Chapter 4

The Evolving Politics of Sovereign Wealth Funds*

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§ 4:1 Introduction

In recent years, sovereign wealth funds (SWFs) have grabbed the international spotlight, igniting intense debate. Sensing the difficult political terrain that they must navigate, such funds have generally adopted a low profile. And by offering attractive financing terms and generally taking passive minority positions in the companies in which they invest, they have been a desirable source of capital for distressed companies. Maintaining a low profile has been a wise political choice, and earlier calls to regulate these funds have quieted down. However,

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* This chapter is an updated version of an article that first appeared in the *Revue d'Économie Financière* and is reprinted herein with permission: Laura Badian, Gregory Harrington, "The Evolving Politics of Sovereign Wealth Funds," Revue d'Économie Financière, Sovereign Wealth Funds Special Issue (June 2009).

† The authors wish to acknowledge the assistance they received from Lindell C. Toombs Jr., an associate at Arnold & Porter LLP, in preparing this article.

the severe global financial crisis and a concomitant shift in the geopolitical and economic landscape in the United States, Europe, and other members of the Organisation for Economic Co-operation and Development (OECD) may present these funds with their greatest political and economic challenges yet.

While Paris burns (as do countries and markets around the world), one might assume that SWFs, by providing cash infusions to faltering financial institutions and other falling stars, would be able to raise their political capital, but this is not necessarily the case. "I will not be the French President who wakes up in six months' time to see that French industrial groups have passed into other hands," President Nicolas Sarkozy remarked in October 2008,[1] insisting that France needs to protect its national companies from foreign "predators." He fears that SWFs will amass too much power if permitted to invest in important French businesses while the souring global economy drives down acquisition costs. Sarkozy has decided that France should start its own fund to shield French enterprises from foreign investments. These policies reflect what many experts say the global economy cannot afford in the current environment (protectionism and "beggar thy neighbor" policies).

Other European nations have not followed suit. Indeed, the British government, led by Prime Minister David Cameron, has actively courted investment in British businesses by SWFs. Most recently, British oil company BP reportedly has held discussions with SWFs in Abu Dhabi, Kuwait, Quatar, and Singapore, to help it raise cash and fend off takeover bids while it addresses the oil spill in the Gulf of Mexico.[2] Although only appointed prime minister in May 2010, Mr. Cameron has already directed Britain's top diplomats to improve relations with SWFs.[3] Meanwhile Germany vehemently opposed Sarkozy's suggestion that European nations collaborate to establish a common protectionist fund. Michael Glos, Germany's Minister of Economics and Technology from November 2005 until February

1. Ben Hall, *Sarkozy Plans New French Wealth Fund*, FIN. TIMES, Oct. 23, 2008.
2. *See* Amena Bakr & Nicolas Parasie, *BP Approaches Funds to Fend Off Takeover Bids: Source*, REUTERS, July 6, 2010, *available at* www.reuters.com/article/idUSTRE66510C20100706.
3. *See* Alex Barker, *Foreign Office Builds Economic Reinforcements in Brics*, FIN. TIMES, Aug. 5, 2010.

2009, said that such a policy "contradicts all the successful principles of our economic policy."[4] The current economics minister, Rainer Brüderle, similarly supports the objective of marketing Germany "as an attractive investment destination, particularly for sovereign wealth funds."[5]

In the United States, SWF regulation has been on hold as the Obama administration and Congress have focused their attention on Wall Street reform as a result of the credit crisis and the faltering economy. But this may be the calm before the storm. If the global economy continues to falter and enters a double-dip recession, protectionist legislation that appeals to populist sentiment could come to the fore. Although the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), signed into law on July 21, 2010,[6] does not regulate sovereign wealth funds, it imposes registration, reporting, and record-keeping obligations on investment advisers to "private funds" (including hedge funds and private equity funds) under the Investment Advisers Act of 1940. This change opens the door to eventual regulation of SWFs, and an argument that foreign investment funds should not be treated more favorably than domestic ones.

SWFs have their backers, at least for now, while their funds are badly needed. "We need the money," proclaimed Barney Frank (D-MA), the Chairman of the U.S. House Financial Services Committee. "The infusion of money is helpful. . . . We'd be worse off without it."[7] But it is difficult to see how SWFs can continue to escape a tighter regulatory grip in the United States when private equity funds, hedge funds, and other non-bank financial institutions have been unable to escape unscathed. Indeed, one of the main arguments SWFs have relied on to

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4. Douglas Herbert, *Sarkozy's Economic Axis of Evil*, FRANCE 24 INT'L NEWS, Oct. 22, 2008.
5. *See* Federal Ministry of Economics and Technology, *The Foreign Trade and Investment Campaign Tapping Opportunities—All Around the World,* Mar. 2010, at 18, 21–22, *available at* www.bmwi.de/English/Navigation/Service/publications,did=340278.html.
6. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
7. David Enrich, Robin Sidel & Susanne Craig, *World Rides to Wall Street's Rescue*, WALL ST. J., Jan. 17, 2008.

muster support for an open investment environment in recipient countries—that domestic and foreign pools of capital should be treated on a level playing field—may soon work to their disadvantage.[8]

The fate of SWF investment depends not only on the political and economic circumstances in recipient countries, but the environment in their home countries. The negative returns that many SWFs received on their investments in 2008 have had the effect of putting many of these funds on the defensive. At the same time, the home countries of many funds have not been immune from the financial crisis, particularly with the fall in commodity prices and the decline in exports to industrialized nations, and managers are facing increased pressure to make domestic investments.

