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Sovereigns as Shareholders

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SOVEREIGNS AS SHAREHOLDERS*

PAUL ROSE**

This Article considers the increasing impact of equity investments made by sovereign wealth funds. Observers have increasingly viewed sovereign investments with a high degree of suspicion due to the potential for the investments to be used as political tools rather than traditional investment vehicles. While this risk is considerable, much of the discussion surrounding sovereign investment ignores or minimizes the mitigating effect of a number of regulatory, economic, and political factors. This Article argues that continued vigilance, but not additional regulation, is necessary to ensure that U.S. interests are not jeopardized by sovereign investment in U.S. enterprises. While the United States is able to protect its interests in domestic markets, it is limited in the steps it can take to ensure that its interests are not harmed by politically-motivated sovereign investments in other countries. Many countries outside the United States do not have the regulatory structure or political power to adequately defend national interests. Due to the potential political harms associated with sovereign investing, this Article argues in support of the Santiago Principles, an international code of conduct for sovereign investments.

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INTRODUCTION

International investment implicates much more than the flow of cash and goods; considerable political issues are often at stake.¹ Commerce may affect national security and may stoke national pride.² For example, in the late 1980s and early 1990s, Japanese investors turned from bidding on U.S. Treasury notes³ to purchasing iconic U.S. businesses and properties, including the movie studio MCA and the Pebble Beach golf course.⁴ These foreign investments were a cause for alarm in the United States in part because the

1. "The relationship between international politics and international investment," says British economist John Kay, "is an issue as old as commerce." John Kay, *Sovereign Wealth Investment is a Force for Stability*, FIN. TIMES (Asia), Feb. 27, 2008, at 11, available at <http://www.ft.com/cms/s/e3737986-e4d6-11dc-a495-0000779fd2ac.html>.

2. As David Hume wrote over 250 years ago,

[n]othing is more usual, among states which have made some advances in commerce, than to look on the progress of their neighbours with a suspicious eye, to consider all trading states as their rivals, and to suppose that it is impossible for any of them to flourish, but at their expence.

DAVID HUME, OF THE JEALOUSY OF TRADE, *reprinted in* HUME: POLITICAL ESSAYS, at 150 (Knud Haakonssen ed., Cambridge University Press 1994) (1752).

3. Japanese investors once purchased approximately forty percent or more of all Treasury notes. See James Sterngold, *Intractable Trade Issues with Japan*, N.Y. TIMES, Dec. 4, 1991, at D1.

4. *Id.*

Japanese operated under a more controlled, top-down form of capitalism that created “not just a clash of cultures [but] a clash of economic strategies, a competition of ideas.”⁵ Yet, when the Japanese turned their attention to other markets, especially mainland Asia, the U.S. concerns shifted: “Japanese electronic goods and automobiles will not disappear from American shelves or showrooms, but increasingly they will come from factories in Asia, rather than in Japan or the United States. That will mean less job creation in Ohio or Tennessee, as the Japanese start up fewer new ventures in the United States.”⁶

Both concerns echo today with the rise of sovereign wealth funds (“SWFs”)—generally defined as government investment vehicles funded by foreign exchange assets and managed separately from official reserves.⁷ The emergence of these funds has given rise to several important questions. Are SWFs benign, long-term investors that will add stability to global capital markets? Or, do SWFs represent a new kind of state capitalism that threatens our national security by allowing our political rivals access to and control of our firms and technologies? As the United States attempts to protect itself against such political investment, what are the consequences for the United States if SWFs turn their attention to other markets?

SWFs have made a number of high profile acquisitions in recent months. In 2007 alone, China’s SWF, China Investment Corp. (“CIC”), purchased a 10% stake of private equity fund Blackstone for \$3 billion⁸ as well as \$5 billion in convertible securities of investment bank Morgan Stanley.⁹ Abu Dhabi’s SWF, the Abu Dhabi Investment Authority (“ADIA”), acquired \$7.5 billion in convertible securities of Citigroup,¹⁰ and Abu Dhabi’s Mubadala Development SWF acquired \$700 million of stock in Advanced Micro Devices

5. *Id.*

6. *Id.*

7. U.S. DEPT. OF TREASURY, SEMIANNUAL REPORT ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES, app. 3, at 1 (2007), available at http://www.treas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007_Appendix-3.pdf.

8. See Kate Linebaugh et al., *China Puts Cash to Work in Deal with Blackstone*, WALL ST. J., May 21, 2007, at A1.

9. See Michael J. de la Merced & Keith Bradsher, *Morgan Stanley Posts First Quarterly Loss, and Welcomes Chinese Investor*, INT’L HERALD TRIB., Dec. 19, 2007, <http://www.iht.com/articles/2007/12/19/business/morgan.php>.

10. See Nick Timiraos, *Will Overseas Funds be a Juggernaut?*, WALL ST. J., Dec. 1, 2007, at A11.

(AMD).¹¹ Borse Dubai acquired 20% of Nasdaq,¹² and Dubai World purchased \$424 million in MGM stock.¹³ Two strategic SWFs, Singapore's Government of Singapore Investment Corp. ("GIC") and a Saudi Arabian fund, purchased \$11.5 billion in convertible securities from the Swiss bank UBS.¹⁴ Temasek Holdings, Singapore's other SWF, purchased \$4.4 billion in Merrill Lynch stock and then in 2008 received U.S. regulatory approval to increase its stake in Merrill Lynch from 9.4% to 13.7%.¹⁵ In early 2008, GIC acquired a four percent stake in Citigroup for \$6.88 billion,¹⁶ while a group of investors, led by SWFs Kuwait Investment Authority and Korean Investment Corp., acquired around ten percent of Merrill Lynch's stock for \$6.6 billion.¹⁷

This list of acquisitions shows that SWFs are, in most cases, formed by countries that receive large capital flows from the United States through investment and trade in goods and commodities such as petroleum. Some of the U.S. trade deficit with such countries is offset through purchases of U.S. Treasury bills. Nearly 74% of U.S. Treasury securities were held by foreign official institutions¹⁸ as of

11. See Lina Saigol & Chris Nuttal, *Abu Dhabi's Mubadala Poised to Buy Up 9% Stake in AMD*, FIN. TIMES (Asia), Nov. 16, 2007, at 1, available at <http://www.ft.com/cms/s/5cc6bf0c-94b2-11dc-9aaf-0000779fd2ac.html>.

12. See Norma Cohen & Robert Anderson, *Exchange Rivalries Usher in a New Era*, FIN. TIMES, Sept. 20, 2007, at 19, available at <http://www.ft.com/cms/o/7a2adb36-67db-11dc-8906-0000779fd2ac.html> (describing the terms of Borse Dubai's acquisition of Nasdaq).

13. See Chris Reiter & Steve Orlofsky, *Dubai World Raises Stake in MGM Mirage*, REUTERS, Dec. 28, 2007, <http://www.reuters.com/article/industryNews/idUSN2846164220071230>.

14. See Daisy Ku, *Sovereign Fund Investments Surge in 2008—Dealogic*, REUTERS UK, Mar. 18, 2008, <http://uk.reuters.com/article/marketsNewsUS/idUKL1885212720080318> (last visited Nov. 9, 2008) (reporting on foreign investors' acquisition of equity in UBS).

15. *Temasek Raises Stake in Merrill Lynch*, REUTERS, Sept. 30, 2008, <http://www.reuters.com/article/innovationNews/idUSTRE48T4FE20080930>; see also Press Release, Merrill Lynch & Co., Inc., Merrill Lynch Enhances Its Capital Position by Raising Up to \$6.2 Billion From Investors, Temasek Holdings and Davis Selected Advisors (Dec. 24, 2007), available at http://www.ml.com/index.asp?id=7695_7696_8149_74412_86378_87784 (reporting the purchase of an initial "\$4.4 billion in Merrill Lynch common stock [with] the option to purchase an additional \$600 million of Merrill Lynch common stock by March 28, 2008").

16. Press Release, Gov't Inv. Corp. of Sing., GIC Invests USD 6.88 Billion in Citigroup (Jan. 15, 2008), available at <http://www.gic.com.sg/PDF/News%20Release%20-%20GIC%20invests%20USD%206.88bn%20in%20Citigroup.pdf>.

17. See Ku, *supra* note 14.

18. Foreign official institutions are defined as "government institutions involved in the formulation of monetary policy, but also include national government-owned investment funds and other national government institutions." U.S. DEP'T. OF

June 2007, with approximately \$479 billion held by China and \$79 billion held by oil-exporting nations in the Middle East.¹⁹ However, China and other SWF sponsor countries have expressed interest in putting their funds into equity instruments that may produce higher yields.²⁰

As a general matter, SWFs, like other investment funds, have sought returns on investment in the assets themselves, and thus far have not made (or through the application of existing regulations, have not been permitted to make) investments in the United States for strategic political purposes. Examples of these purposes include the acquisition of a company to attain sensitive technology or to secure for a sovereign access, perhaps exclusive access, to particular commodities or products. SWFs have generally refrained from political investments even in countries that do not have legislation comparable to the U.S.'s foreign acquisition regulations. However, a number of features associated with SWFs have raised serious concerns about their activities. While SWFs have existed for decades with little notice or impact, the profile of SWFs has increased markedly in recent years. SWFs are already a significant force in global capital markets. There are approximately thirty-two sovereign wealth funds in operation today. Ten of the largest have formed since 2000.²¹ By various estimates, these SWFs combined control assets worth \$2 to \$3 trillion.²² SWFs are also expected to increase significantly in the amount of assets under management. One estimate predicts that within ten years SWFs could control over \$13 trillion in assets.²³

The growth of SWFs in recent years is driven by several factors, all of which suggest a continuing increase in the economic importance

TREASURY, REPORT ON FOREIGN PORTFOLIO HOLDINGS OF U.S. SECURITIES AS OF JUNE 30, 2007, at 13–14 (2007), available at <http://www.treas.gov/tic/shl2007r.pdf>.

19. *Id.* at 10.

20. See, e.g., *Keep Your T-bonds, We'll Take the Bank*, ECONOMIST, July 28, 2007, at 75.

21. See EDWIN M. TRUMAN, PETERSON INST. FOR INT'L ECON., SOVEREIGN WEALTH FUNDS: THE NEED FOR GREATER TRANSPARENCY AND ACCOUNTABILITY 2–3, (2007), available at <http://www.iie.com/publications/pb/pb07-6.pdf>; see also GERARD LYONS, STANDARD CHARTERED BANK, STATE CAPITALISM: THE RISE OF SOVEREIGN WEALTH FUNDS 26 (Nov. 13, 2007), available at http://banking.senate.gov/public_files/111407_Lyons.pdf (listing the launch years of the top twenty-two largest SWFs).

22. See, e.g., INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT 45 (Oct. 2007) [hereinafter GFSR] (estimating that SWFs hold “between \$1.9 trillion and \$2.9 trillion” of the “foreign assets held by sovereigns”); LYONS, *supra* note 21, at 1.

23. LYONS, *supra* note 21, at 9.

of SWFs in the coming years. Standard Chartered, a UK bank that published an influential report on SWFs in 2007, notes that commodities price inflation has been important in the growth of SWFs.²⁴ Fifteen of the largest twenty funds depend on commodities, particularly oil, as their main source of income.²⁵ An excess in foreign currency reserves has also led to growth in a number of SWFs, including China's CIC. China has reserved some \$1.8 trillion.²⁶ Standard Chartered speculates that China believes it needs only \$1.1 trillion on reserve "to cope with any external shock,"²⁷ and uses at least some of the excess to fund CIC and other funds that invest in equity instruments abroad. Thus, "[a]s reserves grow, it would be no surprise if additional amounts were used in stages to swell the size of China's SWF to, say, \$600 billion within two years!"²⁸

Another factor that causes SWFs to grow more quickly relative to other sovereign accounts such as foreign currency reserves is that SWFs are invested more aggressively. While currency reserves are invested conservatively in order to ensure the availability of funds (for such purposes as currency stabilization, for example), SWFs are typically designed for growth.²⁹

With the phenomenal growth of SWFs, each new SWF investment seems to call for further regulation.³⁰ However, any new regulation must be evaluated within the broader context of investor regulation as well as economic and political incentives acting on sovereigns in their role as shareholders. This Article argues that the current U.S. legal framework provides insulation against the potentially negative effects of domestic sovereign investment. Still,

24. *Id.* at 7–8.

25. *Id.* at 27.

26. See State Administration of Foreign Exchange, People's Republic of China, Monthly Foreign Exchange Reserves, 2008, http://www.safe.gov.cn/model_safe_en/tjsj_en/tjsj_detail_en.jsp?ID=3030300000000000,17&id=4 (last visited Nov. 9, 2008).

27. See Lyons, *supra* note 21, at 10.

28. *Id.* Senator Everett Dirksen is attributed (perhaps apocryphally) the line, "[a] billion here, a billion there, pretty soon you're talking real money." The Dirksen Cong. Ctr., "A Billion Here, A Billion There...", http://www.dirksencenter.org/print_emd_billionhere.htm (last visited Nov. 9, 2008). If that is true, what should we call the trillions flowing from SWFs?

29. Stabilization funds, by contrast, are designed primarily as a risk management device and, thus, tend to invest in more conservative instruments such as Treasury notes. ANDREW ROZANOV, SOVEREIGN WEALTH FUNDS: DEFINING LIABILITIES 2 (2007), available at http://www.ssga.com/library/esps/Soverign_Wealth_Funds_Andre_Rozanov_4.27.07rev2CCRI1182371372.pdf.

30. See, e.g., Evan Bayh, *Time for Sovereign Wealth Rules*, WALL ST. J., Feb 13, 2008, at A26, available at http://online.wsj.com/article/SB120286960358864245.html?mod=rss_opinion_main.

SWFs remain tools of sovereigns that may act opportunistically. While the United States has the ability to protect its interests when SWFs purchase securities in U.S. firms,³¹ many other countries do not, and U.S. interests may be harmed through SWF activity outside its jurisdiction. Thus, this Article discusses the importance of international efforts to mitigate the risk that SWFs could be used as political tools.

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

Part II outlines the various regulations that govern SWF investments in U.S. enterprises, arguing that the regulations mitigate many of the potentially negative effects of SWF investment, including possible political activities. Indeed, the risk that sovereigns will use SWFs for harmful political activities is perhaps less likely than the risk that the United States will dissuade SWF investment through protectionist regulation or political application of regulations.

While this Article argues that existing regulatory, economic, and political factors protect the United States against most of the potential threats posed by SWF activities, SWF investment in other markets may yet pose a danger to U.S. interests. For this reason, Part III argues in support of the Santiago Principles,³² a voluntary code of best practices that would provide assurance that SWFs will invest apolitically in any market. In Part IV, the Article concludes by noting some remaining concerns and suggesting lines of future research.

I. SOVEREIGN WEALTH FUNDS: DEFINITIONS AND CONCERNS

A. *Defining and Contextualizing Sovereign Investments*

SWFs may be defined and categorized in various ways, but the central and common feature of all SWFs is their origin as investment vehicles established and controlled by a sovereign political entity.³³ Categorization of SWFs may be based on purpose, investment intent,

31. See *infra* Part II.

32. INT'L WORKING GROUP OF SOVEREIGN WEALTH FUNDS, SOVEREIGN WEALTH FUNDS: GENERALLY ACCEPTED PRINCIPLES AND PRACTICES: "SANTIAGO PRINCIPLES" (Oct. 2008), available at <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf> [hereinafter SANTIAGO PRINCIPLES].

33. INT'L MONETARY FUND, SOVEREIGN WEALTH FUNDS—A WORK AGENDA 4 (2008), available at <http://www.imf.org/external/np/pp/eng/2008/022908.pdf>.

or geographical region. SWFs are created for numerous purposes including use as stabilization funds, endowment funds, pension reserve funds, development funds, or government holdings management funds.³⁴ While all of these funds could be called sovereign wealth funds, for purposes of this Article, the most important of these funds are endowment funds, pension reserve funds, and holdings management funds since these are the funds most likely to invest in global equity markets.³⁵

SWFs are also commonly categorized based on the source of their funds. The first major category is made up of commodity funds created through commodity exports owned or taxed by the sovereign.³⁶ Primarily, this category is composed of petrodollar funds from oil exporting countries, including the funds of Norway, Russia, Kuwait, Qatar, and the Alaska Permanent Fund.³⁷ A second category is composed of non-commodity funds that are established through transfers of assets from official foreign exchange reserves³⁸ including Singapore³⁹ and China.⁴⁰ Singapore's GIC is the largest fund of this type.⁴¹

In both categories, the funds are typically what might be called recycling funds. Funds flow into emerging or commodities-based economies and, for a variety of reasons including a relative scarcity of investment opportunities,⁴² the funds held by the sovereign may be redeployed. Increasingly, these funds may be invested in developed nations as equity investments in public companies. Recycling cash flows back to the United States is viewed as a positive development; rather than funneling investment returns to fund enterprises in other countries, it allows some recapture of the capital.⁴³ While equity investments by SWFs raise serious political and economic concerns,

34. *Id.* at 5.

35. ROZANOV, *supra* note 29, at 3.

36. Press Release, U.S. Dep't of the Treasury, Under Sec'y for Int'l Affairs David H. McCormick Testimony Before the Joint Econ. Comm. (Feb. 13, 2008), <http://www.ustreas.gov/press/releases/hp823.htm>.

37. *See* Lyons, *supra* note 21, at 12.

38. *Id.*

39. *Id.* at 26–27.

40. *Id.*

41. *See id.* at 25 tbl.1.

