Sovereign wealth funds—a measured assessment

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Key points

- As the level of foreign exchange reserves within developing countries has increased, state-controlled investing entities of these countries have shifted their investments away from lower risk and lower yielding assets such as US Treasury obligations and towards a wider class of higher risk, higher yield assets, including equity, fixed income, real estate and alternative investments (eg hedge funds and private equity).
- These types of investments have raised concerns among policymakers in investee countries that such investments may be motivated by non-economic reasons (such as the desire to obtain control over critical infrastructure within an investee country), and therefore raise market integrity and national security issues.
- In this article, the authors argue that any discussion of foreign investment by sovereign wealth funds (SWFs) must recognize the differences in investing objectives among different types of state-controlled investing entities, and that policy responses should focus on those foreign investments that raise market integrity and national security concerns.
- Policy responses which over-react to the issues raised by SWF investment risk creating unintended consequences, such as the impediment of cross-border investment, to the detriment of the world economy.
- Any proposals to address concerns raised by SWF investment should take into account existing regulation, as well as current and proposed voluntary measures, which largely address these concerns.

1. Introduction

Sovereign wealth funds (SWFs) have received extensive publicity in recent months. The prospect of significant investments by SWFs potentially giving foreign countries control over important parts of an investee country's economy has emerged as a political issue, stimulating protectionist sentiment. For example, during the Democratic Presidential primary debates in the USA, concern was expressed about SWFs, and there was a call for more control over their activities.[1] In the EU as well, political figures such as Nicolas Sarkozy in France[2] and Angela Merkel in Germany[3] have raised alarms over the threat

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1 See Democratic primary debate on 14 January 2008, where Senators Hillary Clinton (D-NY) and Barack Obama (D-IL), and former Senator John Edwards responded to questions regarding investment by SWFs (eg Senator Clinton: 'We need to have a lot more control over what they [SWFs] do and how they do it'). <http://www.nytimes.com/2008/01/15/us/politics/15demdebate-transcript.html?_r=2&pagewanted=all&oref=slogin&oref=slogin> accessed 30 April 2008.

2 In the first week of this year, President Sarkozy announced his readiness to defend French companies from aggressive foreign investors.

3 Notable recent instances in which political pressure in Germany opposed potential foreign acquisitions include the indication by Sistema Joint Stock Financial Corporation (a listed company, approximately 60% of which is owned by a Russian individual) in

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posed by SWF investments.[4] While SWFs do deserve attention, much of the public discussion has overemphasized the threat of foreign investment, without differentiating between the varying investment objectives of governmental entities, and without acknowledging that existing regulations in many countries already address the risk posed by direct foreign investment.

This article will argue as follows: any discussion of foreign investment by SWFs must recognize the differences in investing objectives among state-controlled investing entities; proposals to address concerns raised by SWFs should focus on foreign investments that raise market integrity and national security concerns; and such proposals should take into account existing regulation, as well as current and proposed voluntary measures, which largely address these issues. Policy responses which over-react to the issues raised by SWF investment risk creating unintended consequences, such as the impediment of cross-border investment, to the detriment of the world economy.

We first provide an overview of several types of governmental investment entities. Second, we provide an overview of economic forces and trends affecting SWFs' and other governmental investment entities' resources and investment objectives. Third, we discuss concerns that have been raised recently when governmental entities invest in assets other than sovereign debt. Fourth, we provide an overview of existing laws and regulations concerning foreign direct investment (FDI) with a focus on the USA, the structure of which may influence responses in other developed countries. Fifth, we provide an overview of concerns raised in relation to SWF foreign investment, as well as initiatives and proposals intended to address such concerns. We conclude with recommendations in the event SWFs do not follow voluntary guidelines.

2. Background on state-owned investing entities

The term 'sovereign wealth fund' has been defined variously.[5] Generally speaking, the term signifies a state-owned or influenced fund that obtains its funding from foreign-currency reserves or commodity export revenues, though in certain instances, government budget surpluses and pension surpluses have also been transferred to SWFs.

Fall of 2005 that it was interested in acquiring 5–10% of Deutsche Telekom, which triggered vocal opposition, and the purchase by Russia's VTB (Foreign Trade Bank) of 5% of EADS, the parent of Airbus, in August 2006 (and subsequent resale to another Russian bank at the end of last year), which was seen as an attempt to acquire a board seat and obtain technology-sharing outsourcing work.

4 Investment by SWFs can be sensitive even in countries like the UK, which has tended to favour open markets, and Japan. While the UK has been a prominent supporter of open investment markets in Europe, Gazprom's proposed expansion in the natural gas business has tested its commitment. In 2006, Gazprom indicated interest in a transaction with Centrica plc, which supplies gas to 50% of UK retail customers, although this acquisition was not consummated. At the end of January 2008, Gazprom announced its intention to acquire 15% of the gas market, providing gas directly to consumers by 2011. A recent example of the sensitivity of foreign investment in Japan came last fall when Macquarie Airports increased its holdings in Japan Air Terminal Company, the operator of Haneda International Airport in Tokyo, to 19.9%. The transport minister suggested that the government could take action despite Macquarie's public statement that it would not obtain a board seat or seek to control the company.

5 The US Treasury uses the term to mean government investment vehicles funded by foreign exchange assets and managed separately from official reserves. See, eg Robert Kimmitt, 'Public Footprints in Private Markets-Sovereign Wealth and the World Economy' (2008) Foreign Affairs, January/February 2008 (Kimmitt Article). For a list of some of the various definitions that have been used, see Annex II to Sovereign Wealth Funds—A Work Agenda, Prepared by the Monetary and Capital Markets and Policy Development and Review Departments of the IMF, 29 February 2008 (available at http://www.imf.org/external/np/pp/eng/2008/022908.pdf accessed 2 April 2008)(the 'IMF Work Agenda').

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This broad definition encompasses several different types of sovereign entities with different sources for and mandates for investing their assets, including (i) central banks, (ii) stabilization funds, (iii) public pension funds, (iv) government investment companies and (v) state-owned enterprises. While the term 'SWF' is sometimes used indiscriminately to refer to any of these entities, in this article we use the term to refer to public pension funds and government investment companies. There has been a shift by these funds, precipitated by an increase in foreign exchange reserves by developing economies, away from lower risk and lower yielding assets such as US Treasury obligations and towards a wider class of higher risk, higher yield assets, including public equity, fixed income, real estate, bank deposits and alternative investments (eg hedge funds and private equity).[6] As a result, the nature of their investments has raised a number of issues and proposed policy responses which we explore in detail below.

Differentiation between different types of sovereign-controlled entities is integral to identifying policy issues raised by their activities, and in crafting appropriate policies to address such issues. Policy responses should be focused on SWF investment which raises the potential for control by a foreign country of an investee country company for non-economic purposes that raise national security concerns. This issue is potentially raised by sovereign-investing entities—such as public pension funds and government investment companies—that invest in assets which could allow them to take a controlling stake in a company. More serious considerations are raised by investments by state-owned or controlled operating companies, or those subject to government influence. However, these entities are distinct from our definition of SWFs and policy responses should be distinct as well. Accordingly, policy responses should be tailored to take into account the type of sovereign investment entity, its investment objectives and extent of government control, among other factors. In this regard, we discuss regulation applicable to FDI, as well as global initiatives and proposals to address concerns raised by SWF foreign investment, in Sections 5 and 6, respectively.

Below are examples of several types of state-controlled investing entities.

Central banks

Central banks and monetary authorities are the prototypical managers of foreign exchange reserves arising from, and needed to support, international trade and exchange rates.[7] Nevertheless, investments by a central bank may, in some circumstances, raise concerns that it may take a significant controlling interest in a public company in order

6 See, eg Stuart E Eizenstat and Alan Larson, 'The Sovereign Wealth Explosion,' (2007) Wall Street Journal (noting that 'China, South Korea and Singapore have announced plans to move as much as $480 billion of their foreign-exchange reserves from more conservative investments, such as government bonds, to more risk-taking investments in equities, acquisitions of companies, trading strategies and hedge funds.') <http://yaleglobal.yale.edu/display.article?id=9949> accessed 27 May 2008.

7 The International Monetary Fund has released guidelines on the management of such reserves, including a template for reporting to the IMF, that emphasize the importance of transparency and sound administration procedures. Guidelines for Foreign Exchange Reserve Management, 20 September 2001 <http://www.imf.org/external/np/mae/ferm/eng/index.htm#> (IMF Reserve Management Guidelines) accessed 27 May 2008.

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to achieve political objectives. For example, the Saudi Arabian Monetary Agency (SAMA) is Saudi Arabia's central bank tasked with the common central bank roles of issuing currency, managing foreign exchange reserves and supervising banks, among others powers.[8] However, it is also estimated to manage approximately $250 billion of non-reserve assets on behalf of itself and others, a portion of which is managed by external investors and invested in asset classes other than sovereign debt.[9]

Stabilization funds

Stabilization funds provide budgetary support, particularly in the case of commodity-producing countries, when commodity prices fall. One example is the former Russian Stabilization Fund, which was established as an account managed by the Ministry of Finance with the typical purposes and objectives of a stabilization fund—absorbing excess liquidity, reducing inflationary pressure and insulating the economy from the volatility of raw material export earnings—and a corresponding conservative investment policy of investing in highly rated sovereign debt securities.[10] In February 2008, as a result of asset accumulation, the Stabilization Fund was split into two new funds, the Reserve Fund, with approximately $125 billion in assets under management and a conservative mandate as a foreign exchange reserve manager, and the Welfare Fund, with approximately $32 billion in assets under management and a mandate to develop a broader investment policy encompassing a variety of asset classes.[11] The Russian Finance Ministry will set out its investment strategy for the Welfare Fund by October 2008. In the meantime, both funds will invest in sovereign and/or government agency bonds with ratings of AA- or higher.[12]

Public pension funds

An SWF may be an endowment to fund retirement payments, including providing for future citizens by diverting a portion of the current returns on natural resource production to investment.[13] One prominent example of an endowment structure is the

8 <http://www.sama.gov.sa/en/about/> accessed 19 March 2008.

9 S Butt, A Shivdasani, C Stendevad, and A Wyman, 'Sovereign Wealth Funds: A Growing Global Force in Corporate Finance' (2008) 20 J Appl Corp Finance 73–83 <http://ssrn.com/abstract=1115535> (A Growing Global Force). SAMA does not participate in the IMF's special data dissemination standards, which include periodic reporting of a template of information including foreign reserves; however, it announced on 4 March 2008 that it would participate in the general data dissemination standards. Saudi Arabia Begins Participation in the IMF's General Data Dissemination System, Press Release No. 08/42 4 March 2008 (available at http://www.imf.org/external/np/sec/pr/2008/pr0842.htm).

