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# TURMOIL IN U.S. CREDIT MARKETS: EXAMINING THE U.S. REGULATORY FRAMEWORK FOR ASSESSING SOVEREIGN INVESTMENTS

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE U.S. REGULATORY FRAMEWORK FOR ASSESSING SOVEREIGN INVESTMENTS

THURSDAY, APRIL 24, 2008

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# TURMOIL IN U.S. CREDIT MARKETS: EXAMINING THE U.S. REGULATORY FRAMEWORK FOR ASSESSING SOVEREIGN INVESTMENTS

**THURSDAY, APRIL 24, 2008**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10:12 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

## OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. Good morning.

Let me first of all apologize to people, the witnesses and others. We had a hearing ongoing four floors down on the Food and Drug Administration, which I sit on that Committee as well, a hearing about food safety this morning as well. So we are trying to juggle the responsibilities of food safety and the responsibilities of the Committee. So I apologize to my colleagues and to the witnesses for being a few minutes late.

What I would like to do is open up with a few opening comments on the subject matter of today's hearing, and then I will turn to my colleagues for any opening comments they may want to make, particularly Senator Shelby. And then we will hear from our witnesses, and we thank you for being with us.

Today's hearing marks the sixth in a series of hearings examining the ongoing turmoil in U.S. credit markets. Today we are going to focus on a source of capital that has helped some of the largest U.S. financial institutions weather the storm in the credit markets: foreign government-controlled entities known as sovereign wealth funds. This is the second time the Committee has examined these funds. Last year, Senator Evan Bayh of Indiana, a member of this Committee, chaired a very good hearing on this subject, and we appreciate his work in this area.

U.S. financial companies have raised over $60 billion in new equity from both foreign and domestic sources since the credit crunch began in July of 2007. Of that amount, approximately $39 billion, or nearly two-thirds, was supplied by sovereign wealth funds. Ninety-three percent of those bank capital infusions came from sovereign funds in just four countries: the United Arab Emirates, Kuwait, Singapore, and China.

Foreign government investments in our country are not new, of course; however, many analysts project tremendous growth in this area. The International Monetary Fund estimates that more than 20 sovereign wealth funds, largely financed by petro dollars and excess foreign exchange reserves, currently manage $1.9 to $2.9 trillion globally. These funds, while less than the amount of the assets managed by pension funds worldwide, are up to twice the amount of assets managed by hedge funds and up to three times the amount managed by private equity funds.

That amount is growing, by the way, and growing very quickly. Sovereign wealth fund assets are expected to grow to $12 trillion by the year 2012. With that kind of rapidly growing financial muscle, the operations of sovereign wealth funds in U.S. markets have raised questions generally about how they are run, by whom, and for what purpose. Additional questions have been raised about the impact of sovereign wealth funds on the safety and soundness of the U.S. financial system and the security of critical U.S. industries.

I believe, firstly, that the United States can and must continue to maintain an open investment climate while still protecting our economic and national security interests. However, maintaining that vital delicate balance between openness and security will require continued vigilance, including, of course, vigilance by this very Committee.

It was with that balance in mind that Senator Shelby and I authored the Foreign Investment National Security Act, which was signed into law last July. On Monday, the Treasury Department issued proposed rules to implement this law. In my view, these rules are consistent with our legislation's purpose and a very important step forward, and I commend the Department. These rules will not only protect our national security; they will also hopefully bring greater predictability to the investment process. But it is important to note that CFIUS is only one tool available to address concerns about certain investments in the United States.

The United States regulates the activities of and collects data on sovereign investments through a host of statutes. U.S. banking securities, Government contracting, and other laws regulate the activities of both foreign and domestic investors. Federal officials are responsible for implementing those laws, including officials at the Federal Reserve Board, the Securities and Exchange Commission, the Treasury Department, the Commerce Department, and the Defense Department, among others.