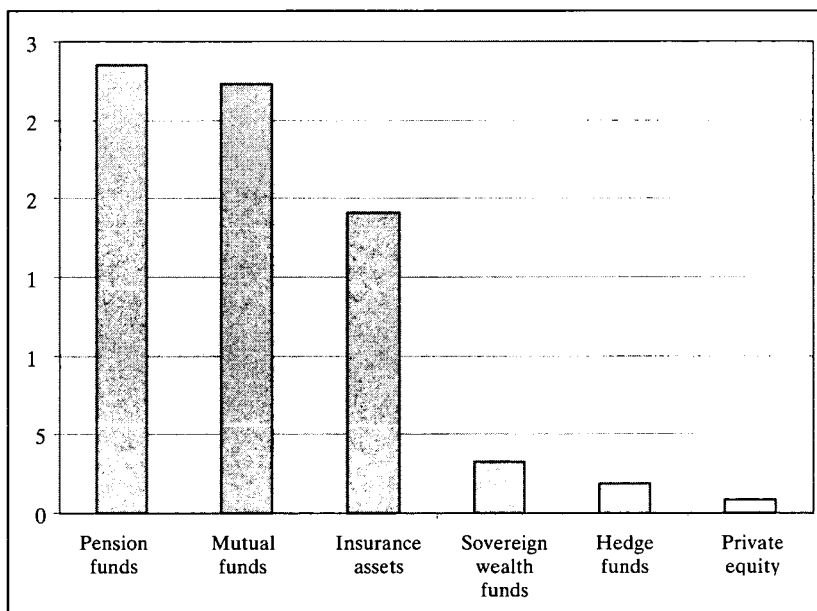
42. *See generally* *Keep Your T-bonds, We'll Take the Bank*, *supra* note 20 (discussing the financial roots of SWFs).

43. DIANA FARRELL ET AL., MCKINSEY GLOBAL INST., *THE NEW POWER BROKERS: HOW OIL, ASIA, HEDGE FUNDS AND PRIVATE EQUITY ARE SHAPING GLOBAL MARKETS* 31 (2007), http://www.mckinsey.com/mgi/publications/The_New_Power_Brokers/ (follow "Launch this report" hyperlink).

the converse problem of no investment from these very wealthy funds may also pose serious long-term threats to sustained economic prosperity. Part of the concern with funds being deployed elsewhere is that there may be less transparency in these investments because funds would not be subject to the type of reporting requirements that monitor publicly traded entities in established markets.

The size and impact of SWFs is best understood through comparison with other major investment vehicles such as traditional institutional funds (including mutual funds), private equity funds, and hedge funds. Considering total assets under management worldwide, Chart 1 demonstrates that SWF assets are only a fraction of the funds managed by institutional investors such as mutual funds and pensions but outstrip private equity and hedge funds investments considerably.⁴⁴

CHART 1
Worldwide Assets by Investor Type,
in Billions, as of December 2007⁴⁵



44. *Id.* at 11.

45. IFSL RESEARCH, SOVEREIGN WEALTH FUNDS 2008 (Apr. 2008), available at http://www.ifsl.org.uk/upload/CBS_Sovereign_Wealth_Funds_2008.pdf.

As shown in Chart 1, institutional investors such as pension funds and mutual funds are by far the largest players in established international capital markets.⁴⁶ However, as noted by the U.S. Treasury, SWFs as a whole are larger than both private equity funds and hedge funds. According to the Treasury, SWFs are also “set to grow at a much faster pace.”⁴⁷ As noted above, there are only approximately forty active SWFs,⁴⁸ while there are hundreds of institutional investors, private equity funds, and hedge funds. Across the market as a whole, the potential footprint of the largest SWFs is second only to the largest institutional funds and far surpasses the largest hedge funds.⁴⁹ The largest SWF, the ADIA fund of the United Arab Emirates, is estimated to control \$650 to \$700 billion which makes the fund roughly fifteen times larger than the Fidelity Magellan Mutual Fund.⁵⁰ If Saudi Arabia creates a fund, as it has indicated it might, its SWF will likely “dwarf” ADIA.⁵¹

B. *Benefits of Sovereign Investment*

Sovereign wealth fund investment has provided and will continue to provide both the sovereign investor and the host countries with a number of beneficial externalities beyond the issuer benefits provided through any specific investments. Significant SWF investment makes the investor nation a partner in the economic health of the host country.⁵² SWF investment may also lead to more open and better-functioning markets within the investor nation. For example, CIC’s recent investments in U.S. enterprises may encourage Chinese reciprocity and provide U.S. firms with increased access to China’s

46. *Id.*

47. See Press Release, U.S. Dep’t. of the Treasury, *supra* note 36.

48. See *supra* note 21 and accompanying text.

49. Institutional investors of various types may have very different investment strategies, and hedge funds and private equity funds may take larger stakes in companies than many institutional investors would seek. See generally FARRELL ET AL., *supra* note 43, at 24–25. But in some cases SWFs tend to invest more like activist hedge funds (with large, influential stakes) than more passive institutional investors. See *infra* notes 198–202 and accompanying text.

50. See Landon Thomas Jr., *Cash-Rich, Publicity-Shy, Abu Dhabi Fund Draws Scrutiny*, N.Y. TIMES, Feb. 28, 2008, at C1.

51. Henny Sender, et al., *Saudi Arabia Aims to Take Lead in Sovereign Wealth Fund Stakes*, FIN. TIMES, Dec. 22, 2007, at A1.

52. This old idea was expressed more eloquently by Montesquieu: “Two nations who traffic with each other become reciprocally dependent; for if one has an interest in buying, the other has an interest in selling; and thus their union thus is founded on their mutual necessities.” 20 BARON DE MONTESQUIEU, OF THE SPIRIT OF COMMERCE, *reprinted in* THE SPIRIT OF THE LAWS, at 316 (Thomas Nugent, trans. Hafner Press 1949) (1748).

developing markets.⁵³ Aligning enterprise interests with sovereign interests through SWF investment could also help in areas such as patent and copyright protection. A large investment by CIC in U.S. media firms, for example, would perhaps incentivize China to protect intellectual property rights more effectively.

SWFs are also generally considered to be stable investors by the U.S. Department of Treasury.⁵⁴ Investment stability has been especially prized in the volatile period associated with the subprime crisis which saw numerous investments by SWFs in U.S. financial firms.⁵⁵

C. *Concerns with Sovereign Investment*

Despite these benefits, however, much more attention has been given to the risks of SWF investment. Concerns over SWFs are focused on the ways in which their activities may differ from those of other investors and on the limitations of host nations in regulating such activities.⁵⁶

1. Political Risk

A primary concern with SWFs is that because the SWF is an investment arm of a sovereign entity, the fund's investments may be used for political purposes. U.S. Securities & Exchange Commission Chairman Christopher Cox, in a representative comment, said that "[i]nvestors and regulators alike have to ask themselves whether government-controlled companies and investment funds will always direct their affairs in furtherance of investment returns, or rather will

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

54. As noted by Deputy Treasury Secretary Robert Kimmitt,

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

Robert M. Kimmitt, *Public Footprints in Private Markets: Sovereign Wealth Funds and the World Economy*, 87 FOREIGN AFF. 119, 122 (2008).

55. See *supra* notes 8–17 and accompanying text.

56. See ROZANOV, *supra* note 29, at 1–4.

use business resources in the pursuit of other government interests.”⁵⁷ Among these government interests might be the acquisition of sensitive technologies or expertise through the purchase of a controlling stake in a company, or the acquisition of a major supplier of a limited natural resource. Economist Lawrence Summers asks:

What about the day when a country joins some “coalition of the willing” and asks the U.S. president to support a tax break for a company in which it has invested? Or when a decision has to be made about whether to bail out a company, much of whose debt is held by an ally’s central bank?⁵⁸

There are also more subtle and less directly regulated ways in which a SWF may exercise political power. For example, a sovereign might direct a SWF to invest in a company in order to encourage the company (either as a condition to investment or perhaps as a shareholder) to build a manufacturing facility in the country in order to provide jobs, diversify the economy, and strengthen the country’s tax base.⁵⁹ Perhaps more benignly, a sovereign might also direct SWFs to invest in companies that have created negative externalities or have manufactured products the sovereign finds socially undesirable, seeking to encourage corporate activities that lessen or eliminate such externalities, or lead to changes in products or modes of production. For example, a SWF could invest in an auto manufacturer in order to influence the automaker to produce vehicles using alternative automotive fuel sources, or it could invest in a pharmaceutical company in order to encourage development of certain therapies. Or, a SWF may invest in companies that provide services to the sovereign as a way of recapturing or reducing some of the costs of such services. A sovereign with significant U.S. investments may also use its investment as a bargaining chip with the federal government. Consider the Treasury or Federal Reserve Board faced with a threat by a sovereign to withdraw its billions from U.S. companies unless the Treasury or Federal Reserve Board adopts

57. Christopher Cox, Chairman, Sec. & Exch. Comm’n, Keynote Address and Robert R. Glauber Lecture at the John F. Kennedy School of Government, Harvard University: The Role of Government in Markets (Oct. 24, 2007), <http://www.sec.gov/news/speech/2007/spch102407cc.htm>.

58. Lawrence Summers, *Funds that Shake Capitalist Logic*, FIN. TIMES, July 29, 2007, <http://www.ft.com/cms/s/2/bb8f50b8-3dcc-11dc-8f6a-0000779fd2ac.html>.

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

a certain policy.⁶⁰ In all these respects, SWFs differ from most other investors because they have the potential to be employed as political or economic tools rather than as investment instruments.

A more nebulous concern is the rise of state capitalism. Capital markets in the United States are dominated by private funds operating primarily under federal government supervision but with limited governmental intervention. Some observers have questioned whether the existing regulatory structure can manage the activity of sovereigns in markets designed for transactions involving predominantly private actors.⁶¹ More generally, the increased involvement of political actors in U.S. capital markets also represents a possible shift from market capitalism to a state capitalism in which commercial motives are mixed with or displaced by political motives. Chairman Cox asks: "If the distinction between government and private activity in our capital markets is increasingly blurred, is there a point at which the entire financial activity we today call a free market stops being precisely that, and morphs into something else?"⁶² Similarly, management scholar Jeffrey Garten argues that the rise of state capitalism demonstrates "government efforts to reassert control over their economies and to use this to enhance their global influence We can expect less productivity, less innovation and less growth, since governments have many goals that the private sector does not."⁶³

Because of the size of China's economic and geopolitical footprint, it is of particular concern to policymakers whether China will be a political investor.⁶⁴ China, unlike those countries whose economies are based on petrodollars, may be less dependent on the financial success of SWF investment activities.⁶⁵ Many petrodollar funds may be attempting to diversify in order to be able to maintain social programs after their petroleum resources no longer provide

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

61. See ROZANOV, *supra* note 29, at 1.

62. Christopher Cox, Chairman, Sec. & Exch. Comm'n, 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), <http://www.sec.gov/news/speech/2007/spch120507cc.htm>.

63. Jeffrey Garten, *The Unsettling Zeitgeist of State Capitalism*, FIN. TIMES, Jan. 14, 2008, http://us.ft.com/ftgateway/superpage.ft?news_id=fto011420081502150015.

64. *A Special Report on Globalisation: The Rise of State Capitalism*, ECONOMIST, Sept. 20, 2008, at 24.

65. *Id.* at 25.

significant income.⁶⁶ China, on the other hand, has a rapidly growing economy that is not dependent on a single resource or industry. China may use funds less conservatively, which creates a heightened concern that they may use their funds for political purposes.

2. Economic and Regulatory Risks

SWFs are increasingly important actors in markets that were not expressly designed to regulate their participation. Although regulators hope that SWFs invest and behave like other investors, the SEC chair and some staff have expressed concern that the SEC may not be able to regulate SWFs as it does other investors.⁶⁷ In a speech on the impact of SWFs, SEC Chairman Cox stated:

Neither international law nor the Foreign Sovereign Immunities Act renders these funds immune from the jurisdiction of U.S. courts in connection with their commercial activity conducted in the United States. But a discussion between the SEC and a foreign government might be quite different if, instead of seeking cooperation in an enforcement matter in which we were mutually interested, the SEC were pressing claims of insider trading against that very government When a foreign private issuer is suspected of violating U.S. securities laws, our experience working with our overseas regulatory counterparts indicates that we could almost always expect the full support of the foreign government in investigating the matter. But if the same government from whom we sought assistance were also the controlling person behind the entity under investigation, a considerable conflict of interest would arise.⁶⁸

Compounding this regulatory challenge is the fact that SWFs are, as a group, less transparent relative to more regulated institutional investors such as pension funds and mutual funds.⁶⁹ Only a few SWFs publish information on their size, returns, composition of their portfolios, investment objectives, and proxy voting policies.⁷⁰ For

66. ROZANOV, *supra* note 29, at 4–5.

67. Cox, *supra* note 57.

68. *Id.*

69. Linda Chatman Thomsen, Dir. Div. of Enforcement, Sec. & Exch. Comm'n, Testimony Concerning Sovereign Wealth Funds and Public Disclosure Before the U.S.-China Economic and Security Review Commission (Feb. 7, 2008), <http://www.sec.gov/news/testimony/2008/ts020708lct.htm>.

70. Paper Presented by Edwin M. Truman at the Conference on China's Exchange Rate Policy, *A Scoreboard for Sovereign Wealth Funds* 14–15 (Oct. 19, 2007), available at

many SWFs, transparency with respect to investment objectives is limited to issuing statements to the press that the fund's objective is a high return on investment,⁷¹ or, in other words, that the SWF does not have any political motive for its investments. However, even where an investment position is clearly disclosed, the SWF may later decide to alter its objectives concerning a particular investment in pursuit of a political goal. If it does this, what should or could be the response of the portfolio company's country of domicile? Additionally, some commentators worry that SWFs may create unique systemic risks.⁷² While SWFs may provide needed capital for U.S. markets, as evidenced by the nearly thirty seven billion dollars invested in U.S. financial firms between June 2007 and February 2008,⁷³ they often take large stock positions (in terms of investment value, although typically not in terms of voting power). These large inflows of capital may inflate asset prices.⁷⁴ Further, a SWF could cause significant turmoil if, for reasons of national exigency, the SWF must liquidate its positions.

Another concern with SWF size and influence is the potential for abuse of informational disparities. Sovereign wealth funds have particular informational advantages that may not be available to other investors, or, in some cases, even to company insiders. For example, a SWF may learn of a pending action against a corporation through government channels. Or, the sovereign could be in the position to bring an action against the competitors of one of its investments. SEC Chairman Cox raised the specter of government power as being "no longer used solely to police the securities markets at arm's length, but rather . . . to ensure the success of the government's commercial or investment activities . . ."⁷⁵ He suggests the possibility of a world in which governments use "the vast amounts of covert information collection that are available through their

<http://www.iie.com/publications/papers/truman1007swf.pdf> (showing the study's transparency and accountability scores for various SWFs).

71. See, e.g., Steven Weisman, *China Tries to Reassure U.S. About its Investing Plans*, N.Y. TIMES, Feb. 1, 2008, at C2.

72. See, e.g., BRAD W. SETSER, COUNCIL OF FOREIGN RELATIONS, SOVEREIGN WEALTH AND SOVEREIGN POWER: THE STRATEGIC CONSEQUENCES OF AMERICAN INDEBTEDNESS, COUNCIL SPECIAL REPORT NO. 37, at 27–35 (September 2008), available at http://www.cfr.org/content/publications/attachments/Debt_and_Power_CSR37.pdf (noting the risks of relying on external financing for the United States); see also FARRELL ET AL., *supra* note 43, at 15–16 (discussing the systemic risks posed by SWFs and hedge funds).

73. See *supra* notes 8–17 and accompanying text.

74. See FARRELL ET AL., *supra* note 43, at 16.

75. Cox, *supra* note 57.

national intelligence services”⁷⁶ in trading and other market activities, to the disadvantage of private investors.

Using an argument that has been raised in defense of insider trading rules generally, Cox argues asserts that “[i]f ordinary investors—an estimated 100 million retail customers who own more than \$10 trillion in equities and stock funds in U.S. markets—come to believe that they are at an informational disadvantage, confidence in our capital markets could collapse, and along with it, the market itself.”⁷⁷ So long as sovereigns are using their funds for wealth creation rather than other purposes, such activities would seem to be against their own interests if they are diversified investors. Again, however, to the extent that sovereigns do engage in manipulative activities, the SEC may be in the politically difficult position of bringing an action against the SWF and its managers.

Courts may also have difficulty accommodating SWFs. Because of their diversified investments and relatively large financial stakes in individual companies, SWFs will inevitably invest in companies that will face lawsuits as a result of securities fraud. Under the application of the Private Securities Litigation Reform Act (“PSLRA”),⁷⁸ the presumptive lead plaintiff will be the shareholder with the greatest loss;⁷⁹ however, a judge might want to exclude the SWF because the SWF would arguably not meet the “typicality” requirement of Federal Rule of Civil Procedure (“FRCP”) 23(a)(3).⁸⁰ Should SWFs be considered typical investors under FRCP 23(a)(3)? Competing potential plaintiffs may challenge the adequacy of the SWF as lead plaintiff and ask for discovery into the business of the SWF,⁸¹ which will likely be uncomfortable for many opaque SWFs that might otherwise prefer to serve as lead plaintiff.

The risks associated with SWF investment are economic, political, and procedural in nature. While SWF investment has perhaps been a boon to the United States because the funds have provided needed capital to distressed U.S. financial firms, questions

76. *Id.*

77. *Id.*

78. Private Securities Litigation Reform Act of 1995, 15 U.S.C. §§ 77z-1, 78u-4 (2006).

79. *See id.* § 101(a) (amending 15 U.S.C. §§ 77z-1(a)(3)), § 101(b) (amending 15 U.S.C. § 78u-4(a)(3)).

80. Under the Federal Rules of Civil Procedure, the claims or defenses of the class representative must be typical of the claims or defenses of the class. FED. R. CIV. P. 23(a)(3).

81. James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1603 (2006).

remain as to whether state investment fundamentally alters private markets. If it does, what are the political consequences of such a change? And, will the United States be able to adequately regulate sovereign investment without such regulation triggering political consequences?