10 Ministry of Finance of the Russian Federation <http://www1.minfin.ru/en/stabfund/about/> accessed 19 March 2008.

11 Lars Rasmussen and Kasper Kirkegaard, Russia: A closer look at the two new SWFs, Danskebank Research, 25 February 2008 <http://www.fxstreet.com/futures/market-review/russia-a-closer-look-at-the-two-new-swfs/2008-02-25.html> accessed 23 March 2008. See also http://www.swfinstitute.org/fund/russia.php.

12 Global Insight, 'Sovereign Wealth Fund Tracker,' April 2008 (SWF Tracker) <http://www.globalinsight.com/gcpath/SWFTracker.pdf> accessed 2 May 2008.

13 SWFs that are funded from commodity extraction may also have the advantage of permitting the country to produce larger amounts than would be economical if the proceeds from production needed to be invested within the country, a consideration worth mentioning in light of current oil prices. Director General Martin Skancke, Asset Management Department, Norwegian Ministry of Finance testimony before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, and the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, US House of Representatives 5 March 2008 <http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr030508.shtml> accessed 23 March 2008.

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Norwegian Government Pension Fund Global.[14] One of the larger SWFs, it is focused on intergenerational savings, with funds set aside and managed with a specific view towards the timing and size of future pension liabilities; it has also sought to promote socially responsible investment through a set of ethical investment guidelines.

Government investment companies

Government investment companies are state-controlled funds that invest in direct and possibly controlling interests in domestic and foreign corporations. While these vehicles are government-owned, they have a variety of objectives that affect their investment strategies, many of which are innocuous.[15] One prominent example of a government investment company is the Abu Dhabi Investment Authority (ADIA), established in 1976. While it does not report publicly, ADIA is generally thought to have the largest amount of assets under management of any SWF, with estimates ranging from $600 billion to $900 billion.[16] Unlike some other funds, it does not appear to disclose investment benchmarks that it uses for managing the risks and results of its portfolio.[17]

A recently formed SWF with the potential to become one of the largest, the China Investment Corporation (CIC),[18] has several characteristics that set it apart from other

14 The Norwegian Ministry of Finance delegated the operational management of the Government Pension Fund Global, estimated to have assets under management of $325 billion, to Norges Bank pursuant to regulation and a management agreement. Notably, the fund periodically publishes all of its investment positions. In addition, it has a set of ethical guidelines and an advisory council on ethics, which considers the ethics of, and sometimes prohibits, investments. It has strategic benchmarks based on indices for its equity investments and for its fixed income investments. Norway also reports the excess return it achieves. Norway is in the process of increasing the equity share of its portfolio to 60% from 42% late last year, which will also increase its exposure to Asia and decrease US exposure. <http://www.nbim.no/Pages/Article____41137.aspx> accessed 27 May 2008.

15 While clear information regarding SWFs' investment policies is limited, it appears that perhaps only SWFs of eight countries (Brunei, Canada, China, Kuwait, Malaysia, Qatar, Singapore and the United Arab Emirates) have policies that may include investments with some degree of control, with Canada and Malaysia having acquired control only over domestic companies. 'Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications', Testimony by Edwin M. Truman, Senior Fellow Peterson Institute for International Economics before the Committee of Banking, Housing and Urban Affairs of the United States Senate, 14 November 2007 (Truman Testimony).

16 See eg *A Growing Global Force* (n 9).

17 ADIA may be taking steps to address concerns related to its lack of transparency—the UAE finance minister has recently issued a statement setting forth certain investment principles, including meeting all applicable disclosure requirements, investing in a well-diversified portfolio across asset classes, geographies and sectors and maintaining appropriate standards of governance and accountability. 12 March 2008 Letter from Yousef Al Otaiba, Director of International Affairs, The Government of Abu Dhabi to the US Treasury Secretary and other OECD authorities (available at http://online.wsj.com/article/SB120578495444542861.html?mod=European-Business-News accessed 23 March 2008). While ADIA has been criticized for its lack of transparency, it bears mentioning that there is variation among countries of the Gulf Co-operation Council on this point and that, for example, the Kuwait Investment Authority (KIA), which has approximately $250 billion in assets under management, reports periodically to the Parliament of Kuwait.

18 CIC was formed in September 2007 when the State FX Investment Corp bought Huijin Investment Company. As of the end of March 2008 it had approximately $300 billion in assets under management. However, in the few months following its inception, it spent a large portion of its initial capital, and it may well receive more capital to invest. Technically, CIC is a separate corporate entity, owned by the Chinese government and reporting directly to China's State Council. CIC has a board of directors with 11 members, including one selected by the employees of CIC. While none of the board members serve on China's State Council, four of the members come from the Ministry of Finance, two from the People's Bank of China, two from the National Development and Reform Commission (China's economic policy think-tank), one from the Ministry of Commerce, and one from China's national pension fund. See eg <http://www.rgemonitor.com> and Michael F Martin, testimony before the US–China Economic and Security Review Commission, 7 February 2008 <http://www.uscc.gov/hearings/2008hearings/hr08_02_07.php> accessed 27 May 2008.

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SWFs, as Brad Setser, a Fellow at the Council on Foreign Relations has noted.[19] Since it was established to decrease the inflationary effects of China's foreign exchange surplus, it funds itself through the issuance of domestic yuan-denominated bonds. These bonds carry an interest rate of 4.5 per cent, which means that if the Chinese Renminbi appreciates by 8 per cent against the US dollar, CIC needs investment returns of 13 per cent net of fees and investment costs for its dollar-denominated investments just to break even. A strategy of attempting to maximize risk-adjusted returns by using an index-based portfolio strategy may not produce sufficient returns, and so CIC may be incentivized to seek higher risk investments, including those involving control.[20] This more aggressive approach is evident in CIC's investment of $5 billion in Morgan Stanley in December 2007.[21] At the same time, it is worth considering that, in addition to scrutiny from investee countries, CIC is the focus of intense scrutiny in its home country due to the large size of China's claims on the US—estimated at one third of China's GDP—and because the losses it has sustained on its investment in Blackstone[22] demonstrate the risks of large equity investments.

Other prominent SWF investment companies include: Qatar Investment Authority (QIA), with estimated assets under management of $50–70 billion; Mubadala, an Abu Dhabi fund with estimated assets under management of $10 billion; Istithmar, a Dubai fund with estimated assets under management of $7 billion; and the Government of Singapore Investment Corporation (GIC), with estimated assets under management of $100–330 billion.[23] These firms, some of which describe themselves as engaged in the venture capital and private equity business, appear to target returns of approximately 15 per cent, which would be consistent with high exposure to control investments, private equity, property, concentrated stakes in public equity and use of leverage.

19 Brad Setser, 'The Implications of Sovereign Wealth Fund Investments for National Security', 7 February 2008 testimony before the US–China Economic and Security Review Commission.

20 CIC's president, Gao Xiqing, however, in a recent interview stated that CIC plans to become more transparent, including by preparing an annual report, and that it has a policy not to obtain control.

21 See WSJ, 'Great Wall Street of China', 20 December 2007 <http://online.wsj.com/article/SB119805649734239175.html> accessed 1 May 2008. China's state-controlled Xinhua News agency reported that the CIC investment involved a $5 billion purchase in securities ranging from $48.07 to $57.68 per share, convertible into common stock; conversion would be calculated at no more than 1.2 times the reference price. See Marketwatch.com, 'Details of CIC's stake in Morgan Stanley revealed' 24 December 2007 <http://www.marketwatch.com/news/story/details-cics-stake-morgan-stanley/story.aspx?guid= per cent7B6175589F-C8D1-49AE-8FA4-EB61BF8F7AC2 per cent7D> accessed 1 May 2008.

22 According to the prospectus for the offering by The Blackstone Group L.P. of its common units in June 2007, CIC's predecessor entity agreed to purchase $3.0 billion of units at $29.605 per unit whereas the price for the units on the NYSE as of late April 2008 was approximately $18 per share.

23 GIC was established in 1981 and is a private company wholly owned by the government of Singapore, which manages funds for a fee on behalf of the government and the monetary authority. The appointment and/or removal of its Directors and Group Managing Director requires assent of the President of Singapore. GIC must also submit its financial statements and proposed budget to the President for approval. The President is entitled, at his request, to any information concerning GIC. In addition, GIC is regularly audited by the Auditor-General of Singapore. There are investment, risk and remuneration committees, which along with the board of directors include independent members. GIC claims to have achieved an average of 9.5% returns in US dollar terms over the 25 year period until 2006. Its portfolio is thought to be approximately 50% equity, 20% bonds and as much as 30% alternatives (private equity, property, commodities) and it is thought to include more investments outside of Asia. In response to recent criticism, GIC has indicated that it will take steps to increase its transparency. http://www.gic.com.sg/ accessed 27 May 2008.

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SWFs can have explicit policy goals beyond investment returns, such as seeking to promote domestic or regional economic development. For example, Singapore's Temasek focuses not only on domestic, but also on regional development.[24] The Korea Investment Company, established in 2005 with approximately $20 billion in assets under management, has indicated that one of its main objectives is to increase the financial skills of the local workforce and to develop the country as the financial hub of northeast Asia.[25] Borse Dubai has acquired significant interests in several exchanges with a view to bolstering the position of Dubai as an international capital centre.[26]

State-owned enterprises

State-owned enterprises, as operating businesses, may also make foreign direct investments. Indeed, these investments may be the most problematic from an investee-country's perspective, particularly when the acquirer and the target are infrastructure companies, because the investments may be seen as a means for gaining political leverage. Prominent examples of attempted acquisitions by state-owned entities that generated significant attention in the USA include the attempted purchase by Dubai Ports World, which is owned by the Investment Corporation of Dubai, of Peninsular & Oriental Steam Navigation Company, a UK company that managed several US ports, as well as the attempted purchase by China National Offshore Oil Company Ltd., another state-owned company, of Unocal Oil Company. In a more recent example, Aluminum Corporation of China (Chinalco) engaged in what seemed at least to some observers as a strategic action when it purchased 9 per cent of the shares of Rio Tinto plc for approximately $14 billion in a precisely executed overnight transaction on 1 February 2008. Given that it was shortly before the deadline under English law for a takeover bid by BHP Billiton and that the Chinese government and Chinalco officials had expressed concern over the potential monopoly power of the resulting merged entity, this investment, which was the largest foreign investment by a Chinese company, whether state-owned or private, to date, has been seen by some as an attempt to interrupt BHP's bid in order to give China better access to iron ore. As of early May 2008, Rio Tinto had rejected two takeover offers from BHP, with the market price of Rio Tinto shares reflecting pessimism in the marketplace that the takeover would be consummated.[27] Although a takeover by BHP would be subject to competition review in the EU, Britain and Australia, China, one of the principal importers of iron ore, May have believed that these reviews would not protect its interest. The Australian Prime Minister said that the Australian Foreign Investment Review Board (FIRB), which must approve foreign stakes in Australian-listed companies

24 Temasek is the other SWF in Singapore. Temasek has estimated assets under management of $10 billion and recently began publishing an annual report listing its investments in some detail.