Section 4:2 provides background information on SWFs, showing how the investment strategy of such funds has evolved in recent years towards riskier investments in foreign markets, a trend that has begun to reverse during the current financial turmoil. In section 4:3 we discuss SWF investment from the vantage point of recipient countries and summarize their concerns. Section 4:4 discusses whether the recent adoption of the Santiago Principles by many of the most important SWFs, and the adoption of OECD guidance to SWFs, is likely to forestall regulation. In section 4:5, we explore the multifaceted challenges that SWFs face in the United States, in the context of the political views of key members of the Obama administration and proclivities of the U.S. Congress. Section 4:5 also focuses on the political outlook for such funds in the United States, the U.S. perspective on these funds is likely to have broader implications for SWFs in other OECD recipient countries.

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8. *See* Bader al Sa'ad, Managing Director of the Kuwait Investment Authority, Keynote Speech at the First Luxembourg Foreign Trade Conference: Overview on the Kuwait Investment Authority and Issues Related to Sovereign Wealth Funds (Apr. 9, 2008), stating that ". . . if a set of principles or codes of conduct are established for sovereign wealth funds, then recipient countries should also have the same set of principles for all pools of capital, including hedge funds, private equity funds, pension funds, savings funds, and other non-listed funds, in OECD and non-OECD countries. There should be a common and level playing field for all."

§ 4:2 Background on Sovereign Wealth Funds

The investment goals of SWFs are as varied as the nations that establish them. However, SWFs are often identified in two broad categories according to the source of their foreign exchange assets: commodity and non-commodity funds.[9] Commodity SWFs are funded with revenue derived from commodity exports. Typically established by oil-rich nations, these funds serve different purposes, such as fiscal revenue stabilization, preservation of inter-generational wealth, and balance of payments sterilization. Non-commodity SWFs are established through assets transferred from official foreign exchange reserves. Due to balance of payments surpluses, nations with non-commodity SWFs have accumulated more reserves than what the government considers necessary to defend the country against financial shocks. These "excess" foreign exchange reserves are deposited into SWFs and managed separately from official reserves.[10]

SWFs have changed dramatically over the last half-century. The first SWF, the Kuwait Investment Office, was created in 1953 for the purpose of investing surplus oil revenues to reduce Kuwait's reliance on its finite oil resources.[11] The fund created little controversy until 1987, when it purchased over 20% of British Petroleum, which had recently been privatized. The British government, concerned that a foreign country would own such a large percentage of the company, forced the Kuwaitis to sell over half of their stake.[12]

However, it was only in recent years that SWFs increased rapidly in number and size, arousing public interest. Although estimates vary

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9. Robert M. Kimmitt, Deputy Secretary of the U.S. Department of the Treasury, *Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy*, FOREIGN AFF., Jan./Feb. 2008; U.S. Department of the Treasury, Report to Congress on International Economic and Exchange Rate Policies, App. 3 (2007) [hereinafter Treasury, Report to Congress], *available at* www.treas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007_Appendix-3.pdf.

10. *See* Treasury, Report to Congress, *supra* note 9. SWFs in China, South Korea and Taiwan are examples of this type of fund. *See Asset-Backed Insecurity*, ECONOMIST, Jan. 17, 2008 [hereinafter *Asset-Backed Insecurity*].

11. *Asset-Backed Insecurity*, *supra* note 10. *See also* SWF Institute, Kuwait Investment Authority, *available at* www.swfinstitute.org/fund/kuwait.php.

12. *Asset-Backed Insecurity, supra* note 10.

based on the definition of "sovereign wealth fund" used, the Sovereign Wealth Fund Institute lists fifty such funds using a broad definition, and estimates that these funds control approximately $3.9 trillion in assets as of June 2010.[13] Analysts project that these funds will continue to grow rapidly. Stephen Jen, an analyst formerly with Morgan Stanley who followed SWFs closely, estimated in May 2007 that SWFs would potentially amass $12 trillion in wealth by 2015.[14] He lowered this estimate to $10 trillion in October 2008 as SWFs suffered large losses during the financial crisis.[15] To put these numbers in perspective, in September 2007, total assets under management by private hedge funds were estimated to be around $2 trillion, U.S. GDP was approximately $12 trillion, the total value of traded debt and equity securities denominated in U.S. dollars was estimated at over $50 trillion, and the global value of traded securities was estimated at approximately $165 trillion.[16] In this context, the wealth of SWFs is significant, but their existence should not automatically set off alarms or lead to paranoia.

The increased size of SWFs in recent years has encouraged many fund managers to shift investment strategies. Following the old adage that "increased risk leads to greater rewards" and courted by cash-strapped countries and companies, many SWFs now have substantial assets invested in equity markets throughout the world. No longer do these funds invest only in U.S. Treasury bonds.

