes of conduct for SWFs. The emphasis thus far has been on *voluntary* self-regulation in an effort to engage sovereign investors with less risk that the sovereign investors will simply invest in other markets, which would have the effect of multiplying concerns for the U.S. and the EU: less money for domiciled firms, yet still affected by the risk of political activity through investment in other markets. The emphasis thus far has been on *voluntary* self-regulation in an effort to engage sovereign investors and not lose them to other markets. The concerns for the U.S. and the EU would multiply if sovereign investors simply invested in other markets: there would be less money for domiciled firms, but the U.S. and EU would still be affected by the risk of political activity through SWF investment in other markets. Again, because these codes are voluntary, the enforcement leverage for the U.S. and other host nations is largely political and economic. Countries like Japan, the U.S. and EU member states that have significant political power and large amounts of two-way cash flows between them and SWF sponsor countries should have the leverage to pursue codes of best practices. Countries that have less leverage may be the beneficiaries of such efforts, but will be more susceptible to the risks posed by political and mixed-motive use of SWF investment because they lack the political and economic power to "enforce" voluntary codes of conduct. Even the ability of more powerful countries to compel adherence to codes of conduct may erode over time. Thus, voluntary codes of conduct should be understood as a first step that addresses an immediate need, while more comprehensive foreign investment rules will be negotiated through a future round of trade talks, difficult as such talks may be.

C. *Voluntary Codes of Conduct*

Ideally, detailed best practices would be created by or in connection with sovereign investors. However, host nations are already working toward outlining best practices for SWFs. In the U.S., Treasury officials have informally suggested a framework for best practices.[148] More formally, the Commission of the European Communities has recently set out some major governance principles for sovereign investors:

- The clear allocation and separation of responsibilities in the internal governance structure of a SWF;
- The development and issuance of an investment policy that defines the overall objectives of SWF investment;
- The existence of operational autonomy for the entity to achieve its defined objectives;
- Public disclosure of the general principles governing a SWF's relationship with governmental authority;
- The disclosure of the general principles of internal governance that provide assurances of integrity;
- The development and issuance of risk-management policies.[149]

The G7[150] finance ministers have also suggested that the International Monetary Fund, World Bank and the Organization for Economic Cooperation and Development could draft a set of principles (which would likely be a more detailed version of the principles above) that sovereign investors could use in managing their SWFs. Specifically, a draft memorandum of the G7 ministers tasked the IMF, World Bank and OECD with creating best practices "in such areas as institutional structure, risk management, transparency and accountability".[151] This paper now turns to each of these four areas with two goals: first, to present aspects of each area that should be considered by host nations and sovereign investors in designing best practices, and second, to suggest that regulation in each of the four areas (and some more than others) could help

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[148] *See, e.g.,* Kimmitt, *supra* note 34.

[149] Communication from the Commission to the European Parliament, The Council, The European Economic and Social Committee and the Committee of Regions, *A Common European Approach to Sovereign Wealth Funds*, COM(2008) 115 provisional, at 10, *available at* http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf.

[150] The G7, or Group of Seven, refers to the finance ministers of the United States, Japan, Germany, France, United Kingdom, Italy and Canada.

[151] MarketWatch, *G7 Warns of Global Risk from U.S. Housing Slump* (Feb. 9, 2008), *available at* http://www.investors.com/breakingnews.asp?journalid=67877978.

mitigate the risks of SWF investment that are not addressed by host country rules such as the CFIUS process.

1. Structure

For many SWFs, there is little to no information on their structure, size, investments and investment objectives. The somewhat *ad hoc* formation of many SWF funds suggests that most funds start with an initially loose structure that is tightened and strengthened as the SWF grows in size and begins to operate in global capital markets, with all the political implications such operations entail. A report by State Street describes the makeshift development of SWF structures:

> Sometimes—and especially with commodity exporting economies—authorities find themselves faced with unexpected windfall revenues that come from a positive terms-of-trade shock. They often respond by ringfencing and accumulating at least part of these proceeds offshore—mainly for sterilization purposes, but also to smooth out potential volatility in budget revenues. Very soon, what started out as a deposit at the central bank or a special purpose account at the Treasury often gets redesigned into a separate fund structure, with its own identity, system of governance and set of rules. Then, as assets in the fund continue to grow beyond the original narrowly defined purpose, authorities may take a step back and revisit the broader objectives, design and structure of the fund, often leading to some sort of a split into a liquidity tranche and a longer-term investment tranche.[152]