25 http://www.kic.go.kr/en/?mid=co01 accessed 27 May 2008.

26 For example, in September 2007 Borse Dubai, which is 60% owned by the Investment Corporation of Dubai, the investment arm of Dubai, acquired approximately 28% of the London Stock Exchange; QIA purchased 10% of OMX AB; and Borse Dubai purchased 20% of NASDAQ.

27 See eg Bloomberg.com, 2 May 2008, 'Rio Shares Trade at Record Discount to BHP Bid Price' (noting that on 2 May, Rio Tinto Group's shares traded as much as 7.1% below BHP's all-stock offer of $162 billion) <http://www.bloomberg.com/apps/news?pid=20601081&sid=aWG_uc5Zx_68&refer=australia> accessed 5 May 2008.

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of 15 per cent or greater, and which has some authority over smaller purchases, was considering investigating Chinalco's purchase. It is perhaps to pre-empt such investigation that Chinalco voluntarily made a submission to FIRB that would allow it to obtain a 19.9 per cent holding in Rio Tinto, the maximum level permitted before a takeover offer must be made under Australian law, even though it had no intention to purchase additional shares of Rio Tinto.[28] Still, this is not necessarily a black and white case of non-economic behaviour, given that Chinalco's bid included $1 billion from Alcoa. Moreover, it has been suggested that a nuanced view of Chinalco's purchase would include consideration that all of the Chinese institutions involved, even if they may ultimately be answerable to the state, are new institutions that are organizationally separate and with managers that are evaluated, at least to some extent, on their own institution's profitability.[29]

As can be seen from these examples, while SWFs may have different considerations in managing their assets, some non-economic considerations are benign. SWFs that do have policy objectives are generally focused on regional development, so that there is relatively little risk that these investments could harm investee countries outside their region. Moreover, it is an important advantage for SWF investees that SWFs do not face withdrawals and other current payment obligations faced by conventional large investors, such as pension funds and insurance companies, which means that they may be able to undertake longer investment horizons with higher risks. Accordingly, most SWFs should be understood as investors that take a longer term view and can take companies private or restructure them in ways that mutual funds cannot.

3. Economic forces and trends affecting SWFs

Although the term 'sovereign wealth fund' was coined in the last several years,[30] sovereign investment entities as a class have a reasonably long history. Early examples include Kuwait, where an investment fund was established prior to Kuwait's independence from Britain in the 1950s. It is noteworthy, however, that there have been many SWFs formed in the last decade, and as of early 2008 SWFs are estimated to have approximately $3–4 trillion of assets under management.[31] This represents a significant portion of the global aggregate equity market capitalization of approximately $50 trillion, although some have questioned whether it overstates their potential impact through FDI since it is at best unclear as to what percentage of funds SWFs have readily available to invest, versus domestic assets they own or invest in—such as national banks, oil companies, or other state-owned entities and investments—that they are unlikely to liquidate anytime soon.[32]

28 Forbes, 'Australian govt to assess Chinalclo's [sic] Rio Tinto investment in national interest' 5 February 2008 <http://www.forbes.com/markets/feeds/afx/2008/02/05/afx4613824.html> accessed 27 May 2008.

29 Richard McGregor, 'A complex rationale for China's raid on Rio' 14 February 2008 *Financial Times*.

30 The term apparently can be traced to a 1995 report by Andrew Rozanov of State Street Global Investors. Martin A Weiss, CRS Report to Congress: Sovereign Wealth Funds: Background and Policy Issues for Congress, Updated 31 January 2008 <http://assets.opencrs.com/rpts/RL34336_20080128.pdf> accessed 23 March 2008 (CRS Report).

31 SWF Tracker (n 12).

32 This question was posed for example by Christopher Balding of the Milken Institute <http://www.milkeninstitute.org/> accessed 27 May 2008.

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Still, this figure is estimated to grow significantly, perhaps to $7.5 trillion or more in the next 4 years.

Below, we provide an overview of the growth of SWFs and how their investments can be expected to shift away from government securities, including US Treasuries and into more aggressive asset categories.

Growth of SWFs

The rise of SWFs is notable as part of a long-term shift in the composition and relative influence of the participants in global capital markets. According to a McKinsey study, of the world's estimated $170 trillion or so of financial assets as of late 2007, the share held by four relatively new kinds of investors—petro-dollar investors, Asian central banks, hedge funds and private equity funds—is approximately 5 per cent and growing, with assets held by these types of investors expected to increase from $8.4 trillion now to between $15.2 and $20.7 trillion in the next 5 years.[33] SWFs generally are a subset of petro-dollar investors and Asian central banks. Due to the tripling of oil prices between 2002 and 2007, petro-dollar investors, including sovereign-owned entities and wealthy individuals, were estimated to have $3.4–$3.8 trillion at the end of 2006 in foreign financial assets resulting from oil and gas revenues, with about half held in the countries of the Gulf Co-operation Council (GCC: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) and about half held in the other large oil exporters, Norway, Russia, Nigeria, Venezuela and Indonesia.[34] Asian central banks have accumulated foreign exchange reserves estimated at approximately $3 trillion while maintaining policies to manage exchange rates against the dollar and foster exports.[35] Hedge fund assets under management tripled from 2002 to mid 2007 and as of that time were $1.7 trillion, which may yield investments of $6 trillion after leverage.[36] Private equity firms had $710 billion in assets at the end of 2006, and while they are the smallest of the four investor classes, they are important because of their dynamism and the growing tendency for large companies to be held privately.[37] SWFs have also been investing in hedge funds and private equity funds, as discussed below, creating powerful combinations, and raising additional concerns regarding the influence SWFs may wield. By way of comparison, the estimated assets under management of pension funds, mutual funds and insurance companies at the end of 2006 were about $21.6 trillion, $19.3 trillion and $18.5 trillion, respectively.[38] In addition, the size of the assets of ADIA ($600–900 billion)

33 Diana Farrell, Susan Lund, Eve Gerlemann and Peter Seeburger, McKinsey Global Institute, 'The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets' October 2007 <http://www.mckinsey.com/mgi/publications/The_New_Power_Brokers/>accessed 23 March 2008 (McKinsey Report).

34 Ibid.

35 Ibid. In addition in the month of January 2008 alone, China's foreign exchange reserves are reported to have increased by $61.6 billion. This approximates the monthly US current account deficit for the month of December 2007 of approximately $60 billion.

36 *McKinsey Report* (n 33).

37 Ibid.

38 Ibid.

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approaches half of the size of the assets managed by the largest asset manager, Barclays Global Investors, at approximately $1.8 trillion.[39]

One important implication of the emergence of these classes of investors is the continued growth of private capital markets. According to McKinsey there has been a larger volume of public-to-private transactions than IPOs in each year since 2002.[40] In addition, the volume of private placements of equity has increased at an average annual rate of 60 per cent since 2002 (although still a relatively small absolute amount of $7.4 billion), while listed IPOs have only been growing at a rate of 17 per cent per year.[41]

Shift in sovereign assets away from the dollar

Although the dollar's share has been slowly declining, the bulk of global foreign exchange reserves are still held in dollars.[42] The dollar's share can be expected to decline further as funds from oil exports and Asian exports are diverted to SWFs.[43] According to testimony from the chief economist of Standard Chartered Bank, if Asian central banks were to switch reserves to match the countries with which they trade, they would need to sell $1.39 trillion, an amount equivalent to approximately a quarter of the world's total reserves.[44]

This system of accumulation of US Treasury foreign reserves in exporting countries has had important economic consequences. For the USA, it has been estimated that accumulation by Asian central banks of foreign exchange reserves in the form of US Treasury obligations has decreased US long-term interest rates by as much as 55 basis points and that investments from petro-dollars have decreased rates by as much as 40 more.[45] In the exporting countries, there is corresponding inflationary pressure. The five out of six countries in the GCC that have retained a peg to the dollar are under pressure to follow the example of Kuwait, which switched from pegging its currency to the dollar to a basket of currencies in May 2007 or risk serious inflation. Moreover, as foreign investments tend to diversify away from US Treasury obligations towards higher yielding

39 *A Growing Global Force* (n 9)

40 McKinsey Report (n 33).

41 Ibid.

42 According to the IMF's Currency Composition of Foreign Reserves data, the proportion of US dollar claims among aggregate allocated official foreign reserves was 68.1, 66.5 and 64.0% in the third quarters of 2003, 2006 and 2007 <http://www.imf.org/external/np/sta/cofer/eng/index.htm> accessed 19 March 2008.

43 For example, a Morgan Stanley analysis has estimated that approximately 40% of SWFs' assets will be in dollars, compared with 60% of their countries' reserves, and approximately 20% will be in yen, compared with just 2% of reserves. Stephen Jen, 'Tracking the Tectonic Shift in Foreign Reserves and SWFs' March 2007 <http://www.morganstanley.com/views/gef/archive/2007/20070316-Fri.html#anchor4580>. Setser and Ziemba estimate that total GCC 'official assets' including generally both reported reserves and SWF assets are 57% in dollars; however, this figure is subject to estimating the dollar composition of the portfolio of ADIA, the largest single institution. 'Understanding the New Financial Superpower-The Management of GCC Official Foreign Assets' December 2007 <http://www.cfr.org/publication/15206/understanding_the_new_financial_superpower_the_management_of_gcc_official_foreign_assets.html> accessed 27 May 2008. Annex I to the IMF Work Agenda provides a model of the potential effect of allocation of foreign currency reserves in countries with newly established SWFs showing significant decreases in US dollar investments.

44 Gerard Lyons, 'State Capitalism: The rise of sovereign wealth funds' 13 November 2007 testimony before the US Senate Committee on Banking, Housing and Urban Affairs <http://banking.senate.gov/public/_files/111407_Lyons.pdf> accessed 5 May 2008, 19.