However, the global economic downturn and volatility in the equity markets reduced SWF profitability. Although only a handful of SWFs disclose performance information when the markets turned down in 2008, it was not difficult to deduce what was happening to

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13. *See* the Sovereign Wealth Fund Institute fund rankings by assets under management, *available at* www.swfinstitute.org/fund-rankings/.
14. *Asset-Backed Insecurity, supra* note 10 (stating that Stephen Jen, an economist at Morgan Stanley, who tracks these funds closely, has "penciled in $12 trillion for 2015").
15. *See* Ye Xie and Anchalee Worrachate, *Jen Exits Morgan Stanley With Dollar Smile Going to BlueGold*, BLOOMBERG, Oct. 6, 2009, *available at* www.bloomberg.com/apps/news?pid=newsarchive&sid=aAd8Yfd2ZVXM.
16. *See* Simon Johnson, *Straight Talk—The Rise of Sovereign Wealth Funds*, 44 FIN. & DEV. (Sept. 2007), *available at* www.imf.org/external/pubs/ft/fandd/2007/09/straight.htm.

funds that had taken major equity stakes. Some SWFs suffered portfolio losses of as much as 25% in 2008.[17] Having suffered major losses on their equity investments, and facing pressure at home, fund managers were understandably reluctant to invest.[18] SWFs face increased scrutiny from the citizens that were supposed to benefit from SWF investments.[19] As a result, the level of SWF investment declined sharply in the first two quarters of 2009, especially in the financial services and real estate sectors, although investment picked up in the second half of 2009.[20]

Diminished returns in 2008 not only contributed to a slower growth rate among SWFs, but there is another reason these funds were less robust than they were at the end of 2007—they simply had less money to invest. Many funds, particularly those based in oil-rich Middle Eastern countries, experienced lower revenue as commodity prices fell. Worldwide demand for oil dropped and the record profits enjoyed by commodity-driven economies waned. Similarly, in many non-commodity-based economies, export receipts fell as major importing nations entered into recession, leaving less cash to flow into SWFs.

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17. *See* Stanley Reed, *Sovereign Wealth Funds Taste Bitter Losses*, BUS. WEEK, Dec. 11, 2008 [hereinafter Reed] (stating that Stephen Jen, an economist at Morgan Stanley, estimates that SWFs had seen declines of 18% to 25% in their holdings in 2008).
18. *See* Lin Noueihed, *Cash-strapped West Looks to Wary Gulf in Crisis*, REUTERS, Nov. 2, 2008 (citing Eckart Woertz, an economist at Gulf Research Centre, who stated, "Some of these Gulf SWFs are estimated to have over half their portfolios invested in equities which have lost 30% or more . . . so naturally they are reluctant.").
19. *See* George Chen, *China's Sovereign Fund Hires Experienced Dealmakers*, REUTERS, Dec. 4, 2008 ("CIC has attracted criticism at home over its investments in US financial institutions which have been battered by the credit crisis, with its stakes in private equity house Blackstone Group . . . and Morgan Stanley . . . diving in value.").
20. *See* Monitor Group and Fondazione Eni Enrico Mattei, *Back on Course: Sovereign Wealth Fund Activity in 2009*, May 17, 2010, *available at* www.monitor.com/iw-cc/command/tabid/69/ctl/ArticleDetail/mid/705/CID/20101305154110429/CTID/1/L/en-US/Default.aspx. *See also* Bob Davis, *Sovereign Funds Tightened the Spigot*, WALL ST. J., May 17, 2010, *available at* http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748704379004575248174033805334.html.

At the same time, as the result of the financial crisis, many SWFs have been under domestic pressure to redeploy their cash to support local markets and "bail out" domestic firms.[21] In addition, the liquidity crunch required central bank reserve managers to maintain larger cash reserves, so that fewer "excess" reserves are available for investment.

Nevertheless, according to *Reuters* data, global announced mergers and acquisitions activity involving SWFs increased in the second quarter of 2010 to $12.5 billion, up from $1.1 billion in the first quarter, with thirty-three transactions completed. In comparison, at the height of SWF mergers and acquisitions activity in the first quarter of 2006, a total of thirty-five transactions were completed with an aggregate value of $45.7 billion. Based on the first month and a half of the third quarter of 2010, SWFs have completed thirteen mergers and acquisitions transactions with an aggregate value of $2 billion. Separate *Thompson Reuters* data shows that SWF investments in British and continental European listed companies fell slightly through August 2010 since the beginning of the year, after having sharply risen in 2009. Some SWFs have expanded their portfolio in emerging and frontier markets in 2010, where they have invested in long-term infrastructure or resource projects.[22]

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21. *See* Reed, *supra* note 17, noting that some funds "have come under pressure to use their assets more for domestic purposes than for foreign investment." *See also* Luo Jun, *Central Huijin Spends $175 Million on Three Banks, Paper Says*, BLOOMBERG, Dec. 3, 2008, reporting that Central Huijin Investment Co., a unit of China's SWF, has invested $175,000,000 in three Chinese banks—Industrial & Commercial Bank of China Ltd., Bank of China Ltd. and China Construction Bank Corp.—to bolster confidence in China's stock market. In December 2008, Qatar's SWF, the Qatar Investment Authority, reportedly invested in various important Qatari financial institutions, including Doha Bank QSC, Qatar's third-biggest bank by assets, Qatar Islamic Bank SAQ and Al Khalij Commercial Bank QSC, to boost their capital levels and support domestic development projects. *See* Ari Sharif, *Qatar Islamic Bank to Sell 39.4 Million Shares to Wealth Fund*, BLOOMBERG, Dec. 24, 2008; Shaji Mathew, *Doha Bank Shareholders Approve Raising Capital by 20%*, BLOOMBERG, Dec. 22, 2008; Ari Sharif, *Abu Dhabi Commercial Bank, Al Khalij, Zain: Gulf Equity Preview*, BLOOMBERG, Dec. 17, 2008.
22. *See Global M&A Involving Sovereign Wealth Funds Pick Up in Q2,* REUTERS, Aug. 16, 2010, *available at* http://uk.reuters.com/article/idUKTRE67F1EG20100816.