The report goes on to argue that creating appropriate structures for SWFs should begin with the definition of liabilities of the fund.[153] Most traditional funds begin with a definition of the liabilities of the funds, and then work towards a structure appropriate to the funds.[154] Many SWFs operate with similar objectives to many of these traditional funds, and so could adopt similar structures. Consider the structure of pension funds. Pension funds are generally managed by professional fund managers, and are ultimately governed by a board of directors, some of which may be selected by existing board members and some of which, in the case of a governmental fund such as a retirement fund for government employees, may be political appointees. In this structure, there are

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[152] Rozanov, *supra* note 23.

[153] *Id.*

[154] *Id.*

two layers of fiduciary responsibility.[155] First, the professional investment advisers are fiduciaries with respect to the plan. Second, the board members are also fiduciaries. The beneficiaries of these fiduciary duties are, ultimately, the beneficiaries of the fund. The principle difference between SWFs and pension funds (as well as all of the other types of investment funds—mutual funds, hedge funds and private equity funds) is the protection of fiduciary duty with all the latter and the absence of fiduciary duties with the former.[156] In the case of the pension and other traditional investment funds, the fiduciary concept (enforced by the sovereign) provides a check against imprudent behavior or political behavior; no such rules bind the activities of SWFs.

Some of the benefits of the fiduciary standard in a traditional fund structure may be offered by the hiring of outside fund managers. Currently, many of these funds are hiring outside help as a signal of investment intent. By making investments through outside money mangers, the SWFs and their sovereign sponsors are more removed from the investment decision and companies are somewhat better protected from being used as a political vehicle. Professional SWF managers may see their role as akin to that of pension fund management, with political appointees on the supervising board. There are limits to benefits of structure alone, however. For example, although professional managers could be considered as fiduciaries to the fund and the sovereign beneficiary, the sovereign is managing the fund for its own purposes and practically cannot be considered as owing an actionable fiduciary duty to its citizens unless the sovereign determines to so bind itself. Further, the relationship between the managers and the sovereign is not identical to the relationship between investment advisers and a traditional fund. The nature of the relationship is not that of a powerful bank and an individual investor with neither the time nor investment skill to effectively manage her retirement funds. While fiduciary regulations and patterns of practice govern a traditional adviser relationship, many of the rules and patterns are inapposite to advisers of SWFs. An adviser-fiduciary of a pension fund will invest according to a "prudent man" standard,[157] which provides predictability to the fund's governors, the fund's beneficiaries, and to the market as a whole. On the other hand, the adviser of a SWF may, under pressure from a host country, set up a structure that imposes similar "prudent man" requirements, but there is no enforcement mechanism that insures that the adviser will invest prudently when the

[155] *See, e.g.*, 29 U.S.C. Part 2510.3-21.

[156] While there may be fiduciary duties between a sovereign and a professional money manager and a sovereign, there is not a fiduciary duty between the sovereign and the ultimate purported beneficiary of the fund—the citizens of the sovereign.

[157] ERISA §§ 402(c)(3), 405(c).

sovereign no longer wishes it to do so for political reasons. Further, unlike most other funds, the sovereign beneficiary of the SWF may decide to step in and change the fund's course despite the expectations and investment trajectory of the fund's managers. For example, China's CIC was thought to have moved to a more conservative investment track after its high-profile purchase of a major stake in private equity firm Blackstone.[158] Indeed, Lou Jiwei, the fund's manager, chairman, stated publicly on Nov. 29, 2007 that the fund would invest primarily in financial instruments like index products[159], and that investments in banks (like the investments by petrodollar SWFs) were probably a year away.[160] Yet less than a month later the fund invested $5 billion in Morgan Stanley, in a move that was characterized by the press as "an abrupt shift in strategy for the $200 billion fund, and underlines the extent to which the government fund appears to be under the direct control of China's leaders;"[161] the fund's management was reported as being surprised by the investment decision by the government.[162]