The purpose of today's hearing is to better understand how well these laws are working to protect U.S. markets and companies while at the same time allowing foreign investment to continue. For example, the SEC requires sovereign funds and other investors with ownership stakes exceeding 5 percent in a public company to file disclosure statements. Hearings held by this Committee in 1975 indicate that this requirement is directed at foreign investors in order to improve the ability of the Federal Government to monitor foreign investment in the United States. The anti-fraud provisions of the Exchange Act, which prohibit market manipulation and other frauds, also apply to sovereign funds.

Like any laws or regulations, the effectiveness of these rules depends on the extent to which they are, of course, enforced. And here another unique challenge is posed by the sovereign wealth funds. SEC Chairman Cox has said it well, and I quote him: "If the same government from whom we sought enforcement assistance were also the controlling person behind the entity under investigation, a considerable conflict of interest would arise. Another issue is the conflicts of interest that arise when government is both the regulator and the regulated."

I am eager to learn about how the SEC is addressing these and other enforcement concerns. It is imperative, in my view, that this Committee know whether existing securities requirements are adequate for the purpose of securing the health and stability of our Nation's markets in the face of increasing investment from foreign sovereign entities.

Similarly, it is also important to examine the adequacy of the authority available to the Federal Reserve Board to maintain the safety and soundness of our Nation's financial system when sovereigns invest billions of dollars into our financial institutions. How does the Fed determine whether a review of an investment in a financial institution is necessary? Given the size and anticipated increase of sovereign investment in U.S. financial markets, do they pose any systemic risks for our country? And how does the Fed assess those risks if, in fact, they exist?

Fundamentally, the Committee and the American public I believe must know with certainty that sovereign wealth funds conduct themselves according to the same standards to which other economic actors are held: transparency, sound governance, commercial purpose, and market integrity. These are critical issues for our economy, and they are being raised at a critical moment, of course, in our Nation's economic life. We cannot afford as a Nation to upset that vital balance that I mentioned earlier between openness and security. If we do, the consequences for our Nation I think will be dire.

So I appreciate the willingness of our witnesses to join us this morning. We all look forward to hearing the thoughts and advice they have on the subjects I have raised in this opening statement on an issue that will be the subject of continued observation and concern to this Committee for many years to come. But it is important we get our arms around it, understand it well, and think carefully and thoughtfully about it.

Now let me turn to Senator Shelby.

**STATEMENT OF SENATOR RICHARD C. SHELBY**

Senator SHELBY. Thank you, Mr. Chairman.

I strongly support this Committee's continuing examination of the economic and security issues surrounding the investment activities of sovereign wealth funds. There are many U.S. statutes and regulations, which Senator Dodd mentioned, which govern foreign investments in American companies, including laws pertaining to investments by individuals, private or publicly trade corporations, state-owned enterprises, and sovereign wealth funds.

While an examination of the law is important, we should also be mindful of how the legal structure interacts with market forces

which ultimately influence our economic growth and, on occasion, our Nation's security.

Notwithstanding our recent economic difficulties, the United States remains a very attractive and accessible market. This may explain in part why we are the largest recipient of foreign investment in the world. Not only are sovereign wealth funds increasing the size of the investments, but they continue to broaden their field of interest in American companies. As sovereign funds acquire stakes in a wider variety of economic sectors, I believe we need to ensure that our national security is not compromised by our openness. I believe the recent regulations written by the Treasury Department implementing the revised CFIUS statute will help add clarity and certainty to the process.

I look forward today to a discussion of how we regulate foreign investments. In particular, I am interested in hearing which statutes and regulations pertain to various types of investments and how they are applied.

Also important is how well our regulatory and law enforcement agencies communicate with each other as individual transactions are evaluated. Sovereign wealth funds and foreign investment in the U.S. are projected to increase significantly in the years ahead. This Committee, as Senator Dodd has reminded you, has a responsibility to fully evaluate the existing legal structures and processes governing foreign investment. Only then can we be sure that we are protecting our Nation's security while maintaining an open investment climate.

This hearing is a good step in that direction, Mr. Chairman. I thank you for calling it.

Chairman DODD. Thank you very much, Senator Shelby.