45 McKinsey Report (n 33).

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assets, there could be a significant effect on the US current account. Up until now, the current accounts imbalance between the USA and the rest of the world has been partially offset by the relatively higher returns the USA has earned on foreign investments, which have long tended to be in higher yielding assets than government debt.[46]

Although they are not fully industrialized, many of the oil exporters and East Asian countries are now net exporters of capital and their investments are not limited to the Organization for Economic Co-operation and Development (OECD),[47] but rather flow to a broad range of countries. The Institute of International Finance (IIF) expects its sample of 30 emerging markets countries, led by the East Asian countries, to have net capital exports in 2008 of around $1.3 trillion. The IIF expects the GCC countries, which were not included in the 30 country sample, to have capital exports of approximately $253 billion in 2008, similar to their current account surplus.[48] Significant portions of these investments will be directed to other emerging markets. For example, the IIF has also reported that investments originating from the Middle East are global, with 20 per cent of investment from Gulf States going to Europe, 11 per cent to the Middle East/ North Africa and 11 per cent to Asia between 2002 and 2006.[49] Similarly, the rate of FDI outflows in non-OECD countries is growing at a faster rate than FDI inflows. For example, according to figures from Chatham House, China's FDI outflows increased at a much higher rate between 2002 and 2005 than its FDI inflows. Over this period FDI outflows increased from $2 billion to $11 billion, or more than five times, while FDI inflows increased only 38 per cent from $52 billion to $72 billion.[50]

Due to their growing size and diversified portfolios, SWFs are a part of, and contribute to, these trends.

Shift in investments to more aggressive asset categories

As foreign reserves accumulate, and as the dollar declines, there is an increased interest by countries that establish SWFs in moving holdings from government debt to higher yielding riskier assets, extending beyond conventional fixed income and equity investments to hedge funds and private equity and beyond. This trend of SWF diversification is apparent in the shift of investments away from US Treasury obligations to different asset classes.

46 According to a report from Chatham House, an independent UK research institution, the IMF figures show that US-owned stock abroad consists of 22% direct investment, 20% portfolio investments and a remainder of primarily banking operations and FX management, while, in contrast, foreign-owned assets in the US consist of 60% portfolio investments and only 10% direct investments. Paolo Subacchi, 'Capital flows and emerging market economies: a large playing field?' Chatham House, September 2007 (Subacchi Report).

47 The OECD is an organization composed of the governments of 30 developed countries formed to address economic, social and governance challenges of globalization as well as to exploit its opportunities. In this article, we use the term 'OECD' to refer to the organization as well as the group of countries of which it is composed.

48 The Institute of International Finance, Inc., 'Capital Flows to Emerging Market Economies' 6 March 2008 <http://iif.com/emr/> accessed 20 March 2008.

49 The Institute of International Finance, Inc., 'Regional Briefing-Gulf Cooperation Council' May 2007 <http://iif.com/emr/emr-af/> accessed 20 March 2008.

50 Subacchi Report (n 46).

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There have been a number of recent announcements highlighting SWFs seeking higher returns through investments in private equity funds. It has been reported that CIC is planning a $3–4 billion investment in a private equity fund advised by J.C. Flowers & Co. LLC,[51] and GIC is planning an investment of $2.5 billion in a private equity fund advised by TPG.[52] In addition, SWFs have completed several large investments in private equity and hedge fund companies, including CIC's $3 billion investment in non-voting common units of Blackstone, Mubadala's $1.35 billion investment in The Carlyle Group and Dubai International Capital's $1.2 billion investment in Och-Ziff Capital Management Group LLC. In addition to investing in such funds, SWFs have competed and partnered with them in such investments as the QIA's potential investment in the UK grocery firm J. Sainsbury Plc last summer, which featured involvement at various times from Kohlberg Kravis Roberts, Blackstone and others, and the KIA investment in the electricity company TXU Corp. (now Energy Futures Holding Corp.), which was made together with Kohlberg Kravis Roberts and TPG.

In addition, several recent SWF investments in concentrated minority equity positions demonstrate some of the characteristics that have led to public attention in the USA and EU. According to Dealogic, SWFs invested $37.9 billion in US financial institutions in 2007.[53] While these investments provided a source of liquidity that was important in addressing market concerns about capitalization of US financial institutions, they also represent significant investments in firms that play an important role in the US economy. Moreover, while none of the investments resulted in a greater than 10 per cent holding, the parties to these transactions took pains, in light of the sensitivity of investments that could be seen as giving SWFs influence, to emphasize the non-controlling nature of the investment.

4. Concerns surrounding investments by SWFs

As described above, there are a variety of state-controlled investing entities (as opposed to state-controlled operating companies), which are differentiated primarily by their investment objectives and sources of funding. These entities have long engaged in investment activities—including investing in foreign assets—without attracting criticism or concern. However, SWFs are currently accumulating large amounts of capital that they can be expected to invest in significant stakes in the equity of foreign companies. There are reasonable policy concerns when state-controlled investment entities invest in foreign equities, especially when there is a possibility that such investments may be made with a view to control or to achieve political objectives. As SEC Chairman Christopher Cox has thoughtfully described,[54] the foreseeable increase in SWF investment raises a variety of issues (such as difficulty of enforcement) beyond the obvious concern that an investee

51 Henny Sender, 'Sovereign wealth finds private equity bedfellows' *Financial Times* (14 February 2008).

52 Costas Paris, 'Singapore May Invest in TPG Fund' Wall Street Journal 14 February 2008.

53 CRS Report (n 30).

54 Christopher Cox, 'The Rise of Sovereign Business' 5 December 2007 and 'The Role of Government in the Markets' 24 October 2007 <http://www.sec.gov/news/speech/speecharchive/2007speech.shtml> accessed 26 March 2008.

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country's national security could be compromised if certain companies—such as defense contractors, infrastructure and key technology companies—become controlled by an entity which in turn is directly or indirectly controlled by a foreign government. Below, we provide an overview of these issues.

Governments as investors

Government interaction in financial markets may lead to inefficiencies. As SEC Chairman Christopher Cox, former US Treasury Secretary Larry Summers and others have observed, a fundamental premise of capital markets is that pricing, and therefore, ultimately, resource allocation, should be determined by individual investors seeking economic returns. As shareholders, governments may have different interests than merely maximizing the value of the shares of the issuer. These other interests could include technology transfer, access to raw materials, access to buyers or even larger political or social purposes. If SWF assets, currently equal to approximately 6 per cent of the amount of global equity market capitalization, grow as expected and were invested principally in equity, these issues could have a significant impact on public capital markets.

Governments as competitors

In addition, competition by publicly backed entities may not be fair or may decrease confidence in markets. For example, government-related entities may have access, through their intelligence services or through official or regulatory contacts, to greater information than the public. Public markets could be damaged if investors came to believe that they were at an information disadvantage relative to sovereign investors.

It is perhaps for these reasons that significant public ownership of companies is something that the USA has, in contradistinction to many other countries, largely rejected, with government activity accounting for a relatively small portion of the US economy.[55] The exceptional public investment entities parallel to SWFs that do exist in the USA, such as the Alaska Permanent Fund (with approximately $37 billion in assets),[56] the New Mexico State Land Grant Permanent Trust (with approximately $9 billion)[57] and the Permanent Wyoming Mineral Trust Fund (with approximately $3.7 billion),[58] are notable for their low profile, portfolio investment model and absence of policy as a factor in investments.

Capital markets enforcement against governments

Enforcement may be difficult against government market participants. If a securities regulator of an investee country sought to investigate allegations of misconduct by a foreign government-owned entity, the securities regulator of such foreign country, to

55 According to the US Bureau of Economic Analysis, government consumption and investment constituted approximately 20% of GDP in the fourth quarter of 2007. <http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=5&FirstYear=2006&LastYear=2007&Freq=Qtr> accessed 27 May 2008.

56 http://www.apfc.org/ accessed 27 May 2008.

57 http://www.sic.state.nm.us/index.htm accessed 27 May 2008.

58 http://treasurer.state.wy.us/investmentsbank.asp#invest accessed 27 May 2008.

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which the securities regulator of the investee country would look for assistance in the case of action against a private market participant, may be faced with a significant conflict of interest.[59] Former US Treasury Secretary Larry Summers gave an example at the Davos World Economic Forum of the potential political ramifications of SWF investments—the Norway Government Pension Fund's short-selling of Icelandic bank bonds two years ago. In this case the Prime Minister of Iceland protested publicly, which demonstrates how investments by foreign governments can complicate efforts at cross-border enforcement, in this case by escalating what would otherwise be a regulatory issue into a political one. It also bears mentioning that in the USA, even if a foreign securities regulator did not actively co-operate in an enforcement action against that country's SWF, the SEC has the ability to take action against entities with assets in the USA. A basic principle of the law of sovereign immunity in the USA is that commercial activity by sovereign entities should not be beyond the reach of US law.[60]

Government administration of large funds

The concentration of power in SWFs increases the possibility of corruption. This is particularly the case for funds managed by civil servants who are not compensated on the basis of the performance of the fund. There is also a risk of insider trading, which could raise particularly difficult enforcement issues. If a senior, politically influential figure in an SWF provided inside information that allowed a relative to trade ahead of the market, one could imagine the securities regulator in that country hesitating to co-operate with the SEC.

5. Existing regulation applicable to SWF foreign investment

Several jurisdictions have regulatory regimes in place to address many of the concerns raised regarding foreign investment by SWFs. These existing regulatory frameworks provide the context for considering any potential additional regulation. These laws and regulations are generally geared towards ensuring disclosure of significant shareholdings, reviewing potentially controlling interests, and in certain instances restricting foreign investment. Below, we provide an overview of how foreign investment is addressed in several OECD countries and touch briefly on regulation of FDI by certain countries that sponsor SWFs, a factor which may colour perception of potential additional regulation by investee countries.

59 A concrete example was the difficulty of enforcement actions in connection with the attempt by Credit Lyonnais, a bank, to acquire Executive Life, an insurance company, through companies affiliated with Francois Pinault, a French businessman with significant connections to then French President Jacques Chirac, in evasion of the laws prohibiting such acquisitions. Karen Shaw Petrou, Sovereign Wealth Funds: Implications For US Financial Institutions testimony before the US–China Economic and Security Review Commission 7 February 2008 <http://www.uscc.gov/hearings/2008hearings/hr08_02_07.php> accessed 23 March 2008. (Petrou Testimony). See also 'The Humbling Of France's Top Tycoon: The Executive Life scandal casts a pall on François Pinault's fortune' *Businessweek*, 8 December 2003.