II. REGULATION OF SOVEREIGN WEALTH FUNDS

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

A. *Political and Economic Factors*

To date, SWFs have generally avoided political activities. In part, this is due to regulatory restraints imposed by host countries. In the United States, investments that might affect national security—such as the acquisition of controlling stakes in firms producing sensitive technologies, vital commodities, or resources—are regulated through the vetting process of the Committee on Foreign Investment in the United States (“CFIUS”). A number of other developed economies, including EU economies, have enacted or are considering similar legislation.⁸² The significant attention created by SWF investment activities has thus far forced SWFs to invest modestly, and, in some cases, to accept conditions to investment that ensure the SWFs remain passive investors. For example, as a condition to its \$7.5 billion investment in Citi, Abu Dhabi’s SWF agreed “not to own more than a 4.9% stake in Citi, and will have no special rights of ownership or control and no role in the management or governance of Citi, including no right to designate a member of the Citi Board of Directors.”⁸³ Indeed, it has been suggested that following a few unofficial rules of investment, largely focused on eliminating the potential for political mischief by either the SWF or the host country, will help SWFs avoid suspicion. For example, a reporter observed that to avoid scrutiny from host country regulators, SWFs should:

82. Carter Dougherty & Stephen Castle, *EU Warns Against Overreaction on Sovereign Wealth Funds*, INT’L HERALD TRIB., Feb. 25, 2008, <http://www.iht.com/articles/2008/02/25/business/fund.php>.

83. Press Release, Citigroup, Inc., Citi to Sell \$7.5 Billion of Equity Units to the Abu Dhabi Investment Authority (Nov. 26, 2007), <http://www.citigroup.com/citi/press/2007/071126j.htm>.

- Buy small stakes, not entire firms.
- Emphasize that board membership, or other control, is not in the game plan.
- Consult in advance with federal agencies and elected officials likely to be sensitive.
- Avoid certain sectors, such as energy or government contracting—though if the stake is small enough, it may not be an issue.⁸⁴

The voluntary adoption of such policies in recent transactions has helped SWFs avoid some of the missteps of the Dubai Ports World (“DP World”) and China National Offshore Oil Company Ltd. (“CNOOC”) transactions (discussed in Part III.C of this Article), that resulted in heightened scrutiny of foreign investment.

There are a number of economic factors that also limit the likelihood that a SWF will be used as a political tool. First, there is some evidence that prior attempts at state capitalism through mixed-motive investment—political motivations combined with commercial intentions—have resulted in relatively poor performance.⁸⁵ Assessing the economic impact of political investments is not always straightforward; for example, it may not be possible to evaluate the return on a strategic investment to acquire military technology that may not produce a viable weapon for years and may never be used in an actual conflict. Nor is it easy to quantify an investment that is ultimately designed to bolster national pride. However, a conventional assessment of publicly- versus privately-managed funds shows that private funds fare significantly better than government-managed funds, and that more politically motivated, government-managed funds tend to fare more poorly.⁸⁶ Studies of government-managed investment in the 1980s indicate that governments are not more successful at allocating capital than private enterprise, especially when the investment decisions are based at least in part on political objectives.⁸⁷

84. Christopher S. Rugaber, *Offshore Investors Take Low Profile to Avoid Political Resistance to Deals*, TORONTO STAR, Dec. 2, 2007, <http://www.thestar.com/Business/article/281708>.

85. *Id.*

86. See Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 841 (1993). But see Annika Sundén & Alicia H. Munnell, *Investment Practices of State and Local Pension Plans*, in PENSIONS IN THE PUBLIC SECTOR 153, 161 (Olivia S. Mitchell & Edwin C. Hustead eds., 1999) (questioning the adequacy of Romano’s sample).

87. See Romano, *supra* note 86, at 805.

Another economic factor that limits political activities is that SWFs are, or will likely become, widely diversified investors with a limited economic interest in each investment (at least with respect to U.S. investments). SWFs are diversified as a result of their large size and their deliberate efforts to limit suspicion. However, a decision to engage in political activities with respect to just one such investment would create a cascade of protectionist responses to many if not all of the SWF's existing or planned investments. For example, a politically-motivated action by a SWF with respect to one of its U.S. investments would draw scrutiny on the SWFs other investments in the U.S. and other host countries, including investigations of completed transactions and more stringent reviews of planned transactions. Most SWFs engage in transactions designed to fall outside CFIUS jurisdiction by limiting their investments to a non-controlling stake.⁸⁸ Even SWF investments that do not fall under CFIUS jurisdiction initially, however, may trigger jurisdiction if the SWF directs or perhaps even influences the company to act in a political manner. During the review of the SWF's activities, CFIUS may exercise its broad remedial powers to freeze or unwind a SWF's investment and would likely investigate the SWF's other U.S. investments to determine whether it has attempted similar political activities with other companies. Viewed from this perspective, the size and diversification of SWFs suggest that it would be economically unwise for SWFs to engage in political activities; SWFs should rationally seek to avoid the uncertainty and potentially heavy regulatory burdens that would result from a deviation from a default investment posture.

Finally, and most significantly, if SWFs did engage in political activities, perhaps against economic interests, the SWFs also risk both political and economic responses.⁸⁹ While some countries may not

88. Transactions that are reviewed and approved by CFIUS are typically more secure for SWFs because CFIUS is limited by statute in its review of post-approval activities. Generally, investigations of SWF investments can be reopened only if a mitigation agreement is breached. *See infra* notes 167–69 and accompanying text.

89. For evidence of a connection between political activities and the financial markets, one may look at the recent experience of Russia. In part due to a shareholder dispute between British Petroleum and its Russian partners (with heavy-handed intervention by the Russian government) and Russia's August 2008 military action in Georgia, the Russian stock market declined 54% between July 1st and September 17th. Jason Bush, *Behind the Russian Stock Market Meltdown*, BUS. WK., Sept. 16, 2008, http://www.businessweek.com/globalbiz/content/sep2008/gb20080917_169033.htm; Jason Bush, *A New Start for TNK-BP*, BUS. WK., Sept. 4, 2008, http://www.businessweek.com/globalbiz/content/sep2008/gb2008094_600699.htm.

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

B. State Corporate Laws

While SWF investments are a relatively novel problem for politicians and regulators, state laws have long dealt with the basic concern presented by SWFs: the potential divergence of interests among shareholders. This problem is regulated or mitigated through a variety of protections. First, corporate law, despite some minor variations from state to state, still provides relatively meager power to shareholders.⁹⁰ Shareholders are entitled to elect, though generally not select, nominees for the board of directors. Shareholders are also entitled to vote on certain major corporate transactions and events, and they have a limited ability to put forward proposals to be included on the company's annual proxy statement.⁹¹ The exercise of voting rights by SWFs in such instances should give no cause for alarm, since SWF investment will almost always result in minority ownership of the corporation and correspondingly limited voting

90. See, e.g., Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 676 (2007) (arguing that shareholders do not, in reality, have the directorial power implied in the idea of "corporate democracy" and the shareholder franchise); see also *id.* at 679-94 (discussing the limitations on the shareholder power to replace directors).

91. 17 C.F.R. § 240.14a-8 (2008).

power and will generally not include the right to representative directors.

Second, the duty of loyalty owed to the company and the shareholders by managers and directors provides some protection against the use of SWFs as a political tool.⁹² Absent self-dealing on the part of management or directors, it is difficult to imagine a company pursuing a transaction that would privilege SWFs or their sovereign sponsors at the expense of other shareholders. On the other hand, if the SWF were a controlling shareholder, or if management or directors were receiving some benefit from a transaction that favored the SWF or sponsoring sovereign at the expense of other shareholders,⁹³ the transaction generally would be voidable under state law unless approved by a majority of disinterested directors or disinterested shareholders, or was found to be fair to the corporation and other shareholders.⁹⁴

Finally, even in the unlikely event that a SWF were permitted to place representative directors on the board, state corporate law holds that the duties of directors run to the corporation and the stockholders as a whole and not to the entity that by contract or voting power placed the director on the board.⁹⁵ Directors owe a

92. See, e.g., *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests.”) (quoting *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)).

93. Besides a state law claim, such a transaction risks Internal Revenue Service scrutiny. A transaction favoring certain stockholders over others may be deemed a constructive dividend, and the corporation would lose the ability to claim it as an expense. See JACOB MERTENS, JR., *THE LAW OF FEDERAL INCOME TAXATION* § 38 (2006).

94. See, e.g., DEL. CODE ANN. tit. 8, § 144 (2008) (“No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director’s or officer’s votes are counted for such purpose, if: . . . (3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders”); MODEL BUS. CORP. ACT § 8.61 (2008) (“A director’s conflict of interest transaction may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against a director of a corporation, in a proceeding by a shareholder or by or in the right of the corporation, if . . . (3) the transaction, judged according to the circumstances at the relevant time, is established to have been fair to the corporation.”).

95. For a discussion of this principle, see R. FRANKLIN BALOTTI & JESSE FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS* § 4.3 (3d ed. 1998). Note, however, that while directors representing minority shareholders face penalties for a breach of fiduciary duties, there is no *respondeat superior*

duty of care, which typically requires them to manage the affairs of the company in accordance with a standard of reasonable care,⁹⁶ and a duty of loyalty, which requires them to manage the interest of the company in good faith and in the best interests of the corporation and its stockholders.⁹⁷ These fiduciary duties place a liability constraint around SWF-appointed director decision-making. Any decision that would place the interests of the SWF or the sovereign at odds with the rest of the shareholders would require disclosure of the adverse interest of the SWF or sovereign, recusal of the SWF-appointee from the deciding vote, and approval of the decision by a majority of disinterested directors, all of whom have fiduciary duties to the corporation and its shareholders.⁹⁸

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

liability for the SWF or the sovereign as there would be for directors of a controlling shareholder.

Note also that if a SWF were able to place a director on the board, CFIUS would likely have jurisdiction and the SWF would likely be required to sign a mitigation agreement (as discussed in Part III.C.3, *infra*) that would provide another level of protection against political or mixed-motive decision making by the SWF and the board.

96. See, e.g., MODEL BUS. CORP. ACT § 8.30(b) (2007).

97. Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 34-39538, 63 Fed. Reg. 15,286 (Mar. 31, 1998) (correcting 63 Fed. Reg. 2,854 (Jan. 16, 1998)), available at <http://www.sec.gov/rules/final/34-39538.txt> [hereinafter Reporting Amendments].

98. See, e.g., *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

C. Federal Regulation

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

1. Securities Regulation

Outside of CFIUS (discussed in Part III.C.3 of this Article), the most important federal regulations for SWFs are the SEC's disclosure rules under the Securities Exchange Act of 1934 ("Exchange Act").⁹⁹ The SEC's Exchange Act Rule 13(d) sets out a tripartite disclosure system for disclosure by shareholders: for a shareholder holding less than five percent of the company's outstanding stock, no disclosures are required by the shareholder. For passive investors, defined under Rule 13(d) as persons not seeking to acquire or influence control of the issuer and who own less than twenty percent of an issuer's outstanding securities,¹⁰⁰ SEC rules mandate a short-form disclosure of identifying information under Schedule 13G and require certification that the securities were not "acquired . . . for the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect. . . ."¹⁰¹ To avoid even this minimal disclosure burden, most SWF investments have been in amounts below the five percent level.¹⁰²

99. See Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78mm (2006)).

100. See Reporting Amendments, *supra* note 97.

101. See Exchange Act Rule 13d-1(b), 17 C.F.R. § 240.13d-1(b) (2008).

102. As with Al-waleed bin Talal, the Saudi prince who holds nearly five percent of Citigroup, an investor holding less than five percent may have a significant impact on the governance of a company; however, this is the exception rather than the rule. Prince Al-

For investors owning more than five percent of the company and not eligible for Schedule 13G, Schedule 13D requires more detailed disclosures by the investor including, among other things, a discussion of “the purpose or purposes of the acquisition of securities.”¹⁰³ The SEC requirements thus encourage investment under levels that would trigger disclosure requirements. A reasonable reading of the statute would require some of the transparency that SWFs have been asked to provide. Namely, SWFs with significant investments that have designs on control would be required to disclose any purposes for the investment, including political purposes, which, as discussed below, should trigger review by CFIUS.¹⁰⁴ It is possible, of course, that a SWF would not disclose political intentions but then use its investment for political purposes nevertheless. Such activity could bring SEC enforcement action but more importantly would bring heightened political and regulatory scrutiny of all the SWF investments in the United States and probably in every other jurisdiction in which the SWF has invested. Again, for diversified SWFs, the costs of political activity would seem to far outweigh any potential benefits.¹⁰⁵

The federal securities law concept of control person liability also discourages controlling investments. Under section 15 of the Securities Act¹⁰⁶ and section 20 of the Exchange Act,¹⁰⁷ control persons may be held liable for misstatements or omissions in a controlled issuer’s registration statements, prospectuses, and periodic filings.¹⁰⁸ The statutes do not define “control,” although the SEC has provided some guidance in its rules, stating that control is the “possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.”¹⁰⁹ By attaching potential liability to management

waleed’s influence may be justified by his consistent investment focus over the course of a long investment relationship with Citigroup. Andy Serwer & Barney Gimbel, *Prince Alwaleed: Why Chuck Had to Go*, FORTUNE, Nov. 16 2007, http://money.cnn.com/2007/11/08/news/companies/citigroup_alwaleed.fortune/index.htm.

103. See 17 C.F.R. § 240.13d-101, pt. 4 (2000).

104. See *infra* Part III.C.3.

105. See *supra* note 84 and accompanying text.

106. 15 U.S.C. § 77o (2006).

107. 15 U.S.C. § 78t(a) (2006).

108. At least with respect to liability under 20(a) of the Exchange Act, control persons who act in “good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action” may escape liability. *Id.*

109. 17 C.F.R. §§ 230.405, 240.12b-2 (2000).

authority, the securities laws create incentives for passive minority investment.

Finally, section 16 of the Exchange Act places both reporting requirements and trading restrictions (the “short-swing profit” rules) on holders of more than ten percent of a public reporting company’s stock. A SWF that owns more than ten percent in a company’s securities will suffer a decrease in liquidity because of the limitations the short-swing profit rules place on the SWF’s trades in the company’s securities,¹¹⁰ with a concomitant increase in the SWF’s risk in the investment. Thus, the insider trading rules under section 16 of the Exchange Act also serve to limit SWF investment in U.S. firms.¹¹¹

2. Other Federal Regulations

A variety of industry-specific federal regulations also discourage the acquisition of a controlling stake in U.S. firms.¹¹² Given that the most significant investments in U.S. firms by SWFs have been in the financial services industry, the most important of these thus far has been the regulations under the Change in Bank Control Act and the Bank Holding Company Act. Under the Bank Holding Company Act, for example, investors must obtain Federal Reserve Board approval if their investment results in the acquisition or control of twenty-five percent or more of any class of voting securities of a bank

110. Section 16(b) states that any profits realized by beneficial owner of more than ten percent of any class of equity securities of a publicly traded corporation from the purchase and sale (or sale and purchase) of any equity security of such corporation occurring within a six-month period must be disgorged to the company. 15 U.S.C. §§ 78p(a)–(b) (2006).

111. The insider trading rules discourage holding large blocks of shares by any type of investor. For a discussion of the effect of insider trading rules on institutional investor holdings, see Steven Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 618–19 (2006).

112. Another possible line of federal oversight of SWFs is through tax policy. Currently, sovereign wealth funds and foreign central banks received favorable tax treatment for their equity investments under sections 892 and 895 of the Internal Revenue Code. 26 U.S.C. §§ 892, 895 (2000). Professor Vic Fleischer argues for tax-neutral treatment of sovereign wealth funds and, among other alternatives, suggests an

excise tax on equity investments by sovereign wealth funds, but the tax would be waived if the investors met specified goals of transparency, accountability, and low political risk. To ease issues of institutional competence, this approach would require tax administrators to coordinate with other executive branch officials to generate a list of ‘most-favored nations’ that would qualify for the tax exemption. In other words, we would tax sovereign wealth funds favorably, as private financial investors, if they provide evidence that they will act like private financial investors.

Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. (forthcoming 2009) (manuscript at 60, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1234410).

or bank holding company, control of the election of a majority of the board of directors of a bank or bank holding company, or the ability to exercise a controlling influence over the management or policies of the bank or bank holding company.¹¹³ Furthermore, triggering any of these tests results in regulation of the investor as a “bank holding company,” which, among other things, subjects the investor to supervision by the Federal Reserve and imposes examination, reporting, and capital reserve requirements.¹¹⁴

3. Committee on Foreign Investment in the United States

The most direct federal protection against political use of SWF investments is the review process managed by a committee that includes the Secretaries of the Treasury, Homeland Security, Commerce, Defense, State, Energy, Labor,¹¹⁵ the Director of National Intelligence, and the Attorney General (collectively, the Committee on Foreign Investment in the United States, or “CFIUS”). The CFIUS review process in its current form was set out in The Foreign Investment and National Security Act of 2007 (“FINSA”).¹¹⁶ FINSA amended the Exon-Florio process which covers national security review of foreign investments in U.S. entities. The FINSA amendments are the result of the controversy arising from CNOOC’s bid for Unocal and the Dubai Ports World deal. A number of “highly intrusive and restrictive”¹¹⁷ bills were introduced, but, after negotiations, Congress, the Bush administration, and the business community settled on the “‘least bad’ option in an environment where some form of legislative overhaul seemed inevitable.”¹¹⁸

The CFIUS process governs “any merger, acquisition or takeover that is proposed . . . by or with any foreign person which could result in foreign control of persons engaged in interstate commerce in the United States,” and it focuses on investments that may have a security impact on “critical infrastructure.”¹¹⁹ Under recent regulations from the Treasury Department, control is

113. 12 U.S.C. §§ 1841–50 (2006).