Whether this rebound in SWF investment in 2010 will continue depends in part on whether the global economy continues to recover. In the case of oil-rich countries, other factors also may be at play. Dr. Sven Behrendt and Joseph Helou of the Carnegie Middle East Center, Beirut have noted that SWFs in the oil-rich Gulf States have become "systemically significant for a profound transformation of the region's economic geography, as the petro-monarchies move from oil to finance." Thus, SWFs in Arab countries fulfill a "strategic imperative ensuring the lasting competitiveness of Arab countries" by enabling them "to diversify away from one single, dominant and risky source of income: oil."[23]

At the same time, an intriguing trend has emerged in 2010—some SWFs, despite their wealth, are raising capital through private placements. After having suffered large losses during the global financial crisis, these SWFs (which are mostly in oil-rich countries, and reportedly include Qatar, Bahrain, Singapore, Abu Dhabi, and Kazakhstan) are under increasing pressure to deliver results. Private financing may increase a fund's leverage and provide greater ability to achieve returns similar to hedge funds and private equity funds. Another reason for these capital raises is that some funds believe that by involving private investors, the fund's motive for investing internationally will be seen as commercial rather than political, and will be less suspect from the viewpoint of the countries receiving the investment. Thus, some SWFs are now blurring the lines between sovereign and private investment.[24] A question that remains is whether regulation of SWFs and private funds will now converge as well, resulting in greater regulation of these funds.

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23. *See* Dr. Sven Behrendt & Joesph Helou, *Beyond Oil: Global Energy Security & Sovereign Wealth Funds,* J. ENERGY SECURITY, July 26, 2010, *available at* www.ensec.org/index.php?option=com_content&view=article&id=252:beyond-oil-global-energy-security-aamp-sovereign-wealth-funds&catid=108:energysecuritycontent&Itemid=365.

24. *See* Natsuko Waki, *Analysis: Private Capital to Transform Sovereign Wealth Funds,* REUTERS, July 21, 2010, *available at* www.reuters.com/article/idUSTRE66K3QU20100721.

§ 4:3 Advantages and Concerns About Sovereign Wealth Fund Investment

SWFs offer their investee countries and companies at least two very clear advantages: access to capital and mutuality of interests. The primary benefit that recipient nations receive from SWFs investments is increased access to capital. For this reason, most countries at least profess an interest in investment by SWFs. However, access to capital is not the only benefit that recipient countries receive as a result of SWF investment. When SWFs invest in foreign assets, they connect the financial destinies of two national economies. Prosperity is arguably no longer a zero-sum game. As the recipient nation enjoys economic growth, so does the nation that manages the SWF. This could reduce tensions across cultures and encourage more cooperation. Of course, markets do not always go up, and the resulting losses can often increase tension in an otherwise mutually satisfactory relationship.

At the same time, SWF investment brings with it a number of concerns. From a national security viewpoint, policymakers worry that these funds could use their investments to undermine the national security of the recipient nation. This can be a legitimate concern, but there is also the potential for recipient nations to cite national security concerns that are not legitimate as an excuse to keep out foreign direct investment by other countries.

In the United States, political leaders have generally sought to balance the positive aspects of foreign direct investment with the potential risks that foreign control over U.S. assets may pose to national security. Compared to many industrialized nations, the approach taken by the United States is hospitable to foreign direct investment. For example, some countries use an investment screening process that automatically subjects all transactions above a certain value threshold or other criteria to a mandatory review by government agencies, whether or not national security concerns are implicated. In contrast, under the Foreign Investment and National Security Act of 2007 (FINSA),[25] the United States screens foreign acquisitions on the basis of national

25. Foreign Investment and National Security Act of 2007, 50 U.S.C. App. § 2170; Pub. L. No. 110-49, 121 Stat. 246 (2007). FINSA amends the "Exon-Florio" amendment to the Defense Production Act of 1950, which provides for national security reviews of foreign investments.

security concerns. Although filing requirements may apply under other federal or state laws,[26] the United States does not have a general screening process that subjects all large foreign acquisition transactions to a mandatory review.

The principal body responsible for implementing FINSA is the Committee on Foreign Investment in the United States (CFIUS), which is comprised of high-ranking Cabinet members from several government agencies. Final regulations issued by the U.S. Treasury Department effective December 22, 2008 (the "Final Rule"),[27] and related Guidance published on December 8, 2008,[28] expand the scope of national security reviews, codify many CFIUS existing practices, and provide increased clarity and transparency regarding the process.