Structure provides assurance in form, but not necessarily function. Traditional fund structure is designed in relation to a set of regulations applicable in the market or markets in which the firm operates, to a lesser extent, practice principles in the shadow of such regulations. When such regulations no longer apply, the structure no longer provides any guarantees. As a result, SWF fund structure, for purposes of mitigating risk

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[158] CIC's managers have suggested that China will embark on a more conservative investment strategy after the "initial bold stroke". Wall Street Journal. The WSJ suggested that the experience of China's national social security fund may offer an indication of how the funds will operate. In 2006, the social security fund selected 10 global fund managers to manage about $1 BB in initial overseas funds after a six-month selection process. While CIC has recruited a number of experienced money managers, it has not followed a conservative tack as predicted.

[159] Keith Bradsher, *Morgan Investment Marks Shift for China Fund*, NEW YORK TIMES (December 19, 2007), *available at* http://dealbook.blogs.nytimes.com/2007/12/19/morgan-investment-marks-shift-for-china-fund/.

[160] Jamil Anderlini, *China Fund Looks to Mideast as Model*, FINANCIAL TIMES (November 29, 2007), *available at* http://www.ft.com/cms/s/0/ae7ec63c-9ead-11dc-b4e4-0000779fd2ac.html.

[161] Bradsher, *supra* note 159.

[162] The *New York Times* reports that "the decision had been sudden and little expected by the fund's staff." *Id*.

to capital markets rather than risk to the fund itself,[163] is less relevant than regulations designed to directly address undesirable SWF activity.

2. Risk Management

There are two types of economic risk that arise as sovereigns become more active in capital markets. The first risk is the systemic risk created by the influx of capital caused by large SWF investments. If trillions in trade-imbalance revenues are converted back into equity investments, there is little doubt that some of these funds will not be allocated to their best use. Thus far, SWFs foreign investments have been in large companies with liquid trading markets. Likewise, traditional funds are also investing in these same companies because in some cases the fund is tied to an index or, more typically, because the funds prefer to acquire more liquid assets. Will increased investment activities by SWFs raise asset prices to unsustainable levels?[164]

The second type of risk concerns SWF and sovereign-specific risks—for example, unhedged currency risks, or the risk that a sovereign would drain the SWF because of an economic or political exigency. Some of the SWF-specific risks are no different than the sorts of risks encountered and managed by other types of funds. Again, we would expect an appropriately managed SWF to mitigate many of these risks. However, even if many, if not all, the SWF-specific risks (such as currency risks) are hedged, some *sovereign*-specific risks may not be hedged or, perhaps not uncommonly, the SWF is regarded as the hedge for certain sovereign risks. SWFs are created primarily as a result of a surplus of funds, so it is expected that SWF funds are not used for specific current accounts such as current health care costs (the obvious exception among SWFs are stabilization funds, which are used principally to stabilize currency fluctuations; China's SWF, for example, is essentially created from the surplus from the 1.4 trillion stabilization fund—the State Administration of Foreign Exchange (SAFE)—that generally does not invest in equity securities[165]).

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[163] There are many reasons, from the sovereign's perspective, why a robust structure is desirable. However, in this paper I am primarily concerned with the effect of SWFs in the capital markets, rather than the proper form of SWF governance.

[164] McKinsey Global Institute, *supra* note 28, at 58.

[165] A major spike in the activity of China's relatively low-profile stabilization fund occurred recently when the fund purchased large stakes in a three Australian banks, to the surprise of perhaps even the CIC. *See* Jamil Anderlini, Robin Kwong & Justine Lau, *Chinese State Investor Buys Australian Bank Stakes*, FINANCIAL TIMES (Jan. 3, 2008), *available at* http://www.ft.com/cms/s/0/c26ff650-ba2a-11dc-abcb-0000779fd2ac.html?nclick_check=1.

SWF and sovereign-specific risks create risks to other investors in the marketplace. How would companies and markets weather the shock of a quick exit (which may or may not be politically motivated) by a sovereign entity? A sovereign may need to pull its cash out of investments for a variety of reasons (currency support, war, expanded social programs, etc), that may not be relevant to an institutional investor.