60 The SEC's position on these matters was presented, for example, in the Tafara Testimony. The USA has a significant body of law on the limits on sovereign immunity in commercial contexts, including *Republic of Argentina v. Weltover, Inc.*, 504 US 607 (1992) and *I.T. Consultants v. Pakistan, 551* F3d 1184 (DC Cir 2003), interpreting the Foreign Sovereign Immunities Act, 28 USC 1604.

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National security review of foreign investment

Several countries have laws and regulations in place to conduct reviews of foreign investment. While each country's processes differ, these reviews are generally triggered when foreign investment exceeds a certain threshold of ownership, implicates national security concerns, or both.

For example, in the USA, national security review of acquisitions is conducted pursuant to the Foreign Investment and National Security Act of 2007 (FINSA).[61] FINSA was passed in 2007 to codify and strengthen the existing national security review regime[62] after the controversy surrounding the proposed acquisitions by China National Offshore Oil Company of Unocal and by Dubai Ports World of Peninsular & Oriental Steam Navigation Company. In April 2008, the US Treasury proposed regulations to implement the provisions of FINSA (the 'Proposed Regulations').[63] FINSA generally requires the Committee on Foreign Investments in the US (CFIUS) [64] to (i) review acquisitions by foreign persons of control[65] of US businesses in the interest of US national security[66] during a 30 day period after notice or its own initiation of the review, (ii) investigate such acquisitions during an additional 45 day period if the transaction threatens the national security of the US, is by a foreign government controlled entity, would result in critical infrastructure coming under control of a foreign person or the government agency leading the review so recommends and (iii) report its findings to Congress. The President is authorized, as a general matter, to prohibit or suspend, or to order divestiture in respect of, such transactions if, after consideration of specified factors,[67] (i) there is

61 Pub. L. No. 110-049, 121 Stat. 248 (2007).

62 FINSA, which became effective in October 2007, extensively amended the 1988 Exon-Florio Amendment (Pub. L. No. 102-99, 150 Stat. 487 (1988) (codified at 50 U.S.C. App. 2170)) to the 1950 Defense Production Act.

63 Regulations Pertaining to Mergers, Acquisitions and Takeovers by Foreign Persons <http://www.treas.gov/press/releases/reports/proposed_regulations42108.pdf> accessed 27 May 2008.

64 Pursuant to FINSA and Executive Order 13456 dated 23 January 2008, the members of CFIUS are: Secretary of the Treasury (chairman); Secretary of Commerce; Secretary of Defense; Secretary of Homeland Security; Secretary of State; Attorney General of the United States; Chairman of the Council of Economic Advisors; Director of the Office of Management and Budget; Director of the Office of Science and Technology Policy; The U.S. Trade Representative; Assistant to the President for Economic Policy (National Economic Council); Assistant to the President for National Security Affairs (National Security Council); Assistant to the President for Homeland Security and Counterterrorism; Secretary of Energy; Secretary of Labor (non-voting, ex officio); Director of National Intelligence (non-voting, ex officio); and the heads of any other executive department, agency, or office, as the President or the Secretary of the Treasury determines appropriate, on a case-by-case basis.

65 Under the Proposed Regulations, control is defined broadly as 'the power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct or decide important matters affecting an entity' and to include consideration, in situations where more than one foreign person has an interest in a US person, of factors such as whether the foreign persons are related and/or whether they have commitments to act in concert. Significantly, the Proposed Regulations expand the concept of control to include the right to prevent certain decisions, some of which may formerly have been seen merely as minority protections.

66 FINSA clarified the construction of the term national security to include issues relating to 'homeland security', including its application to critical infrastructure.

67 FINSA added to the existing list of factors to be considered (generally domestic production needed for projected national defence requirements, the capability of domestic industries to meet those requirements, the effect thereon of control of domestic industries by foreign citizens, the potential effects of the transaction on sales of military technology to certain countries and the effects of the transaction on US security technological leadership) consideration of the national security-related effects on critical technologies, whether the acquirer is a foreign government-controlled entity and, if so, whether it co-operates with US non-proliferation and counterterrorism efforts or would transship military technologies and long-term US requirements for sources of energy and other resources.

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credible evidence that the foreign person or foreign-controlled entity exercising control might take action that threatens to impair national security and (ii) other laws do not provide adequate protection. There is an exemption from CFIUS review for the acquisition of voting securities 'solely for purposes of investment', which requires the acquirer have no intention to participate in business decisions of the issuer and either (i) not own more than 10 per cent of the company, or (ii) be an entity of a specified type that does not have as a significant portion of its business acquiring control over companies.[68] The Proposed Regulations would revise these provisions to exempt transactions that result in a foreign person holding 10 per cent or less of the outstanding voting interests in a US business, but only if the transaction is 'solely for the purpose of investment';[69] a transaction is 'solely for the purpose of investment' if the person holding or acquiring such interests has no plans or intention of exercising control, does not possess or develop any purpose other than investment, and does not take any action inconsistent with acquiring or holding such interests solely for the purpose of investment.[70]

In the USA, in 2006, of approximately 10,000 M&A transactions, 1,730 were cross-border of which 113 (6.5 per cent) came before CFIUS–-none were blocked.[71] CFIUS has reviewed approximately 2,000 cases since inception in 1988 of which only a few have been blocked.[72] The only presidential divestiture order occurred in 1988 in connection with a Chinese company's acquisition of a US aircraft parts company.[73]

However, despite the small number of final negative determinations by CFIUS, CFIUS review can have an *in terrorem* effect that discourages transactions. For example, an official of CIC has indicated that it will not consider investments in the USA that may be subject to CFIUS review.[74] Another notable recent example of how CFIUS can restrict foreign investment is the decision at the end of February 2008 by Bain Capital and Huawei Technologies to abandon their bid to acquire US computer networking company 3Com after hearing that CFIUS would not approve it.[75] CFIUS was notified because 3Com might be deemed to have critical technology. The initial bid apparently contemplated that Huawei would own approximately 16 per cent of the company and would have seats on the board but would not have management control of the company

68 31 CFR 800.302(d).

69 31 CFR 800.302(c) in the Proposed Regulations. This provision and the examples accompanying it clarify that there is no numerical safe harbour for investments of less than 10% of a company's voting interests. It responds to pressures such as the letter dated 13 March 2008, from House Financial Services Committee Chairman Barney Frank, Financial Institutions and Consumer Credit Subcommittee Chairwoman Carolyn Maloney, and Domestic and International Monetary Policy, Trade and Technology Subcommittee Chairman Luis V Gutierrez to Treasury Secretary Paulson, which requested that the FINSA implementing regulations address investment by SWFs and other foreign government entities by (i) clarifying that the 10% threshold is only one indicia of control and (ii) providing guidance on the factors CFIUS will consider in exercising its waiver authority to permit certain government-owned entities to make acquisitions subject only to a review.

70 31 CFR 800.223 in the Proposed Regulations.

71 Kimmitt Article (n 5).

72 Ibid.

73 Ibid.

74 Henny Sender and Mure Dickie, 'China fears scupper $2bn deal for 3Com' *Financial Times* 21 February 2008.

75 Ibid.

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and that a division of the company that provides security software to the US government would be divested. Huawei is not an SWF—it is privately owned, apparently in large part by its employees, although its founder is a former officer in the Chinese People's Liberation Army.

It remains to be seen whether FINSA and the Proposed Regulations will result in a US national security review process that is objective and transparent and not subject to political pressure or industry lobbying.[76]

Regulation of foreign investment by other OECD countries

Other OECD countries have regimes for formal and informal control over foreign investment and face similar political concerns in maintaining free investment regimes.

France

In France, the operative law is the 1996 Foreign Investment Law.[77] There is a process for reviewing foreign acquisitions triggered by the nature of such acquisitions, including that the acquisition relates to public functions, security and research or trade in substances with military uses. At least nine potential acquisitions have been rejected under the law. France also has informal obstacles to FDI, including government ownership of companies in industries such as defence, infrastructure and energy.

Japan

Japan regulates FDI by its Foreign Exchange and Foreign Trade Control Law, which, as a general matter, requires prior notification of control acquisitions in specified industries and review based on national security, public order, public safety and adverse effects on the economy. Similar to the CFIUS review in the USA, Japan can invoke the law to block foreign investment of more than 10 per cent of a company vital to national security. Japan has recently moved to reject foreign investment from a UK hedge fund, citing national security grounds; this marks the first time Japan has invoked its national security law to block foreign investment. The Finance Ministry of Japan recommended that the Japanese government reject a bid by The Children's Investment Fund Management Ltd, a UK hedge fund, to double its 9.9 per cent stake in Electric Power Development Co. The chairman of the Finance Ministry panel reviewing the investment noted that the electric company was vital to Japan's electricity supply, and that the company's plans to build

76 For a listing of the many recent transactions that have been rejected in the USA and elsewhere on the basis of national security concerns that have been called into question, see Alan Beattie, Stephanie Kirchgaessner and Raphael Minder, 'Left in the cold: Foreign bidders find themselves out of favour' *Financial Times* 25 April 2008 <http://www.ft.com/cms/s/0/b17514a4-1220-11dd-9b49-0000779fd2ac.html>.

77 See eg Steffen Kern, Sovereign wealth funds-state investments on the rise, Deutsche Bank Research, 10 September 2007. According to research by the US Government Accountability Office, after an adverse ruling by the European Court of Justice, France enacted Law 2004-1343, which reformed the foreign investment review process. Based on the law, a 2005 Ministerial Decree identified certain sectors of the economy in which foreign control acquisitions require the prior approval of the French Ministry of Economy, Finance and Employment: defence, power generation and distribution, oil and petrochemical, telecommunications, coal, aviation and shipping. Discussions between France and the EC continue. Foreign Investment-Laws and Policies Regulating Foreign Investment in 10 Countries, GAO-08-320, February 2008 <http://www.gao.gov/new.items/d08320.pdf> (GAO Report) accessed 27 May 2008.

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a nuclear plant also influenced the government's recommendation to block the investment.[78]

Germany

In Germany, the 1961 Foreign Trade and Payments Act gives the government the authority to regulate or restrict FDI for reasons of national security, public order, foreign policy or balance of trade.[79] The German government has announced its intention to amend this law to enhance the scope of industries subject to protection and, perhaps, to establish a process or authority for reviewing applicable FDI transactions similar to the CFIUS process in the USA.