Before I turn to Senator Menendez, let me just mention that there is a piece in this morning's Washington Post, "Justice Department sees surge in global crime networks." And let me just say to my colleagues here, I just mentioned to staff here, I think this is an appropriate area for us to want to look into. This is the Attorney General talking about this issue, and gasoline prices and possibly financial services as well. I am not drawing any hard conclusions here, but I would like to invite Members of the Committee to think about this and how we might as a Committee here examine this issue, some of these questions. So I just raise it here and let you know that we are going to possibly conduct a series of hearings about this very question in terms of the jurisdiction of the Committee.

With that, Senator Menendez.

## STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman. I appreciate you calling this hearing with the Ranking Member.

When it comes to the growing presence of sovereign wealth investment, I think we have more questions than we have answers. Sovereign investment is not a new phenomenon, and it is not just a phrase, and increasingly the lines are becoming more blurred. Instead of an open, clear stake in a company, we are talking about pockets of investment, capital in an investment bank, a stake in an equity firm, or a merged cross-border exchange. We are not talking

about a single investor but a fund that is backed by a foreign government. The impact is less clear, but the implications are far more complex. And even though we are often talking about a 5-percent stake here or an 8-percent interest there, these investments add up.

Now, Mr. Chairman, I have a little difficulty in believing that—I find it hard to believe that a foreign government is willing to invest billions and have no say. If that is the case, then I would like to invite them over personally at the end of the day.

In the last 10 months alone, two-thirds of the equity raised for U.S. financial firms, some $39 billion, has been from sovereign wealth funds. So it is clear there is a strong appetite and a source for foreign capital. We need to make sure we know who is providing it and what, if any, motive they have beyond a purely financial interest. And given the volatility of our market, given that the need for foreign capital will only increase, and that sovereign investment could explode in the coming years, it is imperative that we ask now exactly who is interested in these investments and why.

So today's hearing is an important chance to hear what is being done and where the cracks may be. For instance, are these funds trying intentionally to stay below the radar and not trigger a review? Do we know enough about what their interests may be? Do we know who their investors are? I think these are important questions, and if we do not have the answers, I think it is a cause for concern.

The stakes are rather high, and I share the concerns of a number of my colleagues that we still do not know enough and that we may be falling short of the transparency that we should have for these investments. The door has swung wide open to sovereign investment. None of us want to close it, but we need to make certain checks are in place, and at the very least, we need to know a few basic things about who is coming through the door and why.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Corker.

Senator CORKER. As usual, I would like to hear from the witnesses. Thank you.

Chairman DODD. Thank you very much, Senator.

Senator Reed.

**STATEMENT OF SENATOR JACK REED**

Senator REED. Thank you, Mr. Chairman. I think this is a very important hearing.

Chairman DODD. Don't let Senator Corker intimidate you. If you want to say something, you go ahead.

[Laughter.]

Senator REED. I want to say more than is in my statement, but I want to be polite, too. So I will pretend I am giving up my time, and then I will go on and on and on.

No, I think the questions that have been posed by the Chairman, the Ranking Member, Senator Menendez, and others have really raised the seriousness of the issue and, I think, the importance of the debate. So I am looking forward to hearing the witnesses. It

just strikes me that we have created a regulatory scheme based upon the culture of companies, and now we have a completely different player that has different motivations, different incentives, and has a much longer sort of timeframe in terms of seeing the results, whatever they may be, financial or otherwise. And I think we have to understand that, that the rules that might be working—in fact, there is a real question whether they are working well even for private entities—might not have all of the facets and all the dimensions necessary to fairly deal with this. The issue of accountability, the issue of transparency, great slogans, but we have to translate that into operational rules and procedures. And I think we have to do it seriously, and we have to do it, because these funds are a reality in the world market. They are not going to go away. In fact, the evidence we saw is they are getting bigger.