SWFs are generally highly sophisticated investors, and have likely instituted risk management policies that will help protect the fund and the sovereign and its constituents. Appropriate risk management mechanisms should be similar to those employed by large institutional investors, such as the use of derivatives and hedging devices. However, SWFs should adopt risk management mechanisms commensurate not only with their internal risks but also the external risks imposed on the markets and host countries in which they operate. For example, the SWF should adopt and disclose withdrawal procedures so that unwinding a large investment will not drag down a stock, even if the SWF itself is indifferent to the harm a quick withdrawal would cause to its own economic interests.

3. Transparency

A number of commentators and politicians have expressed concerns with the lack of transparency of SWFs. [166] "Transparency" is generally understood to mean detailed disclosure of such things as investment purpose, results, and holdings. On this measurement, in Chairman Cox's opinion, "the track record to date of most sovereign wealth funds does not inspire confidence."[167] On the other hand, SWF managers have expressed concern with Western notions of transparency. Bader Al-Sa'ad, manager of Kuwait's $200 billion SWF, says that "We are concerned about what they mean when they call for transparency. Do we have to announce every investment before we make it?"[168] A similar concern was expressed by Lou Jiwei, manager of China's CIC SWF: "We will increase transparency without harming the commercial interests of CIC. That is to say it will be a gradual process. Transparency is really a tough issue. If we are transparent on everything, the wolves will eat us up."[169] On the other hand, the failure to operate transparently will continue to draw the attention of regulators and encourage

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[166] *See, e.g.*, Steven R. Weisman, *Concern About 'Sovereign Wealth Funds' Spreads to Washington*, INT'L HERALD TRIB., Aug. 20, 2007.

[167] Cox, *supra* note 35.

[168] Henry Sender, *Fund's Chief Focuses on Long-term Opportunities*, FINANCIAL TIMES, Jan. 2, 2008, at 16.

[169] Martin Arnold, *China Fund Warns Against Protectionism*, FINANCIAL TIMES, Dec. 11 2007.

protectionist responses from host countries. Because China has political and economic power that dwarfs other SWF countries, encouraging China to operate transparently is a primary concern for host countries. A sympathetic organization, the Asian Development Bank, has also encouraged China and other Asian SWFs to "free themselves of government interference and become more transparent",[170] reasoning that "it may be in countries' self-interest to voluntarily take steps to address legitimate fears and reduce the risk of being singled out for special treatment."[171]

Much of the resistance to the transparency demanded by Western host nations may be explained by its association with Western political systems. Transparency often correlates with political traditions of the sovereign. The transparency offered by Norway's SWF, for example, seems to flow from a commitment to transparency as a social and political value rather than a desire to avoid further regulation by host nations. In the investment of funds for the benefit of citizens, such as state pension plans, representative-democracies typically have a tradition of regulating themselves as fiduciaries to their citizens. U.S. government-run pension plans, for example, disclose as private fiduciaries, in contrast to Russia and China, which do not require such disclosures. When a country does not have a tradition of transparency in its political governance, calls for transparency are likely to meet with strong resistance.[172] The concept of fiduciary-type disclosure, which appears to be the expectation attached to transparency, may be a concept that for many sovereigns seems bound up with representative-democratic political systems.

Concerns with transparency may be compounded when SWFs invest in asset managers that are themselves not transparent. Where hedge funds and public equity firms are, under current regulations, not required to disclose information about their major investors, other investors will not be able to evaluate the activities of SWFs. Indeed, perhaps the justifications for a laissez-fair attitude with respect to hedge fund activity may need to be reevaluated if SWFs begin to exploit hedge funds as investment vehicles. Perhaps more benignly, some also see investment in asset managers as a means to acquire intellectual capital that will help SWFs become even more sophisticated investors.

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[170] Raphael Minder, *Transparency of Asia Funds Urged*, FINANCIAL TIMES, Nov. 26, 2007.

[171] *Id*.

[172] An example of this is the resistance of certain developing countries to the transparency provisions of the MAI, as discussed above.