114. *Id.*

115. The Secretary of Labor is a nonvoting, ex-officio member. 50 U.S.C.A. app. § 2170(k)(2)(H) (West Supp. 2008).

116. Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (codified at 50 U.S.C.A. app. § 2170 (West Supp. 2008)).

117. Christopher F. Corr, *US Tightens the Screws on Foreign Investors*, WHITE & CASE, July 26, 2007, http://www.whitecase.com/alert_internationaltrade_0707/.

118. *Id.*

119. 50 U.S.C. app. § 2170(a) (2000).

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; in particular, but without limitation, to determine, direct, take, reach, or cause decisions regarding the following matters, or any other similarly important matters affecting an entity.¹²⁰

The regulations then go on to list decisions that demonstrate control, such as the sale or encumbrance of assets, reorganizations or merger of the entity, closing or relocating facilities, major expenditures, issuances of equity or debt, selection of business ventures, entering into or terminating significant contracts, altering policies for control of sensitive information, appointment or dismissal of senior officers, appointing or dismissing persons with access to sensitive information, and amending organizational documents.¹²¹

Under the CFIUS process, parties to a covered transaction typically file a voluntary notice, often even when it appears that the transaction does not involve a controlling ownership.¹²² After notice is received, CFIUS undertakes a thirty day “National Security Review.”¹²³ Following this review, CFIUS may either allow the transaction to proceed, or may undertake a second, forty-five day “National Security Investigation.”¹²⁴ Certain transactions, however, automatically require the second-stage review, including foreign government-controlled transactions, which are defined as transactions in which “an entity controlled by or acting on behalf of a foreign government seeks to engage in any merger, acquisition, or takeover which could result in the control of a person engaged in interstate commerce in the United States that could effect the national security of the United States.”¹²⁵ An exception to this requirement is a finding by senior CFIUS officials that, after review, the transaction will not

120. Department of the Treasury, RIN 1505-AB88, Regulations Pertaining to Mergers, Acquisitions and Takeovers by Foreign Persons (Nov. 18, 2008), *available at* http://www.ustreas.gov/offices/international-affairs/cfius/docs/finalregs_111408-%20.pdf.

121. *Id.*

122. John B. Reynolds, III et al., *CFIUS Reform Legislation Signed Into Law*, WILEY REIN LLP, Aug. 3, 2007, *available at* http://www.wileyrein.com/publication.cfm?publication_id=13209.

123. See 50 U.S.C. app. § 2170(b)(1) (2000).

124. § 2170(b)(2).

125. § 2170(a).

impair the national security of the United States.¹²⁶ CFIUS officials have also developed a practice (though not a rule) of not formally investigating deals involving the acquisition of less than ten percent¹²⁷ of the company's outstanding stock, provided the acquisition does not bring with it the incidents of control for the investor, such as a seat on the board of directors.

CFIUS, especially after the FINSA amendments, often conditions its approval of SWF investments on the signing of "mitigation agreements" that interested government agencies broker between purchasers and sellers.¹²⁸ Mitigation agreements may require special security agreements, audits, adherence to various federal guidelines and "best practices," and liquidated damages.¹²⁹ In the case of a SWF, a mitigation agreement involving a minority SWF shareholder could reasonably stipulate that the SWF remain a passive shareholder, prohibiting the SWF shareholder from seeking a seat on the board of directors. In practice, however, SWF investors by design tend to invest in amounts that do not compel investigation by CFIUS.¹³⁰ Further, passive investment terms are set by the issuer and the SWF so that the risk of political involvement—not only by the SWF but by U.S. government agencies or members of Congress—is minimized.

The FINSA amendments of 2007 attempt to chart a moderate course with respect to sovereign investment concerns. Some commentators and politicians have expressed concerns that the CFIUS process does not provide sufficient protection. For example,

126. See § 2170(d).

127. 31 C.F.R. § 800.302(d)(1) (2007). The ten percent threshold is not a bright line but merely a rule of thumb; CFIUS looks at *functional* control. See *id.* § 800 app. A. Incidents of control could come at lower levels of ownership than ten percent, especially where there is a limited public float of common stock.

128. *Regulating Sovereign Investments: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. (2008) (statement of Jeanne S. Archibald, Dir., Int'l Trade Practice, Hogan & Hartson LLP).

129. *Impact of Foreign Ownership on Data Controls and Infrastructure: Hearing Before the Subcomm. of Transp., Sec. and Infrastructure Prot. of the H. Comm. on Homeland Sec.*, 110th Cong. (2007) (statements of Stewart A. Baker, Assistant Sec'y for Pol'y, Dep't of Homeland Sec.; Robert B. Stephan, Assistant Sec'y for Infrastructure Protection, Dep't of Homeland Sec.; and Gregory Garcia, Assistant Sec'y for Cyber Sec. and Telecomm., Dep't of Homeland Sec.), video recording of hearing available at <http://homeland.house.gov/SiteDocuments/20070323155353-12290.pdf>.

130. Note, however, that in emerging and domestic economies, SWFs often take controlling stakes. See William Miracky et al., *Assessing the Risks: The Behaviors of Sovereign Wealth Funds in the Global Economy*, MONITOR GROUP, June 2008, at 4, available at http://www.monitor.com/Portals/0/MonitorContent/documents/Monitor_SWF_report_final.pdf.

Senator Evan Bayh argues that shareholders such as Prince Alwaleed bin Talal may exercise influence over a company even while owning less than five percent of the outstanding stock of the company.¹³¹ Such transactions might not come within the scope of CFIUS review, because they do not involve a controlling stake. However, CFIUS still retains the ability to initiate a review even though it did not earlier conduct a formal thirty day review or forty-five day investigation. For example, when a SWF that did not initially acquire control later attempts to acquire and exercise control, CFIUS may begin an investigation and suspend or void any politically motivated transactions.

A SWF may use its investment in a political manner yet still fall outside of the control test that defines CFIUS jurisdiction. However, because CFIUS defines control broadly as the ability to “determine, direct, take, reach, or cause decisions regarding . . . important matters affecting an entity,” there seems to be little that a SWF could do that would fall outside of legitimate investment activity and yet fail to trigger CFIUS review.¹³² The mere exercise of voting rights could not enable the SWF to direct the company to reveal sensitive technologies or to invest in the sponsoring sovereign, for example. The SWF would require control to force such transactions, and the act of attempting to acquire control would trigger CFIUS review. Outside of CFIUS’ jurisdiction, within the murkier sphere of shareholder influence, protection against political activity decreases. Still, even though CFIUS would no longer apply, other factors would work against political activity so that SWFs should not possess influence greater than other shareholders. Suppose again that a sovereign wishes to pressure a company in its SWF’s portfolio to build a factory in one of the sovereign’s poorer regions. If the transaction is fair to the company and its shareholders, perhaps the company will agree. But why would a minority ownership by a SWF suggest that the company and sovereign would not negotiate at arms’ length? Put another way, what pressure could the sovereign apply that would not create serious political and economic consequences for the sovereign and its SWF? It could not, for example, threaten to foreclose opportunities to the company to do business in the country without having such a decision characterized as politically motivated.

131. See Bayh, *supra* note 30.

132. Department of the Treasury, RIN 1505-AB88, Regulations Pertaining to Mergers, Acquisitions and Takeovers by Foreign Persons (Nov. 18, 2008), *available at* http://www.ustreas.gov/offices/international-affairs/cfius/docs/finalregs_111408-%20.pdf.

Likewise, it could not threaten to sell its shares without a similar result.¹³³ Even where CFIUS does not reach, other laws, economic realities, and political consequences provide considerable assurance against political use of SWFs.

A number of concerns remain with the CFIUS process, however, which suggest that the risk of heavy-handed application of CFIUS is greater than the risk of political exploitation of SWFs by sponsoring sovereigns. First, even for transactions that are not reviewed, CFIUS already adds substantial transaction costs to any significant SWF transaction involving a U.S. entity.¹³⁴ Aside from the added costs to the SWF and the issuer of legal advisors that help the parties navigate the CFIUS process, CFIUS also creates potentially costly delays if the transaction is reviewed. By requiring officials to affirmatively sign off on a decision not to investigate, FINSA creates pressure to investigate which will undoubtedly increase the average time for review of SWF deals.¹³⁵

The CFIUS process also raises the possibility of political mischief. The FINSA amendments to the CFIUS process created broad and arguably political tests that may not be directly related to the transaction itself and that may result in transaction approval being tied to political concerns. For example, CFIUS is required to consider: (a) “the adherence of the [SWFs] subject country to nonproliferation control regimes”;¹³⁶ (b) “the relationship of such country with the United States,” specifically regarding its record of cooperating with counter-terrorism efforts;¹³⁷ and (c) “the potential for transshipment or diversion of technologies with military

133. Although such subtle pressures would not always be apparent to regulators because they would occur through non-public channels, sovereigns would face the risk that companies would reveal such pressures. Most companies have welcomed SWF investment under the assumption that SWFs are long-term, low-maintenance investors. If SWFs change the rules, it seems unlikely that companies would play along, especially where doing so runs the risk of derivative lawsuits from other shareholders. On the other hand, a CFIUS investigation would also create problems for the company. What if CFIUS ultimately required investment by the SWF? Selling a large block of shares would certainly depress the stock price of the company.

134. Corr, *supra* note 117; see also Meghan D. Brady, *Buy American (Unless You're Foreign)*, CFO.COM, Feb. 7, 2007, http://www.cfo.com/article.cfm/8659115/2/c_8668196?f=home_todayinfinance (discussing the relationship between foreign investment in U.S. companies and the potential for national security breaches).

135. Corr, *supra* note 117.

136. See 50 U.S.C.A. app. § 2170(f)(9)(A) (West Supp. 2008).

137. § 2170(f)(9)(B).

applications, including an analysis of national export control laws and regulations.”¹³⁸

Politicization of the CFIUS process can also result from both private and governmental activities outside of CFIUS. Private parties have repeatedly used the CFIUS process to achieve private gains.¹³⁹ In 1990, for example, British Tire and Rubber (BTR) attempted a hostile takeover of Massachusetts-based Norton Company.¹⁴⁰ Sixty-four percent of Norton's shareholders accepted BTR's hostile seventy-five dollar-per-share tender offer.¹⁴¹ However, the deal offered little protection for Norton employees, and a coalition established by Norton employees collected 8,300 signatures in opposition to the transaction and placed an advertisement in the *Wall Street Journal*. Soon after, the legislature of the Commonwealth of Massachusetts passed a bill blocking BTR from replacing the Norton board at the company's annual meeting. One hundred nineteen members of Congress then wrote a letter to the president asking for an investigation into the transaction, stating that BTR's acquisition of Norton would not be in Norton's economic interest or in the interests of national security.¹⁴² However, another foreign company, French conglomerate Saint-Gobain, stepped in to make a ninety dollar-per-share offer.¹⁴³ Norton was more pleased with this offer, and neither Norton nor its surrogates raised objections on economic and national security grounds.¹⁴⁴ As two commentators noted,

[i]t is hard to imagine how a British acquisition of Norton raised national security issues while a French acquisition did not. There were no national security issues with the proposed British acquisition; Norton simply did not want to be acquired by BTR, and used a political campaign toward CFIUS to prevent it.¹⁴⁵

138. § 2170(f)(9)(C).

139. For a more detailed discussion of these transactions, see EDWARD M. GRAHAM & DAVID M. MARCHICK, U.S. NAT'L SEC. AND FOREIGN DIRECT INV. 123–41 (2006).

140. David Owen, *BTR in Dollars 1.64bn Bid for Norton*, FIN. TIMES (London), March 17, 1990, at 1.

141. See Andrew E. G. Jonas, *Corporate Takeover and the Politics of Community: The Case of Norton Company in Worcester*, 68 ECON. GEOGRAPHY 348, 363–64 (Oct. 1992); see also *Saint-Gobain Offers Friendly Merger to Norton*, 134 CERAMIC INDUS. 10, 10 (June 1, 1990).

142. See SYED ANWAR KARIM, DEP'T OF THE AIR FORCE, FOREIGN ACQUISITIONS OF U.S. COMPANIES 15 (1995).

143. GRAHAM & MARCHICK, *supra* note 139, at 124.

144. *Id.*

145. *Id.*

In 2002, ST Telemedia, the second largest telecom in Singapore, offered \$250 million for a 61.5% stake in Global Crossing.¹⁴⁶ Carl Icahn was also interested in acquiring Global Crossing. XO Communications, a company chaired by Icahn, sent a letter to the Federal Communication Commission (FCC) requesting that the FCC delay its review of the transaction “to ensure that all interested parties have ample opportunity to assess the public interest implications of the ST Telemedia takeover of Global Crossing by extending the comment cycle in this proceeding until the DOJ and CFIUS have concluded their review.”¹⁴⁷ According to an attorney involved in the representation of Global Crossing, Icahn encouraged congressional opposition to the transaction.¹⁴⁸ Arguing that the transaction was unlikely to pass CFIUS review, Icahn sued to block the transaction and force an auction of the now bankrupt Global Crossing.¹⁴⁹

The potential for the politicization of CFIUS can also be seen in two recent deals—involving state-owned companies, not SWFs—which served to catalyze the FINSA amendments. In June 2005, CNOOC, a state-controlled company, made an unsolicited, all-cash, \$18.5 billion bid for Unocal Oil Company.¹⁵⁰ The bid followed a \$16.5 billion bid in cash and stock by Chevron.¹⁵¹ The bid expectedly raised political concerns.¹⁵² In July, the U.S. House of Representatives voted 398-15 for a resolution asking President Bush to block the transaction as a threat to national security.¹⁵³ Chevron then increased

146. See *Judge Approves Sale of State in Global Crossing to ST Telecom*, N.Y. TIMES, July 2, 2003, at C10 (discussing the court’s later approval of this transaction).

147. Letter from Brian D. Oliver, Executive Vice President, Strategy and Corp. Dev., XO Comm., to Marlene H. Dortch, Sec., Fed. Comm’n. Comm’n. (June 12, 2003), available at <http://sec.edgar-online.com/2003/06/13/0000950133-03-002164/Section7.asp>.

148. GRAHAM & MARCHICK, *supra* note 139, at 126 (noting that author David Marchick, then an attorney with Covington & Burling, represented Global Crossing in the transaction).

149. *Id.*

150. See Xie Ye, *CNOOC Launches Bid for Unocal Take-over*, CHINA DAILY, June 24, 2005, http://www.chinadaily.com.cn/english/doc/2005-06/24/content_454231.htm (reporting the start of a potential take-over battle for Unocal).

151. See Ben White, *Some Unocal Shareholders Reconsider Bid*, WASH. POST, July 7, 2005, at D1 (discussing the political concerns surrounding CNOOC’s bid for Unocal Corp.).

152. China’s Xinhua News Agency characterized the opposition as “unexpected,” and CNOOC complained that “[t]he unprecedented political opposition that followed the announcement of our proposed transaction . . . was regrettable and unjustified.” *CNOOC Withdraws Unocal Bid*, XINHUA NEWS AGENCY, Aug. 3, 2005, http://www.china.org.cn/archive/2005-08/03/content_1137165.htm.

153. H.R. Res. 344, 109th Cong. (2005) (enacted), available at <http://thomas.loc.gov/cgi-bin/bdquery/z?d109:h.res.00344>: (follow “Text of Legislation” hyperlink).

its bid to approximately \$17 billion. Unocal asked CNOOC to sweeten its bid to compensate for the inevitable delays as the Bush administration conducted a lengthy review of the acquisition.¹⁵⁴ CNOOC declined to increase its offer unless Unocal agreed to pay the costs of terminating the Chevron transaction and “lobby for the deal in the US Congress.”¹⁵⁵ Unocal declined, and CNOOC withdrew its bid.

The second contentious sale occurred with the 2006 takeover of Peninsular and Oriental Steam Navigation Company (P&O), a UK firm, by DP World. Following the takeover, DP World would assume P&O’s agreements to manage a number of major U.S. port facilities. In late 2005, DP World approached CFIUS to discuss the transaction.¹⁵⁶ In February 2006, P&O’s stockholders approved the transaction, and CFIUS reviewed the transaction and approved the assumption of the port agreements.¹⁵⁷

Details of the DP World deal soon appeared in the financial press. Shortly after the deal, DP World became a national press news story as New York Senator Chuck Schumer criticized CFIUS approval of the transaction.¹⁵⁸ Schumer was joined by a bipartisan congressional coalition that called for a second review of the transaction and possible legislative action to stop or unwind the deal.¹⁵⁹ President Bush threatened to veto any such legislation, claiming “it would send a terrible signal to friends and allies” to not let the transaction go through.¹⁶⁰

On March 8, 2006, a House Panel overwhelmingly voted to block the deal.¹⁶¹ The following day, DP World released a statement saying

154. *CNOOC Withdraws Unocal Bid*, *supra* note 152.

155. *Id.*

156. JAMES K. JACKSON, CONG. RESEARCH SERV., CRS REPORT FOR CONGRESS: THE COMMITTEE ON FOREIGN INVESTMENT IN THE UNITED STATES (CFIUS) 1 (2008), available at <http://www.fas.org/sgp/crs/natsec/RL33388.pdf>.

157. *Id.*

158. See Stephanie Kirchgaessner & Edward Alden, *Dubai Ports Takeover Prompts Backlash*, FIN. TIMES (London), Feb. 16, 2006, http://www.ft.com/cms/s/d8156740-9f3f-11da-ba48-0000779e2340,dwp_uuid=5aedc804-2f7b-11da-8b51-00000e2511c8,print=yes.html#.

159. Press Release, Senator Charles Schumer, Strong Bipartisan Push To Pass Emergency Legislation Suspending Dubai Port Deal Continues (Feb. 24, 2006), available at <http://schumer.senate.gov/schumerwebsite/pressroom/record.cfm?id=2594538>.