Disclosure requirements

Several countries have disclosure requirements that are triggered in respect of significant holdings of public equity securities. For example, in the USA, Section 16 of the US Securities Exchange Act of 1934 (Securities Exchange Act) generally imposes on every person that is directly or indirectly the owner of more than 10 per cent of any US-registered class of equity securities the obligation to disclose its ownership interest and to disclose any changes within two business days.[80] Regulation 13D–G under the Securities Exchange Act generally imposes an obligation to file Schedule 13D within 10 days when any person or group acquires beneficial ownership of more than 5 per cent of any class of US-registered voting equity securities, regardless of the nationality of the acquirer or the target.[81] Passive investors may be eligible to provide reduced disclosure on Schedule 13G,[82] which generally follows the same timeline as Schedule 13D, although certain passive US institutional investors are permitted to file Schedule 13G within 45 days of the end of the year.[83] Finally, Section 13(f) of the Securities Exchange Act generally requires an institutional investment manager, which includes any person, other than a natural

78 Bloomberg.com, 'Japan Poised to Reject U.K. Fund TCI's J-Power Bid' 16 April 2008 <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aWenHYcJLkyA#> accessed 21 April 2008.

79 According to the GAO Report, this Act was amended in 2004 after a US company bought a controlling share in a German submarine manufacturer. The amendment provided for review of any acquisition of more than 25% of the voting rights of a German company producing armaments, ammunition, cryptographic equipment or engines and gear systems for tanks or other armoured military tracked vehicles.

80 As Ethiopis Tafara, the Director of the SEC Office of International Affairs noted, this additional disclosure requirement reinforces the generally applicable proscription on insider trading under Rule 10b-5 for persons who may have access to inside information due to their position of influence with respect to an issuer. Testimony of Ethiopis Tafara before the Subcommittee on Domestic and International Monetary Policy, Trade and Technology, and the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, 5 March 2008 <http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr030508.shtml> accessed 23 March 2008 (Tafara Testimony).

81 Beneficial ownership is a broad term that generally includes any person who has or shares the power to vote or sell the securities. Schedule 13D generally requires disclosure of: (i) the identity of the acquirer, including management, directors and controlling entities, (ii) the source and amount of funds used to acquire the securities, (iii) the purpose of the acquisition, including any plans for certain control-related actions, (iv) details of holdings and certain purchases of the securities and (v) any arrangements relating to the securities.

82 Schedule 13G generally requires disclosure of: (i) the identity of the acquirer, (ii) the basis for Schedule 13G eligibility, (iii) the amount and percentage of target securities held and (iv) the identity of the persons on whose behalf it owns the securities or who comprise an acquiring group.

83 The SEC has issued no-action letters permitting the more lenient timing requirements to certain foreign institutional investors that would qualify for them if they were US entities and to certain foreign governments. See eg Stichting Pensoenfonds ABP (7 May 2004).

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person, buying or selling securities for its own account, that exercises investment discretion with respect to accounts holding $100 million or more of US-registered equity securities, to file periodic reports with information on the issuer and other characteristics of the securities, their number and fair market value and certain trading information.

Other jurisdictions have similar disclosure requirements triggered by significant shareholdings. For example, as of 20 January 2007, the Financial Services Authority (FSA) in the UK implemented a new regime for notification of major shareholdings under the EU Transparency Directive. The new disclosure regime applies to anyone who holds shares in registered UK public companies or any entities (including non-UK entities) whose shares are admitted to trading on a regulated market (such as the London Stock Exchange) or a prescribed market (such as the Alternative Investment Market), where the UK is their home state for the purposes of the EU Prospectus Directive. Disclosure requirements are triggered where a person holds, either directly or indirectly, shares or financial instruments of listed UK or non-UK issuers conferring voting rights which reach or exceed certain thresholds, as detailed below. When these thresholds are reached, such person must notify the issuer and (if the shares are traded on a regulated market) at the same time file a copy with the FSA. The issuer has the obligation to make public the information contained in the notification. The new regime sets out two separate thresholds depending on whether the shares are issued by UK or non-UK issuers. In the case of UK issuers, direct or indirect shareholders are required to disclose shareholdings which reach or exceed 3 per cent of the total voting rights and each 1 per cent threshold thereafter. For non-UK issuers, direct or indirect shareholders will be required to disclose shareholdings at 5, 10, 15, 20, 25, 30, 50 and 75 per cent, in accordance with the Transparency Directive.

Other regulation of foreign investment

There are several other bodies of law that can affect FDI.

Competition law is an area where countries take different approaches. However, the USA has a system of advance notification under the Hart-Scott-Rodino Act intended to permit competition authorities the opportunity to review large acquisitions before consummation.[84] As a very general matter, whenever there is an acquisition of voting securities or assets with a US connection that meets certain size of person and size of transaction tests (beginning as low as approximately $60 million), there is an obligation to file a notice and wait for a thirty-day review period, subject to a variety of exceptions, including for acquisitions of not more than 10 per cent of a company's voting securities solely for the purpose of investment.

Other laws provide a basis for the review of SWF investments in regulated industries. For example, the US-Bank Holding Company Act of 1956 (the BHC Act) requires approval by the US Board of Governors of the Federal Reserve System (FRB) before a company acquires control of a bank; while there is a rebuttable presumption that

84 Pub. L. No. 94-435, Tit. II, Sec. 201, 90 Stat 1390 (codified as amended at 15 USC 18a).

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acquiring less than 5 per cent of the voting securities of a bank will not provide control, the FRB has discretion over whether a company with less than 5 per cent nonetheless 'exercises a controlling influence over the management or policies of the bank'.[85] There are also change of control-related requirements in other regulated industries such as communications,[86] power[87] and transportation.[88] In addition, US export laws and classified information limitations restrict disclosure of encryption systems to foreign-controlled persons and the granting of public contracts involving classified information.[89]

Finally, while it is not a legal restriction on FDI, it is also interesting to consider whether SWFs should be subject to tax in the manner they would be if they were not sovereign owned.[90]

Collection of information on foreign investment

The USA collects information on foreign direct investment in a mandatory reporting system established by the 1994 International Investment and Trade in Services Survey Act that is to serve as a basis for informed FDI policy.[91] As a general matter, any foreign person acquiring an interest of at least 10 per cent in a US business, including real estate, or any US person in which such an interest is acquired, must file a report within 45 days of the transaction with the US Bureau of Economic Analysis containing information about the acquirer, per cent of ownership acquired and resulting ownership, the identity, employees, assets, revenue and industry of the acquired business, any local tax incentives provided and the cost of the acquisition, and must make periodic filings thereafter.[92]

Regulation of foreign investment by certain SWF-sponsor countries

One factor that can be expected to influence the debate regarding additional regulation of investments by SWFs in the USA and the EU is the regulation of foreign investment by

85 12 USC 1841(a). While the FRB has taken the position that foreign governments are not 'companies' for the purpose of the BHC Act, and the BHC Act specifically excludes corporations controlled by the US or a state government from the scope of the term 'company', SWFs that are corporate entities would be subject to this provision. Scott G Alvarez, General Counsel Board of Governors of the Federal Reserve System testimony before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology, and the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives 5 March 2008 <http://www.house.gov/apps/list/hearing/financialsvcs_dem/hr030508.shtml> accessed 23 March 2008.

86 For example the US Federal Communication Act of 1934, which prohibits, as a general matter and subject to waiver by the US Federal Communications Commission, ownership of a radio station licensee by any corporation directly or indirectly controlled by a corporation more than 25% of which is owned by foreign persons. 47 USC 310.

87 For example the US Nuclear Regulatory Commission's review of any proposed transfer of a licence, including through change of control. 10 CFR 70.36.

88 For example the general requirement that a US air carrier be a 'citizen of the United States' under 49 USC 40102(a)(2).

89 For example the limitations to 'U.S. persons' or foreign governments of licences or approvals under the International Traffic in Arms Regulations. 22 CFR 120–130.

90 Currently in the USA, Section 892 of the Internal Revenue Code exempts foreign sovereigns from US income tax on income from passive investments, which treatment some have found at odds with the proposition that SWFs should be treated as a normal, non-political investors for other purposes. Victor Fleischer, Taxing Sovereign Wealth Funds, 8 March 2008 <http://www.theconglomerate.org/2008/03/taxing-sovereig.html> accessed 23 March 2008. On 13 March 2008 the Senate Committee on Finance asked the non-partisan Joint Committee on taxation for an analysis of this issue. Letter from Sen Max Baucus and Sen Charles Grassley to Mr Edward Kleinbard <http://finance.senate.gov/press/Gpress/2008/prg031308.pdf> accessed 23 March 2008.

91 (P.L. 94472, 90 Stat. 2059, 22 U.S.C. 3101–3108), with implementing rules and regulations set forth in 15 CFR Part 806.

92 A summary of the filing requirements is at <http://www.bea.gov/surveys/pdf/2008fdius_report_req.pdf> accessed 27 May 2008.

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countries with SWFs. The USA in particular has sought more openness towards FDI from several of the countries that have SWFs.

China

In China, foreign investments face a review process that has been characterized as non-transparent, principally under two regulations. The 2006 Provisions for Merger and Acquisition of Domestic Enterprises by Foreign Investors require prior approval for foreign investments that affect national economic security, involve a major industry or result in the transfer of a famous trademark or a traditional Chinese brand; this process has been recognized by the OECD as bringing China closer to international norms for transparent review of investment. The Catalog for the Guidance of Foreign Investment Industries (the 'Catalog'), which provides basic guidance for foreign investment in China, was revised in November 2007; the Catalog divides industries into categories based on whether foreign investment is encouraged, permitted, restricted or prohibited.[93]

Russia

In Russia, the 1999 Federal Law on Foreign Investments was characterized as insufficient to protect national interests in the wake of two attempted acquisitions by US companies that were politically contentious, and legislation is under consideration that would implement a review of certain foreign investments modelled on the US system.[94]

United Arab Emirates

In the UAE at present, foreign persons are prohibited under the Companies Law from owning more than 40 per cent of an Emirati company; however, there is an expectation that this restriction may be relaxed.[95]

6. How to address concerns raised by SWF foreign investment?

The recent increased profile of SWFs has led international bodies to revisit applicable existing guidance, as well as to propose new initiatives, in an effort to address the perceived risks of SWF foreign investment. While there are both well-founded as well as specious reasons for controlling FDI by public entities, countries should maintain a commitment to open markets and avoid restricting direct investments merely because they come from foreign entities. This is particularly true since unnecessary restrictions on foreign direct investments can trigger retaliatory restrictions.