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26. For example, many SWFs have invested in U.S. financial institutions, which can trigger review by the Federal Reserve Board under the Bank Holding Company Act of 1956 or the Change in Bank Control Act of 1978, depending on the circumstances. Transactions in other sectors, such as telecommunications, defense, airlines, maritime, insurance and utilities, may trigger federal or state requirements. Certain merger or acquisition transactions trigger a notification requirement under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. Foreign persons establishing new U.S. operations or acquiring U.S. companies may also be required to file reports with the U.S. Commerce Department, Bureau of Economic Analysis. A full discussion of the requirements of FINSA and other applicable federal and state laws is beyond the scope of this article, but readers may contact the authors for additional information.
27. U.S. Dept. of the Treasury, Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 31 C.F.R. pt. 800 (Nov. 21, 2008), *available at* http://www.treas.gov/offices/international-affairs/cfius/docs/CFIUS-Final-Regulations-new.pdf. For additional information on CFIUS, see U.S. Dept. of Treasury, Office of Investment Security Page, *available at* www.treasury.gov/offices/international-affairs/cfius/.
28. *See* U.S. Dept. of the Treasury, Office of Investment Security, Guidance Concerning the National Security Review Conducted by the Committee on Foreign Investment in the United States, 73 Fed. Reg. 74,567 (Dec. 8, 2008) [hereinafter Guidance].

FINSA provides for review by CFIUS of the national security implications of a "covered transaction"[29] if it results in "control"[30] of a U.S. business by a foreign person. The initial review of a covered transaction must be completed within thirty days. Typically, the thirty-day review period is commenced after CFIUS receives voluntary notice by the parties to a transaction.[31] Although in the vast majority of cases, CFIUS completes its review within the initial thirty-day statutory review period, CFIUS is required to initiate an investigation, which it must complete within a subsequent forty-five-day period, in the following situations:

(1) CFIUS or a member of CFIUS believes that the transaction threatens to impair U.S. national security and that threat has not been mitigated prior to or during the thirty-day review;

(2) an agency designated by U.S. Treasury as the "lead agency" for the transaction recommends, and CFIUS concurs, that an investigation be undertaken;

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29. "Covered transactions" include acquisition transactions, including joint-ventures, by or with a foreign person which could result in control of a U.S. business by a foreign person. The term does not include start-up or "greenfield" transactions. Asset acquisitions are not covered if the assets acquired by a foreign person do not constitute a "U.S. business."

30. Under the Final Rule, "control" is defined as the "power, direct or indirect, whether or not exercised . . . to determine, direct, or decide important matters affecting an entity." CFIUS does not apply a bright-line test to determine whether a transaction results in foreign "control," but considers all relevant facts and circumstances. The Final Rule identifies minority shareholder protections that do not, in themselves, constitute control. The Final Rule clarifies that there is no automatic exclusion based solely on whether an investment is 10% or less in a U.S. business. However, a foreign person will not be deemed to "control" an entity if it holds 10% or less of the voting interest in the entity and it holds that interest "solely for the purpose of passive investment."

31. Parties to a transaction that could present national security considerations have a strong incentive to file a voluntary notice with CFIUS because a covered transaction that has been reviewed by CFIUS, and as to which CFIUS concludes there are no unresolved national security concerns, qualifies for a "safe harbor." Without the benefit of this safe harbor, CFIUS has authority to initiate review of a transaction even after it closes if it determines that national security concerns are implicated.

(3) the transaction is a foreign government-controlled transaction; or

(4) the transaction would result in foreign control of any "critical infrastructure" of or within the United States, if CFIUS determines that the transaction could impair national security and that risk has not been mitigated.

With respect to transactions described in (3) and (4) above, CFIUS would not initiate the additional forty-five-day investigation if the U.S. Treasury Department and any lead agency it has designated determine, at the Deputy Secretary level or higher, that the transaction will not impair the national security of the United States.[32]

Critics point out that, broadly interpreted, FINSA could be used as a protectionist instrument, obstructing investments by SWFs that do not raise traditional national security concerns. Although the U.S. Treasury's Guidance clarifies that "CFIUS focuses solely on any genuine national security concerns raised by a covered transaction, not on other national interests,"[33] CFIUS has historically construed "national security" broadly.[34] There has been a slower pace of CFIUS reviews in 2009, but a higher percentage of matters under review were escalated to a second-stage forty-five-day "investigation." This increase in investigations may partially be attributed to FINSA, which established a presumption of investigation for foreign government transactions and transactions where "critical infrastructure" is involved. The increase in the number of CFIUS investigations in 2009 is attributable in part to the continued role of state-owned enterprises and sovereign

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32. *See* Guidance, *supra* note 28, at 74,568.
33. *Id.*
34. The term "national security" is not defined in the statute or regulations, other than to note that the term includes issues related to homeland security. However, the statute lists a number of factors that are to be considered by CFIUS and the President in determining whether a transaction poses a national security risk, including whether a transaction would result in control of "critical infrastructure" that could impair national security, or would result in foreign government control of a U.S. entity.

investment in 2009, even though the pace of mergers and acquisitions slowed down.[35]