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

161. *Ports Deal News Tracker*, WALL ST. J. ONLINE, Mar. 15, 2006, http://online.wsj.com/public/article/SB114071649414581503-6cMsd79X0W1Po8sqVlrCDNtfFrg_20070417.html.

that “[b]ecause of the strong relationship between the United Arab Emirates and the United States[,] and to preserve this relationship[,] . . . DP World will transfer fully the U.S. operations of P&O Ports North America, Inc. to a United States entity.”¹⁶² DP World eventually sold P&O’s U.S. ports operations to an American International Group subsidiary.¹⁶³

As made clear in the foregoing examples, the key to success of private efforts to exploit the CFIUS process is the encouragement of congressional involvement, which was enhanced through the FINSA amendments. FINSA provides for enhanced congressional oversight, requiring CFIUS to report to:

- (i) the majority and minority leaders of the House and Senate,
- (ii) the chair and ranking members of the Senate Banking Committee and the House Financial Services Committee, (iii) *any* House or Senate committee having oversight over the lead agency in the CFIUS review, (iv) Senators and Members of Congress from the district concerned, and implicitly (v) governors whose states “interact” with the critical infrastructure involved.¹⁶⁴

As practitioners have argued, “[s]uch broad ranging, transaction-by-transaction Congressional involvement in the potentially explosive issue of foreign investment can only raise the risk of political mischief, particularly where US constituents have an interest in opposing a competing foreign investor.”¹⁶⁵ The danger in the CFIUS process is that political abuse is easily masked as the furtherance of a legitimate task and the protection of national security. The risk of such political or protectionist measures, however, is less investment in the United States. For example, the head of China Investment Corp. warned that his \$200 billion SWF will avoid investing in countries that use national security as an excuse for protectionism: “If an economy will use national security as a criteria [sic] for entry of sovereign wealth funds, we will be reluctant to tap the market because you are

162. Press Release, H. Edward Bilkey, Chief Operating Officer, DP World (Mar. 9 2006), *available at* http://portal.pohub.com/pls/pogprtl/docs/PAGE/DP_WORLD_WEBSITE/DP_WORLD_MEDIA_CENTRE/MEDIA_CENTRE_NEWS_RELEASES/NEWS_RELEASES_2006/17%20DPW%20PRESS%20STATEMENT.PDF.

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

164. Corr, *supra* note 117; *see also* Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (codified as amended at 50 U.S.C.A. app. § 2170 (West Supp. 2008) (describing the heightened oversight required by FINSA).

165. Corr, *supra* note 117.

not sure what will happen [N]ational security should not be an excuse for protectionism.”¹⁶⁶

FINSA provided some assurance that CFIUS would not be used politically *after* a transaction is approved by tailoring the CFIUS “evergreen” provision,¹⁶⁷ which allows CFIUS to reopen an investigation and stop or unwind a previously-cleared transaction. Rather than allowing for an arbitrary reopening of an investigation into an existing and approved investment, the CFIUS evergreen provision has two firm triggers that provide some certainty to SWFs with investment intentions. First, a transaction investigation may be reopened “if any party to the transaction submitted false or misleading material information to the Committee in connection with the review or investigation or omitted material information, including material documents, from information submitted to the Committee.”¹⁶⁸ Second, CFIUS may reopen an investigation: (1) “if any party to the transaction or the entity resulting from consummation of the transaction intentionally and materially breaches a mitigation agreement”; (2) if the “breach is certified to the Committee by the lead department or agency monitoring and enforcing such agreement or condition as an intentional material breach”; and (3) if CFIUS “determines that there are no other remedies or enforcement tools available to address such breach.”¹⁶⁹ The challenge for CFIUS is to satisfy its congressional reporting mandate while also protecting itself from political pressures. Ironically, the mitigation against political risk may be one-sided—dangers against foreign political activity are mitigated, but increased congressional oversight and involvement creates political risks for SWFs.

FINSA will successfully discourage political investment by SWFs. However, FINSA may also have the unintended effect of discouraging active sovereign investors and perhaps even some passive sovereign investors, unless experience with the CFIUS process eases SWF concerns that CFIUS will be politicized.

The FINSA amendments have already had a pronounced effect on deals, with CFIUS and firms acting in accordance with FINSA

166. Leonora Walet, *China Investment Corp Warns Western Governments Against Protectionism—Report*, FORBES, Dec. 10, 2007, <http://www.forbes.com/markets/feeds/afx/2007/12/10/afx4424545.html>.

167. Corr, *supra* note 117.

168. 50 U.S.C.A. app. § 2170(b)(1)(D)(ii) (West Supp. 2008).

169. 50 U.S.C.A. app. § 2170(b)(1)(D)(iii)(III) (West Supp. 2008).

even before the effective date of the legislation.¹⁷⁰ Law firms handling these matters note report that notifications to CFIUS in 2006 were seventy-four percent higher than in 2005,¹⁷¹ and that “CFIUS is receiving filings at a pace that, if maintained, would reach approximately 150 cases for 2007, substantially exceeding the 113 filed in 2006.”¹⁷² While filings have increased,¹⁷³ some argue that actual SWF investment has not.¹⁷⁴ In anticipation of the CFIUS legislation, 2006 saw significant increases in the number of deals escalated to the forty-five day investigation stage, the number of deals in which CFIUS required mitigation, and the number of “informally blocked” deals wherein investors simply pulled out of the CFIUS review process.¹⁷⁵

CFIUS could be made less susceptible to politicization through Treasury guidance requiring that “critical infrastructure” will be read narrowly so that valid concerns for national security are not exploited. Congress demonstrated awareness of the potential for political misuse of CFIUS when it opted for a more limited scope of CFIUS review. The final FINSA draft defines “critical infrastructure” as systems or assets “so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security.”¹⁷⁶ Earlier drafts included much broader language that would have allowed critical infrastructure to include “national economic security and national public health or safety,” terms that could be held to cover a very wide range of benign investments.¹⁷⁷ However, even the limitation to “national security” is still broad enough to invite mischief.¹⁷⁸ As Attorney David Marchick has noted,

[T]here are certain areas of “critical infrastructure,” broadly defined, that in the ordinary course simply should not raise national security concerns. For example, there has been great

170. See Corr, *supra* note 117.

171. *Id.*

172. John B. Reynolds, III, et al., *supra* note 122.

173. See Corr, *supra* note 117; see also Mihir Desai & Nihar Shah, *The Deal Breaker*, THE AMERICAN, May 29, 2008, available at <http://www.american.com/archive/2008/may-june-magazine-contents/the-deal-breaker> (explaining how the FINSA amendments have increased the number of investigations performed by CFIUS).

174. See Corr, *supra* note 117.

175. See *id.*

176. 50 U.S.C.A. app. § 2170(a)(6) (West Supp. 2008).

177. Foreign Investment and National Security Act of 2006, S. 3549, 109th Cong. (as referred to H. Comm. after being received by Senate).

178. See § 2170 (a)(6).

controversy in certain states regarding the privatization of toll roads. While that debate is understandable, it would be far more difficult to see how foreign ownership of a toll road would raise national security issues. The same logic applies to most investments in agriculture and food. Ben and Jerry's is owned by a Dutch company, and Häagen-Dazs is owned by Diageo, a British company. I can think of many great ways to describe Cherry Garcia, but central to national security isn't one of them.¹⁷⁹

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

D. Expectations of Sovereign Wealth Funds as Shareholders

Having briefly sketched the regulatory framework in which SWFs operate, this Section will now turn to the reasonable expectations of regulators, directors, managers, and other shareholders with respect to SWF behavior as shareholders within this framework. This Article has thus far argued that existing regulations compel passivity on the part of SWFs and thus minimize the threat that equity investments will be used as political tools. Aggressive use of the CFIUS process may create risks, however, including loss of investment. Further, the passivity compelled by existing regulations may not always be desirable. The term "passivity" in the context of investor behavior is often equivocated. When regulators and politicians expect SWFs to invest passively, there are at least two ways in which the term may be used. First, passivity may be defined as it is by the SEC. Under Exchange Act

179. *The Impact of Foreign Ownership and Foreign Investment on the Security of our Nation's Critical Infrastructure: Testimony Before the Subcomm. on Trans. Sec. and Infrastructure Protection*, 110th Cong. 3 (2007) (statement of David Marchick, Covington and Burling LLP), available at <http://homeland.house.gov/SiteDocuments/20070516155704-95465.pdf>.

Rule 13d-1, passive investors are investors that “have not acquired and do not hold the securities for the purpose of or with the effect of changing or influencing the control of the issuers of the securities.”¹⁸⁰

The second definition is not limited only to those investors that do not intend to exercise control, but also those who are “passive shareholders,” with the term “passive” serving as an antonym to “activist.”¹⁸¹ Thus, in contrast to this definition of activism, a passive shareholder may be defined as a shareholder who is not only disinterested in control but is also not involved in any activities that may affect firm behavior or decision making. While practically all investors fall within such a definition, there are a number of reasons why SWFs should not be expected or required to assume such a role. One disadvantage of passive investment is that the SWF may be unwilling to engage with management; as noted by the *Financial Times*, “the reason the sovereign funds have been given the opportunity to invest in Wall Street’s financial groups is precisely because of misjudgments by managements that were either ignorant of risks and contingent liabilities or tolerant of them.”¹⁸² However, because of the risk of political backlash, SWFs may not encourage needed reforms, as might other investors such as pension funds, hedge funds, or private equity firms. For very large portfolio firms such as many of the largest financial institutions, the kind of investor activism pursued by private equity firms and hedge funds is not possible. As explained by Blackstone chief executive Stephen Schwarzman, “the scale of these companies dwarfs our ability to make a meaningful contribution. We can’t finance them with our limited resources.”¹⁸³ As discussed above, hedge funds and private equity firms control only a fraction of the wealth of SWFs. The *Financial Times* also notes another advantage of SWFs:

[B]ecause they do not depend on borrowed money nearly as much as private equity firms do to finance their stakes, the

180. 17 C.F.R. § 240.13d-1 (2008).

181. In a representative definition, Bernard Black describes shareholder activism as “proactive efforts to change firm behavior or governance rules.” BERNARD S. BLACK, *Shareholder Activism and Corporate Governance in the United States*, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 459, 459 (Peter Newman ed., 1998).

182. Henny Sender, *Silence Not Golden for Sovereign Funds*, FIN. TIMES (London), Jan. 17, 2008, http://www.ft.com/cms/s/0127cf0e-c51a-11dc-811a-0000779fd2ac,Authorised=false.html?_i_location=http%3A%2F%2Fwww.ft.com%2Fcms%2Fs%2F0%2F0127cf0e-c51a-11dc-811a-0000779fd2ac.html%3Fnclick_check%3D1&_i_referer=&nclick_check=1.

183. *Id.*

companies in which they invest do not become loaded with debt. 'The sovereign funds are safer and less risky owners than private equity because they can live with lower leverage and lower returns,' says a senior banker in New York.¹⁸⁴

The rise of sovereign wealth funds comes in an era of increased institutional investor activism. Institutional investors generally have grown in importance, both as a function of their relative size in the market, and because proxy advisors and other corporate governance industry firms enable institutional investors to overcome many of the collective action problems, which in the past made greater investor activism infeasible.¹⁸⁵ Institutional investor activism has significantly affected corporate governance in the United States in recent years, most notably in removing anti-takeover protections and requiring majority voting for election of directors.¹⁸⁶

Like institutional investors, it should be expected that many, if not most, funds will want to use this environment to their advantage and take an active governance role, at least in the sense of engaging with management and the board and exercising shareholder voting rights. SWFs have not and are not likely to behave according to a single paradigm. Rather, some SWFs may invest like socially-conscious pension or mutual funds, some may invest aggressively like some hedge funds, and some may invest passively like many mutual funds.¹⁸⁷ SWFs may be voluntarily passive for several reasons. A SWF may determine to remain a passive investor for the same reason that many investors remain passive: it is economically rational to remain passive when activism is unlikely to result in any appreciable economic benefit for the SWF, perhaps because the investment is relatively small and significant expenditure of resources would result in insignificant gains. Like other investors, SWFs will vote on corporate matters. SWFs may also attempt to place proposals on a portfolio company's proxy (although apparently this has yet to occur).

An expectation of this broader form of passivity by SWFs may deter legitimate investments. To require such passivity as an implicit condition to investment negates the essential nature of equity

184. *Id.*

185. See Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 897-98 (2007).

186. See GEORGESON, 2007 ANNUAL CORPORATE GOVERNANCE REVIEW 6-7 (2007), available at <http://www.georgeson.com/usa/download/acgr/acgr2007.pdf>.

187. See *supra* notes 8-23 and accompanying text (describing various investments made by SWFs).

investment.¹⁸⁸ On the other hand, an active role in governance (presumably by the professional managers of SWFs, who are typically drawn from the ranks of fiduciary institutional investor firms) may prove beneficial. Active minority shareholders are often of significant benefit to their portfolio companies. One such example is Nelson Peltz, who holds minority positions in, among many firms, Heinz and Wendy's.¹⁸⁹ Peltz has pushed through a number of changes at both companies, and both companies appear to have benefited significantly as a result.¹⁹⁰

Likewise, Saudi Prince Al-waleed Bin Talal's Kingdom Holding Company (KHC) is cited as a model minority shareholder.¹⁹¹ One of KHC's investment philosophies is

a strategy for long-term investments, [seeking] businesses with strong management teams that are capable of delivering sustained growth and continuously strong returns. [KHC] intends to continue to support management teams while seeking to be an active investor taking investment positions large enough to give KHC a voice in the strategic management of its portfolio companies.¹⁹²

Prince Al-waleed owns approximately 4.3% of Citibank yet made front-page news when in early 2007 he publicly called on Citigroup to "take draconian measure[s] to control the costs."¹⁹³ After Al-waleed spoke out, Citigroup accelerated cost cutting measures.¹⁹⁴ While Prince Al-waleed's role in the cost-cutting decision and the effect of the decision are debatable, a more important measure of his influence

188. Such a requirement is nearly converse to the practice of empty voting; both practices separate economic interest from activism, with empty voting retaining voting power and no economic interest, and passive shareholding retaining economic interest but avoiding any form of activism. For a discussion of the practice of empty voting and other types of vote manipulation, see Bernard Black & Henry Hu, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 929-36 (2006); Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPREN. BUS. L.J. 1, 19-28 (2006).

189. Julie Jargon, *Peltz Uses "Common Sense" to Reshape Food Industry*, WALL ST. J., Nov. 11, 2007, at A1.

190. *Id.*

191. See, e.g., *Ignore the Murk and Myths of Sovereign Funds*, INFORMED (The Investor Relations Society, Europe), Dec. 13, 2007, at 4, available at <http://www.ir-soc.org.uk/files/pdf/bulletin/bulletin243.pdf>.

192. Kingdom Holding Company, *Investment Philosophy*, http://www.kingdom.com.sa/en/InvP_InvPhilosophy.asp (last visited Nov. 9, 2008).

193. David Wighton, *Alwaleed Urges Draconian Moves on Costs at Citigroup*, FIN. TIMES, July 18, 2006, at 1, available at http://us.ft.com/ftgateway/superpage.ft?news_id=fto071820061444591170.

194. *Cracks in the Edifice*, ECONOMIST, Nov. 8, 2007, at 89.

as an investor is seen later in 2007. In an interview with *Fortune* magazine, Prince Al-waleed stated that he spoke to then-CEO Charles Prince regularly, and during the subprime crisis they spoke “almost every two or three days. Four or five calls over the past [ten] days.”¹⁹⁵ Prince Al-waleed was later thought to have influenced the ouster of Charles Prince when he withdrew his support of Prince after Citigroup acknowledged the need for an \$8 to \$11 billion write-off related to the subprime crisis.¹⁹⁶

While SWFs may raise concerns over investor intent, engaged SWFs would likely be better co-shareholders—from the perspective of other long-term investors—than highly leveraged, activist hedge funds and private equity firms, as engaged SWFs may be able to make investments that such firms cannot. Markets have tended to react positively to SWF investments, suggesting that shareholders are not overly concerned with the possibility of political activity by SWFs.¹⁹⁷ Further, shareholders may recognize that by welcoming investments by SWFs, companies are more likely to be welcome in the SWF sponsor country.¹⁹⁸ The benefits attributable to a large, stable shareholder may be part of the explanation for the surge in Sony stock price following a large investment by Dubai’s SWF.¹⁹⁹ In Tokyo, Sony stock closed up 4.6%.²⁰⁰ After CIC’s announcement that it would invest in Morgan Stanley, Morgan Stanley’s shares rose nearly 6% (versus a 1.67% gain by the S&P 500 on the same day).²⁰¹ In the case of Mubadala’s investment in AMD, the share price performed as well as the sector overall; in Dubai’s investment in Citigroup, the share price underperformed the market but outperformed its sector.²⁰²

195. Serwer & Gimbel, *supra* note 102 (quoting interview with Prince Al-waleed).

196. *Id.* Note that the type of beneficial influence exercised by Al-waleed would likely be found to constitute “control” under the Treasury’s new CFIUS rules. *See supra* note 82 and accompanying text.

197. Vidhi Chhaoharia and Luc Laeven, *Sovereign Wealth Funds: Their Investment Strategies and Performance* 23, 43 (Working Paper, Aug. 31, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1262383.

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

199. Peter Sayer, *Dubai Investment Fund Buys Stake in Sony*, PC WORLD, Nov. 27, 2007, http://www.pcworld.com/businesscenter/article/139929/dubai_investment_fund_buys_stake_in_sony.html (last visited Nov. 9, 2008).

200. *Id.*

201. Chris Oliver, *Details of CIC’s Stake in Morgan Stanley Revealed*, MARKET WATCH, Dec. 24, 2007, <http://www.marketwatch.com/news/story/details-cics-stake-morgan-stanley/story.aspx?guid=%7B6175589F-C8D1-49AE-8FA4-EB61BF8F7AC2%7D>.