What basic information would constitute reasonable and fair disclosure for SWFs? One "scorecard" for SWF transparency, presenting a U.S.-type disclosure model, suggests SWFs should provide the following:

- An annual report on its activities and results;
- A quarterly reports on its activities;
- The size of the fund;
- Information on the returns it earns;
- Information on the types of investments—for example, in what sectors and in what instruments;
- Information on the geographic location of investments;
- Information on the specific investments—for example, which instruments, countries, and companies;
- Information on the currency composition of investments;
- Identity of holders of investment mandates, e.g., investment advisers;
- Whether the SWF is subjected to a regular audit;
- Whether the audit is published; and
- Whether the audit is independent. [173]

Another model of adequate disclosure is provided by a UK consulting firm, characteristically offering a comply-or-explain set of transparency guidelines[174] for private equity firms, which the firm has also encouraged sovereign wealth funds to sign.[175] The guidelines offer standards for both SWFs and for companies that compose the SWFs portfolio. SWFs are encouraged to provide a discussion of their histories, management, investment approaches and strategic changes, and to disclose investments, returns, valuation procedures, holding periods and case studies of investment activities.

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[173] *See* Edwin M. Truman, *The Management of China's International Reserves: China and a SWF Scoreboard* , *available at* http://www.iie.com/publications/papers/truman1007.pdf.

[174] David Walker, *Guidelines for Disclosure and Transparency in Private Equity*, Nov. 2007, *available at* http://www.altassets.com/pdfs/wwg_report_final.pdf.

[175] Siobhan Kennedy, *Call to Bring Sovereign Wealth Funds and Entrepreneurs Under Private Equity Code*, THE TIMES, Nov. 20, 2007, *available at* http://business.timesonline.co.uk/tol/business/money/funds/article2903698.ece.

SWFs are also encouraged to insure compliance of portfolio companies with applicable regulations. Among other things, portfolio companies are encouraged to identify controlling ownership, including individuals.

Finally, The EU has also set out several principles that SWFs could consider in creating a voluntary disclosure regime, including:

- Annual disclosure of investment positions and asset allocation, in particular for investments for which there is majority ownership;
- Exercise of ownership rights;
- Disclosure of the use of leverage and of the currency composition;
- Size and source of an entity's resources;
- Disclosure of the home country regulation and oversight governing the SWF.[176]

As discussed above, disclosures that meet many of these guidelines currently apply to 5% shareholders of U.S. reporting companies under Section 13 of the Exchange Act, but not all countries have similar guidelines, and most SWF investments will fall under this threshold. Such disclosures assist in enforcement by monitoring agencies such as CFIUS and the SEC, but are also valuable to other investors (including other SWFs) who are concerned with whether and how SWF investment may affect the company.

4. Accountability

To paraphrase Justice Frankfurter, to say that SWFs must be "accountable" only begins the analysis.[177] To whom is the SWF accountable? What obligations does the SWF owe as a result, and what are the consequences if the SWF deviates from these obligations?

The SWF is not accountable in the same way as most other large funds. Unlike funds managed by most institutional investors, which are regulated under the Investment Advisers Act of 1940, SWFs do not owe fiduciary duties to identifiable beneficiaries. In some cases, depending on the goals of the fund, it is not clear who such beneficiaries would be (all citizens of Country X, or certain citizens such as pensioners?). In any event

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[176] Communication from the Commission to the European Parliament, The Council, The European Economic and Social Committee and the Committee of Regions, *A Common European Approach to Sovereign Wealth Funds*, COM(2008) 115 provisional, at 11, *available at* http://ec.europa.eu/internal_market/finances/docs/sovereign_en.pdf.

[177] SEC v. Chenery Corp., 318 U. S. 80, 85-86 (1943) (Frankfurter, J.).

there is likely no legal framework in which to hold SWFs accountable as fiduciaries if beneficiaries were identified. Accountability is thus primarily political, rather than flowing from fiduciary duties.

Accountability and transparency are closely related, since transparency is a prerequisite to accountability. If the fund operates transparently, it becomes more difficult for a SWF manager to avoid questions about whether to invest in companies that do business with pariah nations, pollute, or produce dangerous and controversial products or services (assuming the citizens are, as Norway's, concerned with such issues). The fact that many SWFs are products of regimes that are not democratic begs the question of whether internal political accountability exists for the mismanagement of many SWFs.