Another concern with respect to SWFs is corporate governance. While many policymakers are pleased that foreign entities generally make passive investments, in 2008 Lawrence Summers, senior economic advisor and director of the U.S. National Economic Council, expressed concern at Davos that SWFs may entrench poor management. The passivity of a large, long-term shareholder could result in poor oversight and make shareholder actions against management difficult to enact. As a result, passive and publicity-shy SWFs could breed ineffective corporate governance practices.[36]

Another significant concern is with respect to the motivation behind SWF investment. Few of these funds plainly state their objectives, and none offer any binding assurances that their investment choices will be made on a commercial rather than a political basis. This has led to widespread speculation over what drives these funds to invest. At Davos, Lawrence Summers expressed concern that SWFs may invest for "multiple motives," that is, for political or non-economic motives in addition to economic motives.[37] For example, a SWF might invest in an airline with the intent of pressuring that airline to service flights in the SWF's owner-nation. Alternatively, a fund might take an equity stake in a company to enable it to harvest and extract technology that the owner-nation has been unable to develop

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35. *See* Mark E. Plotkin & David N. Fagan, *Foreign Direct Investment and U.S. National Security: CFIUS Under Obama Administration*, PERSPECTIVES ON TOPICAL FOREIGN DIRECT INVESTMENT ISSUES No. 24 (Vale Columbia Center on Sustainable International Investment, June 7, 2010), *available at* www.vcc.columbia.edu/content/foreign-direct-investment-and-us-national-security-cfius-under-obama-administration (noting that in 2008, CFIUS reviewed 155 cases and less than 15% were investigated, whereas in 2009, CFIUS reviewed less than half as many transactions, but investigations "became the rule rather than the exception").

36. *See* Lawrence Summers, Remarks at the World Economic Forum, Davos, Switzerland (Jan. 24, 2008), *available at* http://sovereignwealthfunds.wordpress.com/2008/01/27/sovereign-wealth-funds-%e2%80%98it%e2%80%99-topic-at-2008-world-economic-forum/ (video). *See also* Daniel Gross, *SWFs Seek Acceptance in U.S.*, NEWSWEEK, Jan. 24, 2008.

37. *See id.*

on its own. Even more invidiously, a SWF could invest to stifle competition, actively seeking to sabotage the companies it holds so that the owner-nation's flagship industry can dominate international markets.

Capitalist markets operate under the assumption that investments are made in order to maximize value and earn a return. If SWFs are investing large pools of assets for reasons other than earning a profit, equity prices will not reflect value, distortions will appear in the market and inefficiencies will result.

Summers has also expressed concern about "politicization," which is almost the reverse of the "multiple motives" concern. It assumes that SWFs and the governments that control them invest for the purpose of maximizing returns, but could use their political leverage to prevent losses or generate wealth through their investments.[38] A SWF that invested billions of dollars to acquire a minority stake in a failing bank could theoretically use its diplomatic influence to obtain a bailout for the company. While this may be a legitimate concern, it is also possible that politics could work against a SWF. A bank that a government might otherwise bail out could lose its popular appeal for assistance if the host government disfavors the SWF's owner-nation.

Some commentators have expressed concern with the excessive economic and political leverage of these funds. Testifying at an April 24, 2008 Congressional hearing on SWFs, Ethiopis Tafara, Director of the Office of International Affairs at the U.S. Securities and Exchange Commission (SEC), noted that if SWFs increase five-fold by the middle of the next decade, as one investment bank had forecast at the time, "that could make these funds, collectively and perhaps individually, the largest shareholders in many of the world's biggest companies that are today privately owned."[39] While investment funds in Kuwait, Qatar, Dubai and Abu Dhabi are reportedly shifting assets to support collapsing local markets after losing billions of dollars in Western countries, in November 2008, Sameer al-Ansari, Chief Executive of

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38. *See id.*
39. *See The Regulatory Framework for Sovereign Investments*, *Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (Apr. 24, 2008) (testimony of Ethiopis Tafara, Director, Office of International Affairs, U.S. Securities and Exchange Commission).

Dubai International Capital, reportedly remarked "to become the largest shareholders in the ten largest companies in the world would cost about $50 billion at present and that's actually not a lot of money. . . . Imagine the power and influence this region would have if we were the shareholders in the ten, twenty, thirty largest companies in the world."[40]

A number of commentators, including former Chairman of the SEC, Christopher Cox, have expressed concerns that SWFs lack transparency. Although SWFs must generally disclose their share ownership and certain other information under sections 13 and 16 of the U.S. Securities Exchange Act of 1934 (the "Exchange Act"),[41] Cox suggested in 2007 that additional regulation, including disclosure requirements, might be necessary.[42] It is unclear what position Mary