202. *Id.*

CHART 2

Market Reactions to SWF Investment

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

On the other hand, a recent, preliminary study suggests that while SWF investment has initially been viewed as a positive, share prices of SWF portfolio companies have tended to drop over time.²⁰³ The study’s authors suggest that the decrease may be attributable to concerns that SWFs will be used as political tools.²⁰⁴

In some cases however, SWFs already act like other large institutional investors, such as public pension funds.²⁰⁵ A number of the largest SWFs, including Norway’s Government Pension Fund-Global,²⁰⁶ Singapore’s Temasek fund,²⁰⁷ and Alaska’s Permanent

203. See Veljko Fotak et al., *The Financial Impact of Sovereign Wealth Fund Investments in Listed Companies* 3 (Working Paper, Mar. 18, 2008), available at <http://ssrn.com/abstract=1108585>.

204. *Id.* at 2–3, 7.

205. One money manager speculates that SWFs will behave like pension plans in terms of asset allocation, with portfolios of approximately 60% equities, 30% bonds, and 10% alternatives. See George Hogue, *Market Insight: Sovereign Funds Should Be Watched with Caution*, FIN. TIMES, Dec. 12, 2007, available at <http://www.ft.com/cms/s/0/a20ca2ec-a8d6-11dc-ad9e-0000779fd2ac.html>. If all SWFs were to index 60% of their assets to, as an example, the FTSE Global All Cap index, they would collectively own around 4.6% of the 7,805 companies in the index. However, note that these numbers may not hold true for SWFs controlled by Islamic states, since certain forms of lending may violate Shari’ah law. For a discussion of the asset allocation of petrodollar SWFs, see FARRELL ET AL., *supra* note 43, at 53.

206. Norwegian Ministry of Finance, The Global Pension Fund, <http://www.regjeringen.no/en/dep/fin/Selected-topics/The-Government-Pension-Fund.html?id=1441> (last visited Nov. 9, 2008) (providing detailed disclosures on Norway’s Government Pension Fund-Global).

207. Temasek Holdings, <http://www.temasekholdings.com.sg/> (last visited Nov. 9, 2008) (showing Temasek’s disclosures).

Fund²⁰⁸ provide information on size, results, and portfolio composition. SWFs may signal how they will exercise their votes as shareholders by disclosing proxy voting policies, as Alaska does.²⁰⁹

Some SWFs, especially Western SWFs, will likely seek to be activist in ways similar to pension funds. For example, like pension funds concerned with the detrimental effects of certain products on their pensioners, SWFs may choose to avoid investment in tobacco companies because a significant portion of the country's health expenditures are related to diseases associated with tobacco usage. Norway's SWF recently announced that it was initiating a review of such problematic investments. Finance Minister Kristin Halvorsen said the fund would report to parliament on its investments in 2008, and that "[p]roduction of tobacco, gambling for instance, nations that break human rights . . . the sex industry these are entirely concrete issues" that the fund would consider.²¹⁰ Norway's SWF has signed on²¹¹ to the UN's "Principle for Responsible Investment" ("PRI"),²¹² a set of non-binding best practices. Funds publicly indicate their acceptance of the best practices by becoming signatories to the PRI via a UN website.²¹³ Among other things, PRI signatories pledge to incorporate environmental, social, and governance ("ESG") issues into investment analysis and decision-making processes. They propose to do so through investment policy statements, support for ESG-related tools, metrics, and analyses, and encouragement of the adoption of ESG measures by financial analysts, consultants, brokers, research firms, or rating companies.²¹⁴ PRI signatories also pledge to

208. The Alaska Permanent Fund Corporation, <http://www.apfc.org/home/Content/home/index.cfm> (for the Alaska Permanent Fund Corporation's disclosures) (last visited Nov. 9, 2008).

209. See, e.g., ALASKA PERMANENT FUND CORPORATION, RESOLUTION OF THE BOARD OF TRUSTEES SETTING OUT INVESTMENT POLICIES RELATING TO PUBLICLY TRADED SECURITIES, RESOLUTION 07-07, 9 (2007) available at http://dev.apfc.org/_amiResolutions/Res_07-07.pdf.

210. John Acher, *Tobacco, Gambling, Sex Face Norway Oil Fund Test*, REUTERS, Jan. 16, 2008, <http://uk.reuters.com/article/oilRpt/idUKL1623708420080116>. Norway has already divested its fund of holdings in companies that make nuclear weapons and cluster bomb components. *Norway's Global Pension Fund Drops 3 Weapon Producers Over Ethics Concerns*, INT'L HERALD TRIB., Jan. 11, 2008, available at <http://www.iht.com/articles/ap/2008/01/11/business/EU-FIN-Norway-Oil-Fund-Ethics.php>.

211. Principles for Responsible Investment, Signatories to the Principles for Responsible Investment, <http://unpri.org/signatories/> (last visited Nov. 9, 2008).

212. Principles for Responsible Investment, About, <http://unpri.org/about/> (last visited Nov. 9, 2008).

213. Principles for Responsible Investment, *supra* note 211.

214. Principles for Responsible Investment, The Principles for Responsible Investment, <http://unpri.org/principles/> (last visited Nov. 9, 2008).

be active owners by creating and exercising shareholder rights in accordance with a disclosed ESG policy.²¹⁵

Given the forces that encourage SWFs to act passively and apolitically, it is unlikely that many SWFs will join Norway as active ESG investors through the UN's PRI or their own ESG criteria (although the number of signatory SWFs may not be significant, at least in the near future). A more likely general trend will be adherence to a corporate governance policy that ultimately emphasizes share value maximization or investment on economic grounds, such as the policy set out in the Santiago Principles.²¹⁶ Of the funds that have disclosed voting policies, Alaska's Permanent Fund has indicated a policy of engagement and support for greater shareholder rights, but the ultimate goal of its policies is "the best financial interest of the Fund,"²¹⁷ rather than a set of social policies.

Existing U.S. regulations already promote the right kind of passivity—a non-controlling minority stake, with the ability of CFIUS to counteract most political activity. Complete passivity, however, is not necessary for the protection of U.S. interests. Further, imposing passivity on SWFs might merely push SWFs to invest in other jurisdictions with lax regulatory standards or political impotence to protect themselves against opportunistic SWF activities. In such jurisdictions, SWFs could operate without the reporting and corporate governance restraints imposed by U.S. law. Certainly, even SWFs in search of benign, diversified investment opportunities will invest in jurisdictions outside the United States. However, legislators and regulators should be wary of any changes that would encourage or accelerate a shift in SWF investments away from the U.S.²¹⁸

215. *Id.*

216. Santiago Principles GAPP.19 states "[t]he SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds. SANTIAGO PRINCIPLES, *supra* note 32, at 22.

217. ALASKA PERMANENT FUND CORP., RESOLUTION OF THE BOARD OF TRUSTEES SETTING OUT INVESTMENT POLICIES RELATING TO EQUITY SECURITIES, RESOLUTION 05-05 (2005), available at http://www.apfc.org/_amiResolutions/Res05_05.pdf.

218. There is some evidence that this is already occurring. See generally Press Release, Monitor Group, Monitor Group Research Reveals Sovereign Wealth Fund Investment Shift from Western Markets to Middle East, North Africa and Asia (October 7, 2008), available at http://www.monitor.com/Portals/0/MonitorContent/documents/Monitor_Q2_SWF_press_release.pdf.

III. INTERNATIONAL STANDARDS FOR SOVEREIGN INVESTMENT

The manner in which SWFs invest in U.S. enterprises suggests that, at present investment levels, there is limited risk that SWFs will use equity investment as a political tool. To the extent that SWFs engage in political investment, it will likely not involve visible investments in highly regulated enterprises or sensitive industries in entities domiciled in jurisdictions that, like the United States, have enacted legislation such as FINSA. Instead, the most significant political investment may concern less monitored, less regulated investments in emerging economies. For example, China has committed funds to many investments in Africa and Asia.²¹⁹ While such investments almost certainly involve financial concerns, there are likely political advantages to such investments. Some investments might provide insurance that certain natural and strategic resources will continue to flow to China exclusively or at preferential prices. Other regional investments may be valuable because they create ties with other sovereigns or regions within another sovereign. However, such investments could pose serious risks to the United States. It is in the best interests of the United States and other host countries to ensure that SWFs will act apolitically and transparently wherever they choose to invest.

A. Individual Country Responses

There are a variety of approaches that other governments have attempted in dealing with sovereign investment. The U.K., for example, has a provision that allows the government to intervene in mergers that affect national security.²²⁰ The German government has redrafted its foreign investment rules to allow for a vetting process

219. MICHAEL F. MARTIN, CRS REPORT FOR CONGRESS: CHINA'S SOVEREIGN WEALTH FUND 9–10 (2008), available at http://assets.opencrs.com/rpts/RL34337_20080122.pdf (detailing investments within China); Sovereign Wealth Fund Inst., *China-Africa Development Fund*, <http://www.swfinstitute.org/fund/cad.php> (last visited Nov. 9, 2008) (describing the Fund's focus on Africa); Sovereign Wealth Fund Institute, *China Investment Corporation*, <http://www.swfinstitute.org/fund/cic.php> (last visited Nov. 9, 2008) (citing CIC investments both within China and in Japan).

220. In response to concerns over SWF investments, U.K. Chancellor Alistair Darling stated:

If it became clear that a company was not acting in a commercial way, or we had reason to believe it was going to make an investment in this country where there were issues of national security, for example, then we have powers under the existing Enterprise Act to take action.

Sumeet Desai, *Darling Says Sovereign Funds Need to Follow Rules*, REUTERS, Oct. 22, 2007, <http://uk.reuters.com/article/fundsNews/idUKNOA22927320071022>.

similar to the CFIUS process.²²¹ Under the legislation, German officials could prohibit transactions in which a stake of twenty five percent or more is acquired if the acquisition could threaten “public security or order.”²²² As with CFIUS, the German legislation arguably protects against external political influence at the expense of potential internal political mischief. Germany is perhaps chiefly concerned with Russian influence. In 2006, Russian state-controlled bank OAO Vneshtorgbank acquired a five percent stake in European Aeronautic Defence & Space Co. (“EADS”), a parent of Airbus. In a move similar to U.S. firms’ responses to SWF investments, EADS informed the bank that despite the relatively large stake, it would not consider allowing the bank a seat on the board, nor would it allow it to influence corporate governance.²²³ Unlike many SWFs, however, the Russian firm was more likely pursuing political goals as well as financial goals, evidenced by a comment from Sergei Prikhodko, an aide to Russian President Vladimir Putin, stating that: “A holding by the state makes sense when we can take decisions or have an influence If we see an economic interest as well, then we will insist on having a stake, thanks to which we would have at least a blocking minority.”²²⁴

France has also expressed concern with SWF investment, with French president Nicolas Sarkozy declaring that: “In the face of the increasing power of extremely aggressive speculative funds and sovereign funds which do not obey economic logic [France is taking] the political and strategic choice to protect its companies, to give them the means to defend and develop themselves.”²²⁵ Australia has developed what appears to be potentially (depending on regulatory application) the most protectionist response to SWFs by reviewing foreign investment through a six factor analysis involving: (1) the investor’s independence from the relevant foreign government; (2)

221. Agence-France Presse, *Germany Moves to Block Sovereign Wealth Funds*, INDUSTRY WK. (Aug. 21, 2008), available at <http://www.industryweek.com/ReadArticle.aspx?ArticleID=17121>.

222. *Id.*

223. Kevin Done, *EADS Chiefs Warn Off Moscow*, FIN. TIMES (London), Sept. 15, 2006, <http://www.ft.com/cms/s/0/6caf981a-4456-11db-8965-0000779e2340.html> (last visited Nov. 9, 2008).

224. *Russia Could Seek Blocking Minority Stake in EADS Eventually—Putin Advisor*, FORBES, Sept. 12, 2006, <http://www.forbes.com/markets/feeds/afx/2006/09/12/afx3010667.html>.

225. Helen Beresford, *Sarkozy to Use CDC to Defend French Cos Against ‘Aggressive’ Speculators*, FORBES.COM, Jan. 8, 2008, <http://www.forbes.com/afxnews/limited/feeds/afx/2008/01/08/afx4505120.html>.

the investor's behavior under the law and "common standards of business behaviour[;]" (3) the impact of the investment on competition; (4) the impact on government revenue and policies, including tax; (5) national security; and (6) whether "an investment may impact on the operations and directions of an Australian business, as well as its contribution to the Australian economy and broader community".²²⁶

In the developing world, Indian Finance Minister P. Chidambaram has expressed concern about foreign investment, declaring that "[i]t is important for developing countries to avoid shocks. . . . Regulation must stay one step ahead of innovation."²²⁷ Under Indian law, foreign investors must be registered with the state securities regulator, SEBI, and are allowed to invest only through participatory notes.²²⁸ New rules impose a limitation on "proprietary notes" investments, and SEBI now exercises tighter control over registration renewals.²²⁹

Thailand is also determined to implement investment restrictions. New regulations require that some foreign investors sell holdings or voting rights exceeding fifty percent of the outstanding stock of Thai companies.²³⁰ The restrictions arose as a result of the sale by former Prime Minister Thaksin to Singaporean SWF Temasek of a majority stake in the Thai telecom company Shin.²³¹ The acquisition "galvanized public protests against Thaksin [majority owner and former prime minister], eventually culminating in the September coup. The military leaders who staged the coup are intent on showing that the Shin sale was illegitimate to justify removing Thaksin."²³² After the negative reaction, however, Temasek was

226. Marc Moncrief, *Swan Gives Foreign Governments a Peek at FIRB Guidelines*, BUS. DAY, Feb. 18, 2008, available at <http://business.theage.com.au/business/swan-gives-foreign-governments-a-peek-at-firb-guidelines-20080217-1snl.html#>.

227. *US Treasury Secretary Paulson Pushes India to Speed Up Opening of Financial Markets*, INT'L HERALD TRIB., Oct. 30, 2007, <http://www.iht.com/articles/ap/2007/10/30/business/AS-FIN-India-US-Paulson.php>.

228. For a background on these regulations, see generally INDIA MINISTRY OF FIN., DEP'T OF ECON. AFFAIRS, REPORT OF THE EXPERT GROUP ON ENCOURAGING FII FLOWS AND CHECKING THE VULNERABILITY OF CAPITAL MARKETS TO SPECULATIVE FLOWS (2005), available at http://finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/Report_EGFII.pdf.

229. Joe Leahy, *Bull Run Is Brought to the Ground*, FIN. TIMES, Oct. 17, 2007, http://us.ft.com/ftgateway/superpage.ft?news_id=fto101720071847208990.

230. Thomas Fuller & Wayne Arnold, *Thailand Threatens Fresh Restrictions on Foreign Investors*, INT'L HERALD TRIB., Jan. 9, 2007, available at <http://www.iht.com/articles/2007/01/09/business/baht.php>.

231. *Id.*

232. *Id.*

determined to avoid sensitive investments. The chairman of Temasek stated that Temasek would avoid investing in “iconic” companies overseas, instead opting for minority stakes in future investments and seeking local partners in acquisitions, such as through joint venture agreements: “We’ve got to take various factors into account, such as whether the company or the activity is iconic for that country, whether it will arouse all kinds of emotional sentiments.”²³³

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

In either case, managing SWF investments requires two steps. First, following the example of the United States, host nations should create clear, enforceable regulations that will protect national security and politically sensitive assets with the goal of providing a clear framework for SWFs undertaking investment in a given country. However, countries will have different standards for investment and acceptable disclosure. Also some countries may not have the political power to prohibit undesirable SWF behavior. Others may lack the political will to prevent SWF investments in their country from being used as political tools against other countries. As a second level of regulation, international agreements or voluntary codes of best practices would provide a common set of rules. While not providing a host nation the ability to enforce its regulations on SWF operations outside its markets, they would nevertheless, fill gaps in individual country regulation. These rules would provide additional certainty for SWFs’ transactions to the benefit of both the sovereign and the host nation.

B. Multilateral Agreements

Multilateral agreements, such as a treaty negotiated through the World Trade Organization (“WTO”), provide an attractive solution to the risks associated with SWF investment. In contrast to a set of voluntary best practices, the multilateral agreement would be enforceable by the country through WTO dispute resolution

233. *Temasek to Avoid Politically Sensitive Investments*, YAHOO! ASIA NEWS, Nov. 23, 2007, <http://asia.news.yahoo.com/071123/3/3be57.html>.

proceedings. The difficulty in setting up a multilateral agreement for SWFs, however, is demonstrated by the number of unsuccessful attempts that have been made in the recent past to develop a multilateral framework for foreign direct investment generally. In 1995, members of the OECD, led by France, engaged in discussions on a possible Multilateral Agreement on Investment (“MAI”).²³⁴ The objective of the MAI was “to provide a broad multilateral framework for international investment with high standards for the liberalisation of investment regimes and investment protection and with effective dispute settlement procedures, open to non-Members.”²³⁵ However, the inability of OECD members to come to terms, combined with increasingly high-profile protests against the MAI, ended discussions by 1998.²³⁶

The World Trade Organization also put a Multilateral Investment Agreement (“MIA”) on the agenda for the Doha round of trade talks²³⁷ but developed and developing countries failed to reach a consensus on the MIA. A particular sticking point was the requirement of transparency for member countries (which was essentially a requirement that developing countries operate transparently).²³⁸ Ultimately, the issue of foreign investment was dropped from the Doha agenda in 2004.²³⁹

Trade talks involving SWFs would also face the same difficulties as multilateral foreign investment agreements. There would first be difficulties in achieving a consensus among countries accepting sovereign investment because the political risks associated with sovereign investment differ by country and by sovereign investor. For example, Germany may be more concerned with investment from Russia than investment by Abu Dhabi. On the other hand, the wide gulf between the interests of developed and developing nations that

234. See generally ORGANISATION FOR ECON. CO-OPERATION AND DEV., NEGOTIATING GROUP ON THE MULTILATERAL AGREEMENT ON INVESTMENT (MAI) (1995), available at <http://www.oecd.org/daf/mai/pdf/dg1/dg1a951e.pdf> (discussing the agenda of the drafting group).