One final point is that sometimes I have the impression—and I think it is shared by a lot of people on the street—that we are taking our money at the gas pump, sending it over to many countries who now are creating sovereign wealth funds to buy our banks. And that might be, you know, a gross simplification, but there is a certain, I think, appeal and reality to that, and it has huge consequences. So I think we have to be serious about this inquiry.

Thank you.

Chairman DODD. Thank you, Senator Reed.

Senator Schumer.

**STATEMENT OF SENATOR CHARLES E. SCHUMER**

Senator SCHUMER. Well, thank you, Mr. Chairman, Ranking Member, and the witnesses, and I will apologize in advance. We have a markup in Judiciary, and I have a bill up, so I will not be able to hear your testimony. But as you know, I have been long involved in this issue, starting with Dubai Ports World, which was an anomalous situation because we were dealing with a key national security issue, and what applied there does not apply here necessarily. So I would just like to make a couple of points.

First, Senator Reed talked about oil. We spend money on gas and oil, and the price is too high. But ultimately, in part we have ourselves to blame. We have not had an energy policy to wean ourselves away from oil for a very long time. My view is the administration thinks what is good for big oil is good for America, and big oil is happy to have the price go up and it is happy to be in cahoots with OPEC.

And, second, in a broader sense, we have for now over a decade imported far more than we have exported. We have borrowed more than we have saved. We have spent or consumed more than we have produced. So there is a shortage of capital here, particularly when a crisis hits. We do not have it here in America because of these somewhat profligate habits that, again, have been allowed to just fester with no one doing anything about it. And then when we need capital, we have two choices, neither of them very good: get them from places that we are not particularly comfortable getting them from, or get no capital and have our economy contract and have tens of thousands, if not millions, thrown out of jobs.

So let's face the realities here. It is easy to rail against sovereign wealth funds, but the alternative is even uglier. So what do we do?

First, we do have to make sure there are certain—they are all not the same. The countries are not the same, and what they buy is not the same. You have to look at security. I stand by what many of us did—Senator Menendez was very much involved as well—with the Dubai Ports World, because dealing with a port where somebody could smuggle in a nuclear weapon—and I do not think the Government of Abu Dhabi wanted to do it, but who knows if somebody could have infiltrated, changed a freight manifest, and God forbid.

On the other hand, there are some countries that seem to use their economic wealth for political purposes. A classic example is Russia. We have seen Putin do this with Europe. Who would want to let Putin or a Russian sovereign wealth fund buy an American natural gas company? I sure as heck would not. Some are more benign and—or less harmful, and countries in the Middle East, countries—Singapore—seem to be investing for economic purposes. And that is the one line that we have to assure, that the investment is for economic not political purposes. And that leads to transparency.

There are a whole lot of questions such as: Do sovereign wealth fund officials report to an independent board of directors or directly to the government? Do they disclose their investment goals? If those goals change, are those made public? Are directors in the investment management team selected on the basis of business qualifications, not political affiliation? Is there a stringent code of conduct that compels boards of directors and management to report attempts by government influence of investment decisions?

Abu Dhabi and Singapore have commendably moved in that direction. The IMF is putting out guidelines. But this is something we have to be very careful about. If you are doing nothing wrong, if your goals are economic, you should not mind transparency. And my thrust has been and will continue to be to make sure that there is real transparency here so that political decisions do not influence economic decisions.

Mr. Chairman, thank you for having this hearing. I thank the witnesses, and I look forward to reviewing the testimony and the questions.

Chairman DODD. Well, thank you, Senator Schumer. There is the old saying that any port in a storm, and the mismanagement of our economy over the last number of years, leading to the problems of illiquidity have caused in a sense that old saying to be the case—any port in a storm, and so institutions looking for capital are out there shopping for it and are willing to take it in almost any place it is available. And that is one of the concerns that has been produced by this economy over the last number of years. So the questions raised by our colleagues here are very worthwhile ones, and we have two very good witnesses here this morning who can share, I think, some thoughts about this. There are a lot of questions, obviously.