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40. *See* David Robertson, *Sovereign Wealth Funds Switch from Western Investments*, TIMES ONLINE, Nov. 26, 2008, *available at* http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5233278.ece.
41. Beneficial ownership of more than 5% of a class of equity securities registered under the Exchange Act must generally be disclosed on Schedule 13D or 13G, as applicable. Institutional investment managers who exercise investment discretion over $100 million or more of SEC-registered securities file reports on Schedule 13F on a quarterly basis reporting on all SEC-registered securities in their accounts. Under section 16 of the Exchange Act, an owner of more than 10% of a registered class of equity securities of a U.S. domestic company must file a statement of ownership regarding its position and changes to its position.
42. *See* Christopher Cox, Chairman of the U.S. Securities and Exchange Commission, *Remarks at the Gauer Distinguished Lecture in Law and Policy at the American Enterprise Institute Legal Center for the Public Interest: The Rise of Sovereign Business* (Dec. 5, 2007). Although Chairman Cox's remarks were made prior to the adoption of the Santiago Principles (discussed herein), Edwin Truman, a leading commentator on SWF best practices, has written that ". . . disturbingly, many of the principles are silent about disclosure to the general public or only call for disclosure to the fund's owner. That approach does not promote the needed accountability to citizens of the country with the SWF or of other countries. As we knew would be the case, the IWG punts on each fund's revealing its size even while endorsing full annual reports where that information would be redacted." *See* Edwin M. Truman, *Making the World Safe for Sovereign Wealth Funds*, PETERSON INST. INT'L ECON., Oct. 14, 2008, *available at* www.petersoninstitute.org/realtime/?p=105.

Schapiro, the current Chairman of the SEC, will take regarding SWF regulation, but she has consistently supported tighter SEC regulation of private investment funds. For example, in remarks made on July 27, 2010, she noted that hedge funds "have flown under the regulatory radar for far too long. The lack of a comprehensive database for private funds has made it virtually impossible to monitor them for systemic risk and investor protection concerns."[43] Now that SEC registration of investment advisers to hedge funds and private equity funds is required under the Dodd-Frank Act, there is little reason to believe that Chairman Schapiro would not support imposing additional obligations on SWFs, especially if political winds were to shift in that direction.

Finally, other critics of SWFs have pointed out that many governments have "inside information" not generally available to the public, both with respect to current market conditions and the viability of regulatory proposals. Officials could share this information with SWF managers, giving them an unfair advantage.[44]

§ 4:4 The Santiago Principles and OECD Guidance on Sovereign Wealth Funds

Faced with international criticism and potentially protectionist regulations, SWFs have not stood idly by while pundits in recipient nations debate their fate. Representatives from the world's largest SWFs held a series of meetings in 2008 to address the mounting public scrutiny directed at them. Working with the IMF, these SWFs collaborated to publish a set of twenty-four investment principles intended to guide these funds as they acquire assets abroad. Known collectively as the "Santiago Principles," these guidelines call for more

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43. *See* SEC Chairman Mary L. Schapiro, *Moving Forward: The Next Phase in Financial Regulatory Reform,* Remarks at the Center for Capital Markets Competitiveness, U.S. Chamber of Commerce (July 27, 2010), *available at* www.sec.gov/news/speech/2010/spch072710mls.htm.

44. *See Sovereign Wealth Funds and Public Disclosure, Hearing Before the US-China Economic and Security Review Commission* (Feb. 7, 2008) (testimony by Linda Chatman Thomsen, former Director, Division of Enforcement, U.S. Securities and Exchange Commission), *available at* www.sec.gov/news/testimony/2008/ts020708lct.htm.

transparency, increased accountability, sound governance policies and firm commitments to investing on economic, rather than political grounds.[45]

Over two dozen nations, including many of the Gulf and Asian countries that have the largest SWFs, claim to support the Principles. If followed, the Principles could make significant strides in addressing the concerns associated with SWFs. However, there are important weaknesses in the Principles—they are voluntary, non-binding, and unenforceable. Left without binding assurances from the funds themselves, political leaders in recipient nations could still seek to regulate unilaterally the activities of these funds.

Although OECD recipient nations have begun working collaboratively to address international concerns about SWFs, the results of their efforts have been limited. Recipient nations recognize the importance of remaining open to international investors but acknowledge that each individual nation has a duty to protect its national security interests. In June 2008, the OECD Ministerial Council adopted the OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies (the "Declaration").[46] The Declaration does not prohibit recipient nations from regulating SWFs. Instead, it seeks to establish a framework by insisting that such regulations be transparent and limited to national security interests. Like the Santiago Principles, the Declaration is nonbinding and unenforceable.

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45. *See* International Working Group of Sovereign Wealth Funds Sovereign Wealth Funds Generally Accepted Principles and Practices, "Santiago Principles" (Oct. 2008), *available at* www.iwgswf.org/pubs/eng/santiagoprinciples.pdf. *See also supra* Appendix 3B.
46. The Declaration, endorsed by ministers from thirty-three recipient nations, espouses two key principles. First, recipient nations should remain open to foreign investment from SWFs and avoid taking protectionist actions. Only legitimate national security concerns should restrict foreign investments. Second, recipient countries should not "discriminate against investors in like circumstances," *i.e.*, to the extent possible, SWFs should be governed by policies generally applicable to foreign and domestic investors. *See* OECD, Declaration on Sovereign Wealth Funds and Recipient Country Policies (June 5, 2008), *available at* www.oecd.org/dataoecd/18/14/41816692.pdf; *supra* Appendix 3A. *See also* OECD, Guidance on Sovereign Wealth Funds, *available at* www.oecd.org/document/19/0,3343,en_2649_34887_41807059_1_1_1_1,00.html.

Individual nations could abandon these Principles (and adopt protectionist policies at any time), if they believe it is in their best interests to do so.