235. Organisation for Econ. Co-Operation and Dev., Multilateral Agreement on Investment, http://www.oecd.org/document/35/0,2340,en_2649_201185_1894819_1_1_1_1,00.html (last visited Nov. 9, 2008).

236. See EDWARD GRAHAM, INT’L INST. OF ECON., FIGHTING THE WRONG ENEMY: ANTIGLOBAL ACTIVISTS AND MULTINATIONAL ENTERPRISES 10–12 (2000).

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

238. *Members Divided Over Transparency, Definition at WTO Investment Talks*, BRIDGES WKLY. TRADE NEWS DIG., Vol. 6, No. 15 (April 23, 2002) at 2.

239. World Trade Organization, Doha Work Programme: Decision Adopted by the General Council on 1 August 2004, WT/L/579 (2004).

proved insurmountable in earlier foreign investment talks may narrow somewhat when it comes to SWFs. Many SWFs are sponsored by sovereigns that accept significant foreign and sovereign investment. As a result, these SWFs might be expected to have an interest in a balanced approach to SWF regulation. Further, there are fewer nations that have SWFs at or near the top of their trade agendas: namely a couple dozen major sovereign investors and the G7 economies. Thus, one might envision a simpler trade process than the Doha trade negotiations.

Wall Street Journal columnist Bob Davis argues for a two-step SWF trade discussion.²⁴⁰ In the first stage, the United States, Europe and Canada would work out common positions on issues such as whether government funds should be limited to minority stakes, whether certain companies, such as defense and media companies should be off-limits to any investment, and whether countries whose funds invest in certain sectors such as financial services should be required to open those same sectors in their domestic markets to foreign investment.²⁴¹ A failure to coordinate, he argues, could result in funds playing “one country against another to attract investment, like auto makers play one state in the United States against another to get a richer package of tax cuts.”²⁴² In the second stage, the SWF sponsor countries would participate in the interest of “maintaining the freest possible access to invest in the world’s richest markets.”²⁴³ If the talks ended in failure, the United States and Europe could unilaterally impose rules.

While a trade agreement may be preferable in the long term because of enforceability, there are disadvantages as well. First, assuming even host nations (or even a smaller group of host nations, as Davis posits) could come to common terms on the content of such an agreement, such a process could take years.²⁴⁴ Finalizing an agreement with sovereign investors would likely be an even longer process. But SWFs are already investing now, and SWFs are rapidly increasing in size. The glacial pace of trade negotiations is ill-suited to deal with the pressing concerns of global capital flows in the near term. Further, some sovereign investors such as China have strongly

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

241. *Id.*

242. *Id.*

243. *Id.*

244. *See id.* (“The funds now have between \$2 trillion and \$3 trillion to invest, a kitty that could reach \$10 trillion within a decade.”).

resisted calls for further regulation of SWFs, essentially threatening to take their capital to other markets if Western nations decide to change the rules.²⁴⁵

Because of these concerns, to date both the United States and the European Union have promoted the adoption of best practices, or codes of conduct, for SWFs. The emphasis thus far has been on *voluntary* self-regulation. The goal is to engage sovereign investors in discussions of appropriate investment objectives and procedures while minimizing the risk that the sovereign investors will simply invest in other markets. Losing SWF investments would multiply concerns for the United States and the EU. Each would have less money funding domiciled firms yet would still be affected by the risk of political activity through investment in other markets. However, because these codes are voluntary, the enforcement leverage for the United States and other host nations is largely political and economic. Countries like Japan, the United States and EU member states that have significant political power and large amounts of two-way cash flows between them and SWF sponsor countries should have the leverage to push codes of best practices. Countries that have less leverage may be the beneficiaries of such efforts, but will be more susceptible to the risks posed by political and mixed-motive use of SWF investment because they lack the political and economic power to “enforce” voluntary codes of conduct. Even the ability of more powerful countries to compel adherence to codes of conduct may erode over time. Thus, voluntary codes of conduct should be understood as a first step that addresses an immediate need, while more comprehensive foreign investment rules should be negotiated through a future round of trade talks, as unpredictable as the outcome of such talks may be.

C. *Voluntary Codes of Conduct*

Ideally, detailed best practices would be created by, or in connection with, sovereign investors. However, host nations are already working toward outlining best practices for SWFs. In the United States, Treasury officials have informally suggested a framework for best practices,²⁴⁶ and on March 19, 2008, the Treasury Department reached an agreement with Abu Dhabi and Singapore

245. See *supra* note 166 and accompanying text.

246. See, e.g., Kimmitt, *supra* note 54, at 4 (suggesting that economic factors should drive SWF investment decisions and that SWFs should operate transparently).

on a set of policy principles based on those best practices.²⁴⁷ More formally, the Commission of the European Communities has recently set out some major governance principles for sovereign investors:

- The clear allocation and separation of responsibilities in the internal governance structure of a SWF;
- The development and issuance of an investment policy that defines the overall objectives of SWF investment;
- The existence of operational autonomy for the entity to achieve its defined objectives;
- Public disclosure of the general principles governing a SWF's relationship with governmental authority;
- The disclosure of the general principles of internal governance that provide assurances of integrity;
- The development and issuance of risk-management policies.²⁴⁸

The G7²⁴⁹ finance ministers also suggested that the International Monetary Fund ("IMF"), the World Bank, and the Organization for Economic Cooperation and Development ("OECD") draft a set of principles that sovereign investors could use in managing their SWFs. Specifically, a draft memorandum of the G7 ministers tasked the IMF, World Bank and OECD with creating best practices "in such areas as institutional structure, risk management, transparency and accountability."²⁵⁰ The result of this mandate is the relatively sparse Santiago Principles, a set of "generally accepted principles and practices" created by a working group comprised of representatives from twenty-six SWF sponsor-nation representatives, working in coordination with IMF officials.²⁵¹ This Article now turns to a

247. Press Release, U.S. Dep't of the Treasury, Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi (Mar. 20, 2008), available at <http://www.treas.gov/press/releases/hp881.htm> (noting that SWF should invest based on economic rather than political factors).

248. *Commission Proposal for a Common European Approach to Sovereign Wealth Funds*, at 9, COM (2008) 115 final (Feb. 27, 2008), available at http://ec.europa.eu/commission_barroso/president/pdf/COM2008_115_en.pdf.

249. The G7, or Group of Seven, refers to the United States, Japan, Germany, France, United Kingdom, Italy, and Canada (in this context, the finance ministers of these countries).

250. *G7 Warns of Risks from U.S. Housing Slump*, MARKET WATCH, Feb. 9, 2008, <http://www.marketwatch.com/news/story/g7-warns-global-risk-us/story.aspx?guid={03829F31-7840-464C-992A-D5FDE6407532}> (quoting Communiqué, Group of Seven Finance Chiefs, Feb. 9, 2008).

251. SANTIAGO PRINCIPLES, *supra* note 32, at 1.

discussion of whether the Santiago Principles address or mitigate the major concerns in these four areas.

1. Structure

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

Sometimes—and especially with commodity exporting economies—authorities find themselves faced with unexpected windfall revenues that come from a positive terms-of-trade shock. They often respond by ringfencing and accumulating at least part of these proceeds offshore—mainly for sterilization purposes, but also to smooth out potential volatility in budget revenues. Very soon, what started out as a deposit at the central bank or a special purpose account at the Treasury often gets redesigned into a separate fund structure, with its own identity, system of governance and set of rules. Then, as assets in the fund continue to grow beyond the original narrowly defined purpose, authorities may take a step back and revisit the broader objectives, design, and structure of the fund. Often, this could lead to some sort of a split into a liquidity tranche and a longer-term investment tranche.²⁵²

The report further argues that creating appropriate structures for SWFs should begin with the definition of liabilities of the fund.²⁵³ Most traditional funds begin with a definition of the liabilities of the funds, and then work towards a structure appropriate to the funds.²⁵⁴ Many SWFs operate with similar objectives to many of these traditional funds, and so could adopt similar structures. Consider the structure of pension funds. Pension funds are generally managed by professional fund managers, and are ultimately governed by a board of directors. Board members may be selected by existing board members or, in the case of a governmental fund such as a retirement

252. ROZANOV, *supra* note 29, at 1.

253. *Id.* at 3.

254. *Id.* at 1.

fund for government employees, may be political appointees.²⁵⁵ In this structure, there are two layers of fiduciary responsibility.²⁵⁶ First, the professional investment advisers are fiduciaries with respect to the plan. Second, the board members are also fiduciaries with respect to the beneficiaries of the fund. The principal difference between SWFs and pension funds (as well as all of the other types of investment funds—mutual funds, hedge funds, and private equity funds) is the protection of fiduciary duties with the latter and in many cases the absence of fiduciary duties with the former.²⁵⁷ In the case of pension and other traditional investment funds, the fiduciary concept (enforced by the sovereign) provides a check against imprudent or political behavior; no such rules bind SWF activities.

Some of the benefits of a traditional fund structure may be achieved by hiring outside fund managers.²⁵⁸ Currently, many of these funds are hiring outside help as a signal of investment intent. By making investments through outside money managers, the SWFs and their sovereign sponsors are more removed from the investment decision and companies are somewhat better protected from being used as political vehicles. Professional SWF managers may see their role as akin to that of a pension fund manager, with political appointees on the supervising board.

There are limits to the benefits of structure alone, however. For example, although professional managers could be considered fiduciaries to the fund and to the sovereign beneficiary, the sovereign is managing the fund for its own purposes. The sovereign cannot practically be considered as owing an actionable fiduciary duty to its citizens unless the sovereign determines to bind itself. Further, the relationship between the managers and the sovereign is not identical to the traditional relationship between investment advisers and a

255. See, e.g., Neil Weinberg, *Sanctimonious in Sacramento*, FORBES, May 10, 2004, http://www.forbes.com/forbes/2004/0510/052_print.html (discussing the California Public Employees' Retirement System pension fund board's mix of "politicians, political appointees and union reps").

256. Employee Retirement Income Security Act (ERISA) § 405(c)(3), 29 U.S.C. § 1104(a) (2000).

257. See Investment Advisors Act of 1940 § 206, 15 U.S.C. § 80b-6 (2006). See generally TAMAR FRANKEL, *THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS* (rev. ed. 2004) (describing SEC and other regulations pertaining to money managers). While there may be similar fiduciary duties between a sovereign and a professional money manager, there is not a fiduciary duty between the sovereign and the ultimate purported beneficiary of the fund—the citizens of the sovereign.

258. See ROZANOV, *supra* note 29, at 1 (indicating that external managers play a major role from the beginning of a traditional fund's lifecycle while SWFs typically do not hire external managers until much later).

fund. The nature of the relationship is not that of a powerful bank and an individual investor with neither the time nor investment skill to manage her retirement funds effectively. While fiduciary regulations and patterns of practice govern a traditional adviser/advisee relationship, many of the rules and patterns are inapposite to advisers of SWFs. A pension fund's adviser-fiduciary will invest according to a "prudent man" standard,²⁵⁹ which provides predictability to the fund's governors, the fund's beneficiaries, and to the market as a whole. On the other hand, a SWF adviser may, under pressure from a host country, set up a structure that imposes similar "prudent man" requirements. In this instance, however there is no enforcement mechanism that insures that the adviser will invest prudently when the sovereign no longer wishes it to do so for political reasons. Further, unlike most other funds, SWF's sovereign beneficiary may decide to step in and change the fund's course despite the fund manager's expectations and investment trajectory. For example, China's CIC was thought to have moved to a more conservative investment track after its high-profile purchase of a major stake in private equity firm Blackstone.²⁶⁰ Indeed, Lou Jiwei, the fund's manager, chairman, stated publicly on November 29, 2007 that the fund would invest primarily in index products,²⁶¹ and that investments in banks (like the investments by petrodollar SWFs) were probably a year away.²⁶² Yet, less than a month later, the fund invested \$5 billion in Morgan Stanley, in a move that was characterized by the press as "an abrupt shift in strategy for the \$200 billion fund that underlines the extent to which the government fund appears to be under the direct control of China's leaders."²⁶³ Reports

259. Employee Retirement Income Security Act (ERISA) § 404(a).

260. Rick Carew, *China's Sovereign Wealth Fund Forges Strategy, Hunts for Staff*, WALL ST. J., Nov. 20, 2007, at A14 (noting that CIC's managers suggested such a conservative investment strategy would follow the "initial bold stroke" of the Blackstone purchase). Carew also argued that the decision of China's social security fund to hire ten fund managers to control one billion dollars in overseas funds pointed toward this new conservative strategy. *Id.*

261. Keith Bradsher, *Morgan Investment Marks Shift for China Fund*, DEALBOOK, Dec. 19, 2007, <http://dealbook.blogs.nytimes.com/2007/12/19/morgan-investment-marks-shift-for-china-fund/>.

262. Jamil Anderlini, *China Fund Looks to Mideast as Model*, FIN. TIMES (London), Nov. 29, 2007, at 1, available at <http://www.ft.com/cms/s/0/ae7ec63c-9ead-11dc-b4e4-0000779fd2ac.html>.

263. Bradsher, *supra* note 261.

indicate that the fund's management was surprised by the government's investment decision.²⁶⁴

The Santiago Principles do not suggest a structure for SWFs, nor suggest that SWFs must use external money managers. Instead, GAPP 6 states that "[t]he governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence,"²⁶⁵ and GAPP subprinciple 18.2 states that "[t]he investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored."²⁶⁶ Further, GAPP 14 of the Santiago Principles also calls on SWFs to deal with third parties such as "commercial fund managers and custodians, or external service providers"²⁶⁷ on "economic and financial grounds," and to "follow clear rules and procedures."²⁶⁸

The Santiago Principles contain little governance guidance for SWFs, instead functioning as perhaps only a signaling device that the SWFs of the sponsor-nation drafters will be "structured so that [they are] able to exercise effective, independent, and objective judgment in respect of its responsibilities,"²⁶⁹ and will "establish a clear policy of a minimum standard of competency for governing body members."²⁷⁰ While the Santiago Principles may seem weak with respect to fund governance principles, governance structures should be viewed as means rather than ends. Setting out specific one-size-fits-all governance structures for funds, given the variations in size, objectives and roles of SWFs, could be counterproductive because it could create an overreliance on form.

Structure provides assurance in form but not necessarily function. Traditional fund structure is designed in relation to a set of regulations applicable in the market or markets in which the fund operates and to a lesser extent, practice principles in the shadow of such regulations.²⁷¹ When such regulations no longer apply, the

264. A "person familiar with the fund's activities said that the decision had been sudden and little expected by the fund's staff." *Id.*

265. SANTIAGO PRINCIPLES, *supra* note 32, at 7, 15.

266. *Id.* at 8 (quoting GAPP subprinciple 18.2).

267. *Id.* at 19 (citing GAPP principle 14's explanation and commentary).

268. *Id.*

269. *Id.* at 16.

270. *Id.*

271. See ROZANOV, *supra* note 29, at 1.

structure no longer provides any guarantees. As a result, SWF structure is less relevant than regulations designed to directly address undesirable SWF activity for purposes of mitigating risk to capital markets.²⁷² However, disclosure of structures and management, as provided in the Santiago Principles, should at a minimum assist regulators in their monitoring functions by clarifying lines and scope of authority within the SWF.

2. Risk Management

There are two general types of economic risk that arise as sovereigns become more active in capital markets. The first is the systemic risk created by the influx of capital caused by large SWF investments. If trillions in trade-imbalance revenues are converted back into equity investments, undoubtedly some of these funds will not be allocated to their best use. Thus far, SWFs' U.S. investments have been in large companies in liquid trading markets. Likewise, traditional funds are also investing in these same companies because in some cases the fund is tied to an index or, more typically, because the fund prefers to acquire more liquid assets because they will be able to more easily adjust their positions. Will increased investment activities by SWFs, combined with existing institutional investor preferences, raise asset prices to unsustainable levels?²⁷³

The second type of risk concerns SWF and sovereign-specific risks. Examples include unhedged currency risks and the risk that a sovereign would drain the SWF because of an economic or political exigency. Some of the SWF-specific risks are no different than the sorts of risks encountered and managed by other types of funds. Again, we would expect an appropriately managed SWF to mitigate many of these risks. However, even if many, if not all, the SWF-specific risks (such as currency risks) are hedged, some *sovereign-specific* risks may not be hedged. Instead, the SWF is, in fact, the sovereign's hedge against such risks.²⁷⁴

SWF and sovereign-specific risks create risks to other investors in the marketplace. How would companies and markets weather the

272. There are many reasons, such as a reduction in agency costs, why a robust governance structure is desirable. However, in this Article, I am primarily concerned with the effect of SWFs in the capital markets rather than the proper form of SWF governance.

273. See FARRELL ET AL., *supra* note 43, at 60 (cautioning that although SWF investments have contributed to the global market, risk reassessments associated with SWFs could adversely affect the economy).

274. See generally ROZANOV, *supra* note 29 (discussing the use of "stabilization" funds to protect against the sovereign's macroeconomic risks).

shock of a quick exit (which may or may not be politically motivated) by a sovereign entity? A sovereign may need to pull its cash out of investments for a variety of reasons (currency support, war, expanded social programs, etc.) that may not be relevant to an institutional investor in a foreign domicile.