On the other hand, SWFs and their sovereign owners are subject to potential external political accountability in the same sense that a sovereign is politically accountable for other types of activities implicating foreign sovereign entities. However, a major difference between SWF activity and other types of economic activity among sovereigns, such as tariff disputes, is that there are international dispute resolution procedures to manage disagreement among sovereigns over these other economic activities. Unfair trade practices are regulated through procedures set out in the World Trade Organization agreements[178] which were negotiated among nations and ratified by the countries' respective legislative bodies. By contrast, the issues raised by sovereign wealth fund investment are dealt with by each country either through its own legislation or through a variety of regulatory schemes. Thus, to help avoid the possibility of political tit-for-tat resulting from SWF investment, sovereign sponsors and host countries should begin to address dispute resolution procedures for sovereign investment. Also, as noted above, many host nations may not be able to protect themselves without such a mechanism. Even for developed economies like the United States that may possess the political and economic clout to punish another sovereign for the political use of a SWF, hasty political retribution is unlikely to produce an optimal political or economic outcome. Further, the economic and political power on which such retribution depends becomes increasingly fragile as SWFs gain more economic power through our capital markets. Economic power correlates with political power, and the political checks on SWFs become weaker as SWFs become more prominent financial patrons of U.S. enterprise. A handful of investments of several billions may be easily moderated within capital markets valued at nearly $22 trillion.[179] But trillions of SWF investments, even if

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[178] Agreement Establishing the World Trade Organization, *available at* http://www.wto.org/english/docs_e/legal_e/04-wto.pdf.

[179] FEDERAL RESERVE, FLOW OF FUNDS REPORT 90 (Mar. 6, 2008).

representing widely dispersed, minority positions, would strain the ability of CFIUS and other regulators to monitor SWF activity.

V. CONCLUSION

This paper argues for a holistic approach in considering the appropriate regulation of SWFs. While this paper argues that SWFs will be limited in their ability to act politically through their equity investments in U.S. markets, this analysis does not suggest that SWFS are beyond suspicion; the more limited argument presented here is that a variety of regulatory, economic and political factors provide assurance that equity investment in U.S. firms is not an ideal or even likely political tool. However, SWFs may invest in less-regulated equity markets, and equity investments are, of course, only one of many form of investment available to SWFs. Other types of strategic investment, such as the purchase of vital commodity producers or reserves, have the ability to affect U.S. security interests more drastically than SWF activity in the U.S. While the U.S. may be able to protect its interests against such activity, its ability to protect its interests would be significantly enhanced by the voluntary adoption of best practices (and particularly, transparency) by SWFs.

This paper does not address the larger problem that gave rise to SWFs—the massive trade imbalance between the U.S. and most of the SWF-sponsor countries. As Warren Buffett memorably noted in his 2004 letter to Berkshire Hathaway shareholders,[180] writing on the U.S.'s current account deficit,

> As time passes, and as claims against us grow, we own less and less of what we produce. In effect, the rest of the world enjoys an ever-growing royalty on American output. Here, we are like a family that consistently overspends its income. As time passes, the family finds that it is working more and more for the "finance company" and less for itself. . . . This annual royalty paid the world – which would not disappear unless the U.S. massively underconsumed and began to run consistent and large trade surpluses – would undoubtedly produce significant political unrest in the U.S. Americans would still be living very well, indeed better than now because of the growth in our economy. But they would chafe at the idea of perpetually paying tribute to their creditors and owners abroad. A country that is now aspiring to an "Ownership Society" will not find happiness in – and I'll use hyperbole here for emphasis – a

[180] Annual Letter from Warren Buffett to Shareholders of Berkshire-Hathaway, Inc., 2005, http://www.berkshirehathaway.com/letters/2004ltr.pdf.

> "Sharecropper's Society." But that's precisely where our trade policies, supported by Republicans and Democrats alike, are taking us.

While leaving to others the subject of the growing current account deficit, our current ability to regulate the negative effects of SWF investments, without any further international effort, perhaps only buys us time to address the factors that generated SWFs.