We will begin with Scott Alvarez, who is the General Counsel of the Board of Governors of the Federal Reserve System. Mr. Alvarez joined the Federal Reserve Bank in 1981 and has been there for 27 years, a distinguished record. He has held the position of General Counsel since 2004, serving as the chief legal officer. He advises the Board on laws such as the Federal Reserve Act, the Bank

Holding Company Act, Gramm-Leach-Bliley. He also assists congressional staff in drafting and developing legislation related to domestic and international banking issues. So we expect to get to know you rather well, Mr. Alvarez, if we have not already, in the coming months.

Ethiopis Tafara—did I pronounce the first name correctly?

Mr. TAFARA. Absolutely.

Chairman DODD. Thank you. He is the Director of the Office of International Affairs for the Securities and Exchange Commission. Prior to joining the SEC in 1999, Mr. Tafara served at the Commodity Futures Trading Commission, known as the CFTC. I thank him for his years of Federal service as well. Prior to that, he worked for the law firm of Cleary, Gottlieb, Steen & Hamilton, currently oversees the SEC's regulatory policy and enforcement initiatives on the international front. In addition to working with foreign regulatory agencies and organizations, Mr. Tafara represents the SEC in the International Organization of Securities Commissions.

Let me ask both of these witnesses to provide us with their statements. I would like to ask you to kind of limit your remarks to 5 or 6 minutes, if you could. We will accept, of course, your full statements and any supporting data you think would be worthwhile for the Committee to have. And with that, Mr. Alvarez, we will begin with you.

**STATEMENT OF SCOTT G. ALVAREZ, GENERAL COUNSEL, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. ALVAREZ. Thank you, Mr. Chairman, Senator Shelby, Members of the Committee. I am pleased to be here today. I will focus my remarks on a narrow issue: the thresholds that trigger review by the Federal Reserve and the other Federal banking agencies of investments by sovereign wealth funds in U.S. banking organizations.

As a general matter, investments by sovereign wealth funds are subject to the same statutory, regulatory thresholds and requirements for review by the Federal banking agencies as apply to investments by other domestic and foreign investors in U.S. banking organizations. These requirements are established primarily in two Federal statutes: the Bank Holding Company Act and the Change in Bank Control Act. The Bank Holding Company Act requires any company to obtain approval from the Federal Reserve before making an investment in a U.S. bank or bank holding company if the investment meets any one of three statutory thresholds. In particular, Board approval is required before a company acquires ownership or control of 25 percent or more of any class of voting securities of the bank or bank holding company; or acquires control of the election of a majority of the board of directors of the bank or bank holding company; or acquires the ability to exercise a controlling influence over the management or policies of the bank or bank holding company.

In determining whether an investor may exercise a controlling influence over the management or policies of a U.S. banking organization and thereby trigger formal review of the investment, the Board considers the size of the investment, the involvement of the investor in the management of the banking organization, any busi-

ness relationships between the investor and the banking organization, and other relevant factors.

The Bank Holding Company Act itself presumes that an investor that controls less than 5 percent of the voting shares of a U.S. banking organization does not have a controlling influence over that organization.

Chairman DODD. Mr. Alvarez, would you move that microphone a little closer to you, if you don't mind?

Mr. ALVAREZ. Sure.

Chairman DODD. Thank you very much.

Mr. ALVAREZ. Based on its experience, the Board generally has not found that a controlling influence exists if the investment represents less than 10 percent of the organization's voting shares.

The Bank Holding Company Act sets forth the standards that the Board must consider in acting on an application by any company, including a sovereign wealth fund, to acquire a U.S. bank or bank holding company. Those standards require review of the competitive, supervisory, convenience and needs, financial, and managerial effects of the transaction. The managerial standard includes consideration of the competence, experience, and integrity of the investor.

Upon the acquisition of control of a U.S. banking organization, the investing company would, by statute, become subject to supervision by the Federal Reserve, including examination, reporting and capital requirements, as well as to the act's restrictions on the mixing of banking and commerce. Importantly, the restrictions of Sections 23A and 23B of the Federal Reserve Act, which impose quantitative and qualitative limitations on transactions between U.S. banks and their affiliates, would also apply. These statutory provisions limit transactions between the U.S. bank and any company, including a sovereign wealth fund, that controls a U.S. banking organization. These restrictions help assure that the U.S. bank does not engage in unsafe or unsound practices for the benefit of the parent company or its affiliates.