The Santiago Principles are limited in their ability to respond to all of the risks associated with SWF investment in public markets, although they mitigate some of these risks. The Santiago Principles address market risks created by SWFs in GAPP 4, which states that “[t]here should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWFs general approach to funding, withdrawal, and spending operations on behalf of the government.”²⁷⁵ GAPP 3 also states that “[w]here the SWF’s activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.”²⁷⁶ Internal risk management of the SWF is covered under GAPP 22, which state that “[t]he SWF should have a framework that identifies, assesses, and manages the risks of its operations.”²⁷⁷ The rules are designed to increase predictability, but will likely not provide much assurance to other market participants because SWFs by their nature create risks that private investors do not. Linkage to the government (as called for in GAPP 3) is in this respect a potential risk to the market. For example, would SWFs, as part of a coordinated government policy, quickly remove funds from U.S. investments in order to respond to a domestic credit crisis?

3. Transparency

A number of commentators and politicians have expressed concerns with the lack of transparency of SWFs.²⁷⁸ “Transparency” for SWFs is generally understood to mean detailed disclosure of such things as investment purpose, results, and holdings. On this measurement, in Chairman Cox’s opinion, “the track record to date

275. SANTIAGO PRINCIPLES, *supra* note 32, at 7, 13.

276. *Id.*

277. *Id.* at 9, 23.

278. See, e.g., Steven R. Weisman, ‘Sovereign Funds’ Stir Growing Unease, INT’L HERALD TRIB., Aug. 21, 2007, at 4 (noting that members of the Bush administration, including Treasury Secretary Henry Paulson, Jr., and German’s Chancellor Angela Merkel, have expressed concern about the effects of SWFs).

of most sovereign wealth funds does not inspire confidence.”²⁷⁹ On the other hand, SWF managers have expressed concern with Western notions of transparency. Bader Al-Sa’ad, manager of Kuwait’s \$200 billion SWF, the Kuwait Investment Authority, says that: “We are concerned about what they mean when they call for transparency. Do we have to announce every investment before we make it?”²⁸⁰ A similar concern was expressed by Lou Jiwei, manager of China’s CIC: “We will increase transparency without harming the commercial interests of CIC. That is to say it will be a gradual process. Transparency is really a tough issue. If we are transparent on everything, the wolves will eat us up.”²⁸¹ On the other hand, the failure to operate transparently will continue to draw the attention of regulators and encourage protectionist responses from host countries. Because China has political and economic power that dwarfs most other SWF countries,²⁸² encouraging China to operate transparently is a primary concern for host countries. A sympathetic organization, the Asian Development Bank (“ADB”), has also encouraged China and other Asian SWFs to “free themselves of government interference and become more transparent,”²⁸³ reasoning that “it may be in countries’ self-interest to voluntarily take steps that address legitimate fears and reduce the risk of being singled out for special treatment.”²⁸⁴

Much of the resistance to the transparency demanded by Western host nations may be explained by its association with Western political systems. Levels of transparency appear to correlate with political traditions of the sovereign. The transparency offered by Norway’s SWF, for example, seems to flow from a commitment to transparency as a social and political value rather than a desire to

279. Cox, *supra* note 62.

280. Henry Sender, *KIA Chief Focuses on Long-term Opportunities*, FIN. TIMES, Jan. 2, 2008, at 20.

281. Martin Arnold, *China Fund Chief Warns on National Security*, FIN. TIMES, Dec. 11, 2007, at 4.

282. The CIA WORLD FACTBOOK notes, for instance, that China now has the second largest economy in the world on a purchasing power parity basis. CIA, THE WORLD FACTBOOK 2007, at 125, available at <https://www.cia.gov/library/publications/the-world-factbook/geos/ch.html>.

283. Raphael Minder, *ADB Calls for Transparency of Asia Funds*, FIN. TIMES, Nov. 26, 2007, at 1, available at http://www.ft.com/cms/s/0/a818b6d8-9c67-11dc-bcd8-0000779fd2ac.html?nclink_check=1.

284. *Id.* (quoting Donghyun Park, *Beyond Liquidity: New Uses for Developing Asia’s Foreign Exchange Reserves* 34 (Asian Devt. Bank, Econ. and Research Dep’t, Working Paper No. 109, 2007)), available at http://www.adb.org/Documents/ERD/Working_Papers/WP109.pdf.

avoid further regulation by host nations. In the investment of funds for the benefit of citizens, such as state pension plans, representative-democracies typically have a tradition of regulating themselves as fiduciaries to their citizens. U.S. government-run pension plans, for example, provide disclosures similar to private fiduciaries, in contrast to, for example, China, which does not require such disclosures.²⁸⁵ When a country does not have a tradition of transparency in its political governance, calls for transparency are likely to meet with strong resistance.²⁸⁶ The concept of fiduciary-type disclosure, which appears to be the expectation attached to transparency,²⁸⁷ may be a concept that for many sovereigns seems bound up with representative-democratic political systems.

Concerns with transparency may be compounded when SWFs invest in asset managers that are themselves not transparent. Where hedge funds and public equity firms are not required under current regulations to disclose information about their major investors, other investors will not be able to evaluate the activities of SWFs. If SWFs begin to exploit hedge funds as investment vehicles, then the justifications for a laissez-faire attitude with respect to hedge fund activity may need to be reevaluated. Perhaps more benignly, some also see investment in asset managers as a means to acquire intellectual capital that will help SWFs become even more sophisticated investors.²⁸⁸

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

- A quarterly reports on its activities;
- The size of the fund;
- Information on the returns it earns;
- Information on the types of investments—for example, in what sectors and in what instruments;
- Information on the geographic location of investments;

285. Stuart Leckie & Ning Pan, Editorial, *China's Emerging Pensions Giant*, WALL ST. J. (ASIA), Dec. 5, 2006, available at <http://online.wsj.com/article/SB116527186916840408.html?mod=djemasiainlinks>.

286. See ORGANISATION FOR ECON. CO-OPERATION AND DEV., *supra* note 234, at 13, 147 (discussing resistance to the transparency provisions of the MAI).

287. See Sender, *supra* note 280.

288. See *Managers Run 44% of Sovereign Wealth Assets*, PENSIONS & INV., March 7, 2008, <http://www.pionline.com/apps/pbcs.dll/article?AID=/20080307/DAILY/762550071>.

- Information on the specific investments—in which instruments, countries, and companies;
- Information on the currency composition of investments;
- Identity of holders of investment mandates, e.g., investment advisers;
- Whether the SWF is subjected to a regular audit;
- Whether the audit is published; and
- Whether the audit is independent.²⁸⁹

Another model of adequate disclosure provided by a UK consulting firm offers a comply-or-explain set of transparency guidelines for private equity firms.²⁹⁰ The firm has further encouraged sovereign wealth funds to sign.²⁹¹ The guidelines offer standards for both SWFs and for companies that compose the SWFs portfolio. SWFs are encouraged to provide a discussion of their histories, management, investment approaches and strategic changes, and to disclose investments, returns, valuation procedures, holding periods, and case studies of investment activities. SWFs are also encouraged to insure compliance of portfolio companies with applicable regulations.²⁹² Among other things, portfolio companies are encouraged to identify controlling ownership, including individuals.²⁹³

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

- Annual disclosure of investment positions and asset allocation, in particular for investments for which there is majority ownership;
- Exercise of ownership rights;
- Disclosure of the use of leverage and of the currency composition;

289. EDWIN M. TRUMAN, PETERSON INST. FOR INT'L ECON., *THE MANAGEMENT OF CHINA'S INTERNATIONAL RESERVES: CHINA AND A SWF SCOREBOARD* 24–26, (2007), available at www.petersoninstitute.org/publications/papers/truman1007.pdf.

290. DAVID WALKER, *GUIDELINES FOR DISCLOSURE AND TRANSPARENCY IN PRIVATE EQUITY* 24 (2007), available at http://www.altassets.com/pdfs/wwg_report_final.pdf.

291. Siobhan Kennedy, *Call to Bring Sovereign Wealth Funds and Entrepreneurs Under Private Equity Code*, THE TIMES (UK), Nov. 20, 2007, at 51, available at <http://business.timesonline.co.uk/tol/business/money/funds/article2903698.ece>.

292. See WALKER, *supra* note 290, at 41 (noting that achievement of high standards of conduct supports private equity as a whole).

293. See *id.*

- Size and source of an entity's resources;
- Disclosure of the home country regulation and oversight governing the SWF.²⁹⁴

As discussed above, disclosures that meet many of these guidelines currently apply to shareholders with greater than a five percent stake in U.S. reporting companies under section 13 of the Exchange Act,²⁹⁵ but not all countries have similar guidelines. Most SWF investments will fall under this threshold. Such disclosures assist in enforcement by monitoring agencies such as CFIUS and the SEC, but are also valuable to other investors (including other SWFs) who are concerned with whether and how SWF investment may affect the company.

The Santiago Principles call for increased transparency through basic disclosures, such as “[a]n annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.”²⁹⁶ The Santiago Principles also call for audits in accordance with “recognized international or national auditing standards.”²⁹⁷ However, the Santiago Principles also fall well short of the disclosures offered by very transparent SWFs such as Norway's. For example, the Santiago Principles call for disclosure of generally asset allocation, but do not call for SWFs to disclose their individual investment positions.

Another important aspect of transparency for SWFs is investment policy. The Santiago Principles repeatedly call for SWFs to disclose investment policy in an effort to provide assurance that they are investing for economic and financial reasons.²⁹⁸ However, the Santiago Principles again fall short of providing the assurance they should by not condemning non-commercial investment. Instead, the Santiago Principles state that “[i]f investment decisions are subject to other than economic and financial considerations, these

294. *Commission Proposal for a Common European Approach to Sovereign Wealth Funds*, *supra* note 248, at 11.

295. See 17 C.F.R. § 240.13d-101 (2008) (requiring the filing of a Schedule 13D). These are also known as beneficial ownership reports; U.S. Sec. & Exch. Comm'n, Schedule 13D, <http://www.sec.gov/answers/sched13.htm> (last visited Nov. 9, 2008).

296. SANTIAGO PRINCIPLES, *supra* note 32, at 8, 17 (citing GAPP principle 11).

297. *Id.* at 8, 18 (citing GAPP principle 12).

298. *Id.* at 8 (referencing GAPP sub-principles 18.3 and 19.1).

should be clearly set out in the investment policy and be publicly disclosed.”²⁹⁹

4. Accountability

To paraphrase Justice Frankfurter, to say that SWFs must be “accountable” only begins the analysis.³⁰⁰ To whom is the SWF accountable? What obligations does the SWF owe as a result, and what are the consequences if the SWF deviates from these obligations?

The SWF is not accountable in the same way as most other large funds. Unlike funds managed by most institutional investors, which are regulated under the Investment Advisers Act of 1940,³⁰¹ SWFs do not owe fiduciary duties to identifiable beneficiaries. In some cases, depending on the goals of the fund, it is not clear who such beneficiaries would be—perhaps all citizens of Country X, or certain citizens such as pensioners? In any event there is likely no legal framework within the sovereign with which to hold SWFs accountable as fiduciaries even if beneficiaries were identified. Accountability is thus primarily political, rather than flowing from fiduciary duties.

Accountability and transparency are closely related, since transparency is a prerequisite to accountability. If the fund operates transparently, it becomes more difficult for a SWF manager to avoid questions about whether to invest in companies that pollute, produce dangerous and controversial products or services, or do business with pariah nations (assuming the citizens are, as Norway’s, concerned with such issues).³⁰²

The Santiago Principles address accountability issues in several places. With respect to host-country enforcement issues, GAPP 15 states that “SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure

299. *Id.* at 8, 22.

300. In a frequently-quoted passage, Justice Frankfurter stated,

To say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?

SEC v. *Chenery Corp.*, 318 U. S. 80, 85–86 (1943).

301. 15 U.S.C. § 80b-6 (2006).

302. See Acher, *supra* note 210 (recognizing that Norwegian citizens are concerned with such issues).

requirements of the countries in which they operate,”³⁰³ and GAPP 20 states that “[t]he SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.”³⁰⁴ Internal accountability is addressed in GAPP 10, which states that SWF should create an accountability framework in “relevant legislation, charter, other constitutive documents, or management agreement.”³⁰⁵ Yet, the fact that many SWFs are products of regimes that are not democratic begs the question of whether internal political accountability exists for the mismanagement of many SWFs.

On the other hand, SWFs and their sovereign owners are subject to potential external political accountability in the same sense that a sovereign is politically accountable for other types of activities implicating foreign sovereign entities. However, a major difference between SWF activity and other types of economic activity among sovereigns, such as tariff disputes, is that there are international dispute resolution procedures to manage disagreement among sovereigns over these other economic activities. Unfair trade practices are regulated through procedures set out in the World Trade Organization agreements³⁰⁶ which were negotiated among nations and ratified by the countries’ respective legislative bodies. By contrast, the issues raised by sovereign wealth fund investment are dealt with by each country either through its own legislation or through a variety of regulatory schemes. Thus, to help avoid the possibility of political dispute resulting from SWF investment, sovereign sponsors and host countries should begin to address dispute resolution procedures for sovereign investment. Also, as noted above, many host nations may not be able to protect themselves without such a mechanism. Even for developed economies, like the United States, that may possess the political and economic clout to punish another sovereign for the political use of a SWF, hasty political retribution is unlikely to produce an optimal political or economic outcome. Further, the economic and political power on which such retribution depends becomes increasingly fragile as SWFs gain more economic power through our capital markets. Economic

303. SANTIAGO PRINCIPLES, *supra* note 32, at 8, 19.

304. *Id.* at 8, 22.

305. *Id.* at 8, 17.

306. See Agreement Establishing the World Trade Organization, Apr. 15, 1994, 33 I.L.M. 1144 (1994), available at http://www.wto.org/english/docs_e/legal_e/04-wto.pdf (establishing the WTO’s structure and relations among its members).

power correlates with political power,³⁰⁷ and the political checks on SWFs become weaker as SWFs become more prominent financial patrons of U.S. enterprise. A handful of investments of valued at several billion dollars may be easily moderated within capital markets valued at nearly \$22 trillion.³⁰⁸ But trillions of dollars of SWF investments, even if representing widely dispersed, minority positions, would strain the ability of CFIUS and other regulators to monitor SWF activity.

CONCLUSION

This Article argues for a holistic approach in considering the appropriate regulation of SWFs. While this Article argues that SWFs will be limited in their ability to act politically through their equity investments in U.S. markets, this analysis does not suggest that SWFs are beyond suspicion. The more limited argument presented here is that a variety of regulatory, economic, and political factors provide assurance that equity investment in U.S. firms is not an ideal or even likely political tool. However, SWFs may invest in less-regulated equity markets, and equity investments are only one of many form of investment available to SWFs. Other types of strategic investment, such as the purchase of vital commodity producers or reserves, have the ability to affect U.S. security interests more drastically than SWF activity in the United States. While the U.S. may be able to protect its interests against such activity, its ability to protect its interests should be enhanced by the voluntary adoption of the Santiago Principles (and those dealing with transparency, in particular) by SWFs. The Santiago Principles also provide some protection against risks to the U.S. though SWF investment in other countries, although the Santiago Principles remain deficient in a number of respects.

This Article does not address the larger problem that gave rise to SWFs—the massive trade imbalance between the U.S. and most of the SWF-sponsor countries. As Warren Buffett memorably noted in

307. See PAUL KENNEDY, *THE RISE AND FALL OF THE GREAT POWERS: ECONOMIC CHANGE AND MILITARY CONFLICT FROM 1500 TO 2000*, at xxii (1987).

308. FED. RESERVE, *FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES: FLOWS AND OUTSTANDINGS, FOURTH QUARTER 2007*, at 90 (2008), available at <http://www.federalreserve.gov/releases/z1/20080306/z1.pdf> (citing statistics on corporate equity issuances at market value in 2007).

his 2004 letter to Berkshire Hathaway shareholders,³⁰⁹ writing on the U.S.'s current account deficit,

[a]s time passes, and as claims against us grow, we own less and less of what we produce. In effect, the rest of the world enjoys an ever-growing royalty on American output. Here, we are like a family that consistently overspends its income. As time passes, the family finds that it is working more and more for the "finance company" and less for itself. . . . This annual royalty paid the world – which would not disappear unless the U.S. massively underconsumed and began to run consistent and large trade surpluses – would undoubtedly produce significant political unrest in the U.S. Americans would still be living very well, indeed better than now because of the growth in our economy. But they would chafe at the idea of perpetually paying tribute to their creditors and owners abroad. A country that is now aspiring to an "Ownership Society" will not find happiness in – and I'll use hyperbole here for emphasis – a "Sharecropper's Society." But that's precisely where our trade policies, supported by Republicans and Democrats alike, are taking us.³¹⁰

While leaving to others the subject of the growing current account deficit, our current ability to regulate the negative effects of SWF investments, without any further international effort, perhaps only buys us time to address the factors that created SWFs. Continued attention to and research on the effects of SWFs is essential, particularly on their proxy voting behavior and quality of disclosures. SWF investment must be viewed as part of a larger discussion of the political consequences of capital flows. In particular, China's SWF activity is one of many complex policy issues that should be addressed within a larger, comprehensive discussion of U.S.-China economic relations.

This Article also does not address many of the effects of the rise of state capitalism, except as they relate to equity investment in the United States. The analysis in this Article implies that state capitalists will likely be forced to play by the rules of market capitalism if they choose to invest in Western markets. However, with the increase in the number of SWFs, with countries such as India and Japan also indicating that they may create SWFs, and with the

309. Letter from Warren E. Buffett, Chairman of the Board, Berkshire Hathaway Inc., to Shareholders of Berkshire Hathaway Inc. 20 (Feb. 28, 2005), *available at* <http://www.berkshirehathaway.com/letters/2004ltr.pdf>.

310. *Id.*

not-quite-dead possibility that U.S. social security funds may be invested in equity markets,³¹¹ we may yet see the day when SWFs are viewed not merely as commercial tools, but also as economic and political tools used by all sovereigns in the normal course of international affairs.

311. See On The Issues, Barack Obama on Social Security, http://www.ontheissues.org/2008/Barack_Obama_Social_Security.htm (last visited Nov. 9, 2008) (noting that Barack Obama rejects calls for the privatization of social security).