As an initial matter, it is important to keep the issues raised by SWF foreign investment in perspective. Given that acquired assets are under the physical control of the investee

93 GAO Report (n 77) Annex V. Other principal authority includes the State Council's Opinion on Revitalizing Industrial Machinery Industry, which effectively imposes an approval requirement for control acquisitions of 'large, key and backbone equipment manufacturers', the Guiding Opinion Concerning the Advancement of Adjustments of State Capital and the Restructuring of State-Owned Enterprises, which restricts investment in sectors such as defence, power generation and distribution, oil and petrochemicals, telecommunications, coal, aviation, and shipping, deemed critical to the national economy and, beginning in August 2008, the Anti-trust law. Ibid. Still, institutional factors can constitute even greater obstacles than the formal conditions to investment—the authors are familiar with a variety of proposed investments that were frustrated merely by the timing requirements of attempting to comply with unclear and cumbersome approval requirements.

94 GAO Report (n 77).

95 GAO Report (n 77).

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country, the risks of investment may be greater for the SWF than for the investee country; for example, CITGO is a US company that has long been owned by the Venezuelan government without incident. In other words, the investee country has the ability to restrict or regulate interactions between the SWF and the entity it has invested in.[96]

In the first part of this section, we describe several areas of concern that have been identified regarding foreign investment by SWFs. In the latter part of this section, we describe several global initiatives and proposals for addressing such concerns.

Principles for addressing concerns raised by SWF foreign investments

The concerns expressed surrounding FDI by sovereign investing entities generally arise from the potential for political interference with the governance of a state-controlled investing entity, as well as the relative lack of transparency of SWF investment objectives and operations. Below, we discuss these concerns further, as well as set out principles that should be adhered to when formulating a policy response to address such concerns.

Governance standards

Governance standards are an issue for any institution; however, governance issues can be more acute at state-owned institutions. In addition to the possibility that the risk of corruption may be greater due to lower salaries than in comparable private institutions, the management of state-owned entities presents agency problems due to the distance from the ultimate principals, the citizens of the state, which can result in diffuse responsibility and a lack of accountability.

Accordingly, appropriate governance policies and procedures are important from the perspective both of the investing and the investee country to support the institution in achieving its purpose. Areas in which governance guidelines should be considered include: clear allocation and separation of responsibility within the fund and between the fund and other government entities,[97] promulgation of an overall statement of investment policy (which would presumably specify economic goals) and a means of enforcing compliance with that investment policy, operational autonomy as an investing institution, disclosure of policies and procedures to ensure operational integrity, and risk management policies.

Transparency

Transparency is an important consideration because SWFs represent potentially significant actors in capital markets; a lack of transparency could imperil public faith in the markets. This concern is aggravated by the fact that several of the less transparent SWFs in the Middle East and China are likely to become significant forces. Areas in which disclosure should be considered include: the constitutive authority, governance structure and objectives of the institution, the sources and uses of funds, procedures for making investment and divestiture decisions and periodic financial reporting and portfolio disclosure, investment practices (such as the use of derivatives or alternative investment

96 Holman Jenkins, Living with 'Sovereign Wealth' Wall Street Journal, 26 December 2007.

97 Ideally, legislation could establish an SWF as an independent agency, along the model of many central banks. See eg Philipp Hildebrand, 'The Challenge of Sovereign Wealth Funds' <www.telos-eu.com> accessed 2 April 2008.

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classes), the identity of managers, returns on investment, fund size and the conditions for portfolio adjustment.[98]

Some aspects of transparency aid the home government. For example, since part of the reason for establishing many SWFs is fiscal balance, it is generally appropriate for SWFs to specify objectives that are non-cyclical and do not amplify inflation.[99] Other aspects of transparency benefit the market or foster acceptance of SWFs. For example, accurate reporting of fund size or policy for investments and disinvestments could assuage concerns that capricious action by funds could cause market disruption.[100]

Due to the close relationship between SWFs, private equity and hedge funds, one could consider increased transparency as a common issue. In fact, some countries, like Germany, seem to be approaching transparency as applicable to such broad range of investing entities, while others, like the USA, distinguish between them. In particular, US Deputy Secretary of the Treasury Kimmitt noted that concerns regarding transparency can be distinguished in the case of SWFs, on the one hand, and hedge funds and private equity, on the other: the latter can be assumed to be acting out of their own economic interest and so do not represent the same threat to public markets as governmental action.[101]

Initiatives to address concerns of SWF investment

The concerns precipitated by SWF foreign investment have led to several initiatives. These initiatives are based on voluntary guidelines set out by international organizations, or otherwise arrived at in a multilateral arrangement. While these initiatives adhere to the principles we set out above, one of the key challenges for policymakers will be addressing the limitations of voluntary measures; we discuss these challenges, and proposed responses, below.

Existing guidelines

One frame of reference for efforts to address SWF investment will presumably be the considerable existing body of guidance created by international organizations on the topic of governance of sovereign entities and sovereign asset management. In particular, the IMF Reserve Management Guidelines, which were developed in order to allow

98 *Truman Testimony* (n 15); Stuart Eizenstat, 'Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?' testimony before the Joint Economic Committee of the US Congress, 13 February 2008. Judging from the 20 March announcement by the US Treasury and representatives of authorities in Singapore and Abu Dhabi, which noted the usefulness of disclosure of 'purpose, investment objectives, institutional arrangements, and financial information—particularly asset allocation, benchmarks, and rates of return over appropriate historical periods' it appears that some SWFs may consider additional disclosures in this area.

99 Singapore has recognized the value of clarifying the objectives of GIC, as evidenced by the discussions conducted by the Ministry of Finance with GIC on publicizing its processes, governance and purposes of the sovereign-wealth fund. PR Venkat, Singapore Working to Clarify Aims Of Sovereign-Wealth Fund, New York Times, 5 March 2008.

100 Truman suggests considering the relative costs and benefits of improved data collection (as in the draft of the 6th edition of the *IMF's Balance of Payments and International Investment Position Manual*) to break down holdings of equity and debt securities by governments other than as foreign exchange reserves. 'Truman Testimony' (n 15).

101 Nevertheless, similar to SWFs, if perhaps not to the same degree, both the hedge and private equity industries are subject to calls for greater transparency. In efforts to provide suggested guidelines for these entities, Sir Andrew Large chaired the Hedge Fund Working Group which released 'Hedge Fund Standards: Final Report' in January 2008 (http://www.hfsb.org) and Sir David Walker prepared 'Guidelines for Disclosure and Transparency in Private Equity' in November 2007 (http://walkerworkinggroup.com) accessed 27 May 2008.

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countries to develop their reserve management practices and to strengthen the resiliency of the overall international financial architecture, emphasize transparency, clarity of roles and accountability. In addition, the OECD published Guidelines on Corporate Governance of State-owned Enterprises in 2005.[102] These guidelines were formulated in light of problems in the management of state-owned companies and are intended to describe methods for creating an effective legal and regulatory framework that permits fair competition with state-owned entities, for ensuring that the governance of entities is conducted in the best interests of the citizens of the state, and for achieving transparency in governance and management.

Multilateral efforts

In November 2007, the European Commission indicated that it was considering moving to regulate SWFs.[103] However, this initiative faced opposition, particularly in light of the effect it would have on London's position as a capital markets centre. In the USA, the policy has been to emphasize the importance of open markets as well as the need for voluntary guidelines for SWF governance and transparency and for investee country transparency in regulating foreign direct investment.[104] More recently, the EC has announced adoption of a position closer to that of the USA with a common, multi-lateral EU approach to SWF investments premised on capital markets openness, voluntary transparency and governance guidelines, although some uncertainty remains how this will interact with Member States' national security regulation.[105]

In addition, following a meeting in October 2007 hosted by the US Department of Treasury with the Group of Seven (finance ministers from the seven major industrialized nations—USA, Japan, Germany, UK, France, Italy and Canada), the IMF, the OECD, finance ministers and SWFs from eight leading countries (China, Kuwait, Norway, Russia, Saudi Arabia, Singapore, South Korea and the UAE), the IMF undertook to work with SWFs to establish best practices for SWF investment in foreign countries. A draft is expected to be available by autumn 2008.[106] In counterpoint to the IMF initiative to

102 OECD Guidelines on Corporate Governance of State-Owned Enterprises <http://www.oecd.org/document/33/0,3343,en_2649_37439_34046561_1_1_1_37439,00.html> (OECD Guidelines).

103 Joaquin Almunia, the EU's economic commissioner, said '. . . We need to set out European principles because we can't fulfill the internal market and its roles if each member state has different principles. . .In coming weeks, the Commission will contribute a set of principles and guidelines. We hope that they will be adopted by member states and the parliament'. EC to rule on sovereign wealth funds, International Herald Tribune, 29 November 2007.

104 Kimmitt Article (n 5).

105 Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A common European approach to Sovereign Wealth Funds, 27 February 2008 <http://ec.europa.eu/commission_barroso/president/pdf/COM2008_115_en.pdf> accessed 23 March 2008 (the 'EC Guidelines'). The EC Guidelines set out a group of overarching principles member states should follow when determining how to address concerns arising from SWF investment, and further note that the keys to effectively addressing such concerns revolve around obtaining greater transparency in the governance, activities and investments of SWFs. While greater transparency is also a central tenant of the OECD Guidelines, the OECD also sets out a number of additional guidelines, such as ensuring an effective legal and regulatory framework for state-owned enterprises (SOE), as well as the development of policies to clearly identify the extent of the state's involvement in the corporate governance of the SOE.

106 While it is not clear whether this effort will yield a widely adopted set of practices, there have been welcoming indications from some SWF countries. As mentioned earlier, the Director of International Affairs of The Government of Abu Dhabi wrote a letter to officials in the US Treasury and various other OECD countries in which he expressed hope that this process 'will lead to

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develop best practices for SWFs, the OECD is developing best practices for investee countries, building on the US regime. The USA, Singapore and the UAE have already announced a short list of principles in general support of these efforts.[107] It is not yet clear what the relationship will be between the new voluntary SWF guidelines and the existing IMF guidelines.