§ 4:5 Political and Regulatory Challenges in the United States

SWFs present particular difficulties for any governmental body that would set out to regulate them. First, as sovereign government-owned entities, they present special considerations not present in terms of regulating privately owned companies. Bilateral and multilateral government regulations are at stake, questions of sovereign immunity are raised, and the laws or regulations adopted, if not applied on a "one size fits all" basis, raise difficult diplomatic and legal issues. Can the United States have one policy for the China Investment Corporation but another for the Government Pension Fund of Norway?

Second, a major concern with SWFs is lack of transparency in terms of their investment policy and goals. What do they want? Unlike hedge funds or private equity funds, where one of the regulatory concerns is protecting the underlying investors, with SWFs the main regulatory focus is protecting the company and country receiving the investment. Of course, all large, opaque investment funds, whatever their source, raise concerns about concentration of control.

Even though during the Bush administration, the U.S. Treasury Department repeatedly emphasized the positive aspects of foreign direct investment, SWFs attracted a great deal of attention, much of it negative. In 2007, members of Congress expressed alarm when Dubai Ports World proposed acquiring certain U.S. port terminals, and the attention ultimately scuttled the deal. In April 2008, following a series of high-profile investments by SWFs in U.S. investment banks, several members of Congress, including Senator Richard Shelby, ranking member of the Senate Committee on Banking, Housing and Urban Affairs, expressed concern that SWFs could buy up most U.S. industries, and that the United States needed to know more about their intentions and objectives. Recently, the deepening financial crisis has made it increasingly clear that many U.S. financial institutions were woefully undercapitalized, and media attention is focused on the economy and losses in the stock market. Although overall this has lead

to diminished criticisms of SWFs by the media, with the passage of time, press coverage and public sentiment could again turn negative.

While still a candidate, President Obama hinted that regulating SWFs might be necessary. "I am concerned if these SWFs are motivated by more than just market considerations, and that's obviously a possibility," he told reporters. "If they are buying big chunks of financial institutions and their boards of directors influence how credit flows in this country and they may be swayed by political considerations or foreign policy considerations, I think that is a concern."[47] Nevertheless, President Obama came short of directly calling for new regulations.

Hillary Clinton, at the time she was a presidential candidate, was far more critical of SWFs, and her status as Secretary of State gives her the ability to profoundly affect U.S. foreign policy. "I raised the alarm about SWFs . . . because this is a new challenge we face. . . . And I just want to be sure that the IMF, the World Bank, the Federal Reserve, our government, begin to say, look, we've got to have rules here," she said in 2008.[48]

Hillary Clinton is the highest ranking U.S. official to call for regulating SWFs. "Think about how it will begin to constrain us. You know, you cannot get tough with your banker. You cannot stand up if they have very different interests in the Middle East or in Asia than we do and they basically say, fine, you want us to dump dollars? Do you want us to pull our investments out?"[49] Clinton's statements were made while she was a Presidential candidate before the full impact of the financial crisis on the U.S. economy was understood, but there is no indication that she has changed her position as Secretary of State.

Although Lawrence Summers expressed several concerns about SWFs at Davos, he also suggested that if these funds were to get together and agree that they would not pursue any national political objective, it "would allay all the fears out there."[50] Now that many of

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47. *Obama Says Concerned About Sovereign Wealth Funds*, REUTERS, Feb. 7, 2008.

48. Interview by Peter Cook, Bloomberg Television, with Hillary Clinton (Jan. 16, 2008), *available at* www.realclearpolitics.com/articles/2008/01/clinton_on_bloomberg_televisio.html.

49. *See id.*

50. *See* Larry Summers, *Sovereign Wealth Funds Should Agree to Standards to Allay Fears*, 25 NEW PERSPECTIVES Q. (Jan. 25, 2008), *available at* www.digitalnpq.org/articles/economic/238/01-25-2008/larry_summers.

these funds have adopted the Santiago Principles, it is unclear whether Summers will take a tough stance on these funds in the future.

U.S. politicians frequently cited deregulation as a major factor in the collapse of the global economy. Now that the Dodd-Frank Act imposes SEC registration, reporting, and record keeping obligations on investment advisers to "private funds" (including hedge funds and private equity funds) under the Investment Advisers Act of 1940, the door is open for increased regulation of SWFs. While some of the concerns about hedge funds and other private investment funds are fundamentally different than those concerning SWFs, there are many policy issues in common, including lack of transparency, concentration of control, and the potential for a large or leveraged fund to threaten financial stability in the United States or abroad. Moreover, as noted in *supra* section 4:3, SWFs raise a number of additional policy concerns. Therefore, even though SWFs were not the immediate focus of Congressional attention during the recent hearings on financial reform, SWFs should not assume that they will be able to escape tighter regulation indefinitely. In that light, it is possible that a comprehensive regulatory package for reforming the U.S. financial industry will include provisions that target SWFs as well. However, even if SWFs are not the immediate focus of Congressional attention, they seem unlikely to escape tighter regulation for long.

SWFs must be prepared for significant policy changes. If these funds do not actively engage in a dialogue with policy makers, they could potentially be left with stricter rules and fewer investment options. SWFs should emphasize in these discussions that protectionist policies adopted during the current financial crisis would have the effect of inhibiting needed investment, which would be detrimental to both SWFs and OECD recipient countries.