This paper also does not address many of the effects of the rise of state capitalism, except as they relate to equity investment in the United States. The analysis in this paper implies that state capitalists will likely be forced to play by the rules of market capitalism if they choose to invest in Western markets. However, with the increase in the number of SWFs, with countries such as India and Japan also indicating that they may create SWFs, and with the not-quite-dead possibility that U.S. social security funds may be invested in equity markets, we may yet see the day when SWFs are viewed not merely as commercial tools, but also as economic and political tools used by all sovereigns in the normal course of international affairs. However, with the increase in the number of SWFs, with countries such as India and Japan also indicating that they may create SWFs, and with the not-quite-dead possibility that U.S. social security funds may be invested in equity markets, we may yet see the day when SWFs are viewed not merely as commercial tools. SWFs may in fact become economic and political tools used by all sovereigns in the normal course of international affairs.

CHART 1
Assets by Investor Type

Fund Type	Approximate assets under management ($Trillion)
Institutional investors	
Pension funds	**25**
Mutual funds	**21**
Insurance assets	**17**
Sovereign wealth funds	**3**
Hedge funds	**1.5**
Private equity	**1**

CHART 2
10 Largest Institutional Investors

	Institutional Fund	Size ($B)
1	**UBS**	**2,016.0**
2	**Barclays Global Investors**	**1,513.0**
3	**Allianz Group**	**1,493.5**
4	**State Street Global**	**1,441.1**
5	**Fidelity Investments**	**1,421.9**
6	**AXA Group**	**1,260.2**
7	**Capital Group**	**1,165.8**
8	**Credit Suisse**	**1,128.4**
9	**Deutsche Bank**	**1,026.9**
10	**Vanguard Group**	**957.6**

CHART 3
10 Largest Sovereign Wealth Funds

	Sovereign Wealth Fund	Size ($B)
1	**ADIA (UAE)**	**625.0**
2	**Government Pension Fund-Global (Norway)**	**322.0**
3	**GIC (Singapore)**	**215.0**
4	**Kuwait Investment Authority 1953**	**213.0**
5	**China Investment Corporation**	**200.0**
6	**Stabilization Fund (Russia)**	**127.5**
7	**Temasek (Singapore)**	**108.0**
8	**Qatar Investment Authority (Qatar)**	**60.0**
9	**Permanent Reserve Fund (Alaska)**	**40.2**
10	**Brunei Investment Authority (Brunei)**	**30.0**

CHART 4
10 Largest Private Equity Funds

	Private Equity Fund	Size ($B)
1	**Blackstone Group**	**79**
2	**Carlyle Group**	**59**
3	**Bain Capital Partners**	**40**
4	**TPG Capital (Texas Pacific Group)**	**30**
5	**KKR (Kohlberg Kravis Roberts & Co)**	**30**
6	**Cerberus Capital Management**	**22**
7	**Providence Equity Partners**	**21**
8	**Thomas H. Lee Partners**	**20**
9	**Warburg Pincus**	**20**
10	**Hellman & Friedman**	**16**

CHART 5
10 Largest Hedge Funds

	Hedge Fund	Size ($B)
1	**JP Morgan Asset Management**	**33**
2	**Goldman Sachs Asset management**	**33**
3	**Bridgewater Associates**	**30**
4	**D.E. Shaw Group**	**27**
5	**Farallon Capital Management**	**26**
6	**Renaissance Technologies Corp.**	**26**
7	**Och-Ziff Capital Management**	**21**
8	**Barclays Global Investors**	**19**
9	**Man Investments**	**19**
10	**ESL Investments**	**18**

CHART 6
Market Reactions to Selected SWF Investments

Transaction	% Change, 1st Trading Day after Announcement	Exchange % Change	Sector / Competitor % Change
CIC - Morgan Stanley	+ 5.84%	1.67% (S&P 500)	1.9% (Merrill Lynch)
Dubai - Citigroup	-0.50%	1.49% (S&P 500)	-1.24% (money center banks sector)
Mubadala - AMD	-0.47%	0.52% (S&P 500)	-0.47% (semiconductor - broad sector)
Dubai World - MGM	+ 8.92%	1.54% (NYSE Comp.)	1.51% (Las Vegas Sands Corp.)
Singapore & "Middle East" - UBS	+ 2.34%	0.80% (NYSE Comp.)	-0.58% (ABN Amro Holdings N.V.)
Dubai - Sony	+ 1.89%	1.66% (Nikkei 225)	-1.99% (Koninklijke Philips Electronic)