Dispute resolution through the World Trade Organization

There may be another means of addressing concerns about SWF foreign investment under existing law, given that exchange rate undervaluation and SWFs are related phenomena: as foreign reserves of developing countries increase, these countries have increasing amounts of funds to invest through their SWFs. Aaditya Mattoo from The World Bank, and Arvind Subramanian from the Peterson Institute have proposed that these concerns could be addressed through the World Trade Organization (WTO).[108] They argue that the WTO is an appropriate forum because it is a multi-lateral organization with an existing dispute resolution mechanism and provisions that are close to addressing some of the non-security related issues with FDI by SWFs. Specifically, they note that Article XCII of the General Agreement on Tariffs and Trade includes rules designed to ensure that state trading entities of member countries do not take actions that distort trade and require them to act solely on a commercial basis, transparently and without discriminating, and that the Government Procurement Agreement (a legally binding agreement in the WTO focusing on government procurement) requires a high level of transparency with respect to specific procurements, which could be extended to include investments. They reason that China may be motivated to participate in such negotiations by its concern over global trade and by the potential benefits of clarifying, on a multi-lateral basis, the permissible restrictions on access to FDI by SWFs. They also emphasize that the credible prospect of concerted action by the countries affected by exchange rate undervaluation through the WTF could constitute significant leverage. While such a multi-lateral action would be a significant undertaking, it has the important advantage of addressing the economic causes of SWF growth along with the issues relating to their investment activities. In our view, it is more likely that government sponsors of SWFs will wish to address concerns regarding their foreign investments on an individual, rather than multilateral, basis—however, as another

thoughtful consideration regarding the responsibilities of both those making and receiving investments from government capital'. <http://online.wsj.com/article/SB120578495444542861.html?mod=Asian-Business-News> accessed 29 March 2008.

107 These parties announced the following principles for SWFs, together with a similar number of principles for investee countries: (i) SWF investment decisions should be based solely on commercial grounds, rather than to advance, directly or indirectly, the geopolitical goals of the controlling government. SWFs should make this statement formally as part of their basic investment management policies. (ii) Greater information disclosure by SWFs, in areas such as purpose, investment objectives, institutional arrangements, and financial information—particularly asset allocation, benchmarks, and rates of return over appropriate historical periods—can help reduce uncertainty in financial markets and build trust in recipient countries. (iii) SWFs should have in place strong governance structures, internal controls, and operational and risk management systems. (iv) SWFs and the private sector should compete fairly. (v) SWFs should respect host-country rules by complying with all applicable regulatory and disclosure requirements of the countries in which they invest. US Treasury press release of 20 March 2008 <http://ustreas.gov/press/releases/hp881.htm> accessed 27 May 2008.

108 Aaditya Mattoo and Arvind Subramanian, 'Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization', January 2008 Peterson Institute for International Economics Working Paper WP 08-2 <http://www.iie.com/publications/interstitial.cfm?ResearchID=871> accessed 22 March 2008.

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potential approach for addressing concerns surrounding SWF investment, Mattoo and Subramanian's proposal is nevertheless worthy of discussion.

If voluntary measures are not followed, there is a risk of a regulatory response imposing unwarranted impediments to foreign investment by SWFs. It has been argued that more stringent regulation of investment by SWFs is necessary in order to protect the USA from US companies being ultimately controlled by governments, such as those in China, Russia or Saudi Arabia, that do not necessarily subscribe to the principle that private actors, and not the state, should be the profit-maximizing entities in society.

What if voluntary measures do not work?

In the event that SWFs do not follow voluntary measures, commentators have proposed restrictions including limiting investment to only index funds, imposing position reporting requirements,[109] or requiring SWFs that invest in US financial institutions to be managed by a third-party professional manager or through a diversified investment company, with a presumption of control and advance supervisory review and approval for investments of greater than 5 per cent made other than through a third-party manager or a diversified investment company.[110] Some have advocated more stringent measures, such as caps on the share of US companies that could be held by sovereign entities in the aggregate and individually.[111]

While foreign investment by SWFs raises legitimate concerns, it is not clear that these measures could practicably be implemented or, if they could be, that they would improve on the existing applicable regulatory frameworks.

Below, we discuss two proposals intended to address the limitations of voluntary measures

Suspend voting on shares held by SWFs

A proposal by Prof. Ronald J. Gilson of Stanford Law School and Columbia Law School, and Prof. Curtis J. Milhaupt of Columbia Law School, would involve the suspension of voting rights of any shares held by SWFs.[112] The authors note that the concerns arising as a result of SWF investment stem primarily from a tension between two factors, one economic, the other tied to national regulation. As previously noted in this article, and as Gilson and Milhaupt also note, as foreign-exchange reserves of developing countries continue to increase, SWFs are shifting their investment strategies to higher yielding, higher risk investments, with the result being 'high profile, and highly controversial investments'.[113] The policy responses to these investments raise additional tensions,

109 Prof. Peter Navarro testimony before the US–China Economic and Security Review Commission, 7 February 2008 <http://www.uscc.gov/hearings/2008hearings/hr08_02_07.php> accessed 23 March 2008.

110 Petrou Testimony.

111 Alan Tonelson 2/7/08 testimony before the US–China Economic and Security Review Commission, 7 February 2008 <http://www.uscc.gov/hearings/2008hearings/hr08_02_07.php> accessed 23 March 2008.

112 Ronald Gilson and Curtis Milhaupt, Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism, February 2008 (Gilson and Milhaupt) <http://ssrn.com/abstract=1095023>.

113 Gilson and Milhaupt, p 4. The article goes on to cite as examples ADIA's investment in Citigroup, as well as CIC's investment in Blackstone.

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particularly when those investments involve the acquisition of significant but non-controlling stakes which do not trigger thresholds under existing regulation in the investee country for additional disclosure or national security review. In such instances, policy responses to date have been limited to voluntary guidelines calling for increased transparency and adherence to certain governance standards. Gilson and Milhaupt's proposal is intended to address the limitations of voluntary guidelines, which by their nature cannot be enforced, while on the other addressing concerns raised by investments which, while falling below a threshold trigger of government review, may nevertheless influence a company's actions. Gilson and Milhaupt advocate a 'minimalist' approach, which would involve the equity of a US firm acquired by a foreign government-controlled entity losing its voting rights, but regaining them when transferred to non-state ownership, thereby separating control from investment. However, the authors acknowledge that there are a number of issues raised by their approach. As an initial matter, it is unclear how effective divorcing control from investment would actually be in preventing effective control of a firm; a significant shareholder could exercise control without formal voting rights, including through the prospect of withholding future investment. It is also unclear if the suspension of voting restrictions could effectively be enforced, particularly in light of other methods sovereign entities may use to obtain voting rights (eg borrowing shares on a temporary basis). Finally, any analogous retaliatory measures taken by foreign governments could adversely affect US funds' (eg state pension funds) ability to invest in foreign companies.[114]

Utilize existing disclosure requirements

In the event SWFs do not adhere to voluntary guidelines, instead of implementing protectionist policies that would adversely impact global investment, or even taking a (relatively) more 'minimalist' approach as proposed by Gilson and Milhaupt, one potential alternative would be to leverage existing significant shareholding disclosure requirements. For example, it might be effective in the USA for the SEC to require SWFs that file under Section 13D to disclose all of the information called for by the IMF guidelines on transparency. Potentially, SWFs that already comply with such guidelines could, if they met all the other requirements, be eligible to use Schedule 13G. Another variation on this alternative could be to amend 13D and related provisions to require SWFs in particular to disclose their investments in US companies under a lower percentage ownership threshold (eg 1 per cent) unless they adhered to certain guidelines regarding transparency, such as those proposed by the IMF (though this alternative would have the disadvantage of requiring legislation to amend 13D). Under either alternative, these approaches would permit investment while achieving the goal of disclosure and provide a level of information both to the investee company and to the market that the SEC deems appropriate. Other existing regulations, such as the SEC's

114 This concern was echoed in a recent article which further noted that, if applied by the USA to its own sovereign investing entities, this approach 'would disenfranchise as much as several trillion dollars of investments by US state and local government pension funds'. See Edwin M Truman, 'A Blueprint for Sovereign Wealth Fund Best Practices', Policy Brief, Peterson Institute, April 2008, 12.

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Regulation SK,[115] could be bolstered to require management of companies in which an SWF has invested to disclose unusual pressure on business practices from SWFs; these requirements could be supplemented by enhanced whistle-blower protections to increase the likelihood that secret coercion is detected.

7. Conclusion

In order to prevent overreaction by policymakers in responding to foreign investment by SWFs, certain principles should be adhered to, with the overarching goal of ensuring that regulation of FDI by government entities is transparent, proportionate and multi-lateral. We believe that voluntary approaches currently being promulgated should be sufficient to address the actual risks from investments by SWFs.

However, in the event that the political situation demands an additional response, then the next area for consideration should be addressing concerns by bolstering existing regulation (such as that applicable to disclosure of significant shareholdings), or resolving concerns through existing multilateral organizations, such as the WTO, as proposed by Mattoo and Subramanian. Only after considering the efficacy of such responses would we suggest the possibility of limiting investment by, or suspending voting rights of, SWFs that lack an independent third-party investment manager or other indicia of independence from government policymakers. While we encourage an active debate on whether such limitations are reasonable, practical or effective, if we move beyond disclosure as a remedy, we must be careful to avoid regulation that is more symbolic than effective.

The prospect of increasing activity by SWFs does bear attention. Their rapidly growing base of assets raises the prospect of significant investments in the equity of investee country companies, which could pose a variety of market integrity and corporate governance issues. At the same time, however, there are significant regulations already in place both in OECD and developing countries to address national security concerns and significant shareholder and other disclosure regimes provide significant visibility for SWF investments. Moreover, while the outcome is uncertain at present, there is real progress towards voluntary increases in SWF disclosure and governance standards. In the end, the policy concerns relating to the trade and fiscal conditions that have resulted in the dramatic growth of SWF assets pose greater challenges than the legal questions relating to the proper regulation of their investment in securities.[116]

115 17 CFR 229. Generally, Regulation S-K sets out the requirements applicable to the content of the non-financial statement portions of certain statements required to be filed with the SEC, such as registration statements and annual reports to shareholders.

116 'There's been much talk recently of sovereign wealth funds and how they are buying large pieces of American businesses. This is *our* doing, not some nefarious plot by foreign governments. Our trade equation guarantees massive foreign investment in the U.S. When we force-feed $2 billion daily to the rest of the world, they must invest in *something* here. Why should we complain when they choose stocks over bonds?' Warren E Buffett, Letter to the Shareholders of Berkshire Hathaway Inc., February 2008, 17 (emphasis in original) <http://www.berkshirehathaway.com/letters/2007ltr.pdf> accessed 27 May 2008.

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