Investments by sovereign wealth funds that do not trigger the prior approval requirements of the Bank Holding Company Act may, nevertheless, require review by a Federal banking agency under the Change in Bank Control Act. The Change in Bank Control Act generally applies to any acquisition of 10 percent or more of any class of voting securities of a U.S. banking organization where the transaction is not subject to review under the Bank Holding Company Act.

The Change in Bank Control Act also establishes specific factors that must be reviewed. These standards focus on the competitive effects of the proposal, the managerial competence, experience, integrity, and financial strength of the acquirer, certain informational requirements, and whether the transaction would result in an adverse effect on the deposit insurance funds. Unlike the Bank Holding Company Act, the Change in Bank Control Act does not impose any activity limitations or any ongoing supervisory requirements on the owners of banks.

The recent investments by sovereign wealth funds in U.S. financial institutions have remained below 10 percent, and often below 5 percent, of the voting equity of banking organizations. Con-

sequently, these investments have not triggered the formal review requirements of either the Bank Holding Company Act or the Change in Bank Control Act.

Sovereign wealth funds have been a beneficial source of capital for U.S. financial institutions. Over the past several months, sovereign wealth funds have provided equity capital to U.S. financial firms that accounts for a significant portion of the total additional capital raised by these financial companies during this recent period of stress. All of these investments, as well as similar investments made by U.S. private equity firms, have been structured as passive investments that do not trigger the thresholds that would require formal review by the Federal banking agencies under Federal law.

If a sovereign wealth fund were to make an investment that is at a level that meets the statutory thresholds for review, the Federal Reserve and the other Federal banking agencies would carefully apply the standards established in Federal law for reviewing that transaction in the same manner as the agencies apply those standards to reviewing transactions by other investors.

Thank you very much, and I would be pleased to answer any questions.

Chairman DODD. Thank you very, very much, Mr. Alvarez.

Mr. Tafara, thank you very much for being with us.

**STATEMENT OF ETHIOPIS TAFARA, DIRECTOR, OFFICE OF INTERNATIONAL AFFAIRS, SECURITIES AND EXCHANGE COMMISSION**

Mr. TAFARA. Chairman Dodd, Senator Shelby, and Members of the Committee, thank you for inviting me to speak on behalf of the Commission before today's hearing on the regulatory framework applicable to foreign government investment in the U.S. economy and financial sector.

Today sovereign wealth funds hold, by some estimates, more than $2.5 trillion in assets. Some projections estimate that their size will increase fivefold by the middle of the next decade. This could quite possibly make these funds, collectively and individually, the largest shareholders in many of the world's biggest companies.

Sovereign wealth fund investments in the United States is not new. Sovereign wealth funds based on foreign exchange reserves have always tended to invest abroad since their capital was based on a foreign currency. What is new, however, is the size of their investment in the equity markets and their concomitant focus away from the bond markets.

Sovereign wealth fund investment in the U.S. capital market offers definite benefits. Foreign investors, including sovereign wealth funds, can offer U.S. companies a lower cost of capital and a more liquid market for their securities. They also raise a number of potential concerns for regulators and other market participants. Some of these concerns mirror those raised by large hedge funds. By confining the foreign exchange reserves resulting from a thousands or millions of international transactions, an investment fund can wield enormous clout on a market. This creates opportunities for market manipulation and, where an entity owns enough shares of an issuer to control it, insider trading as well.

But sovereign wealth funds also raise other issues. Because they are owned and managed by Government, the incentives that drive fund manager decisions may potentially be very different from those associated with a privately managed investment fund. This is an issue that Chairman Cox has touched on in the past: the concern that sovereign wealth funds, because they are national entities, may not necessarily act like ordinary market participants and, thus, may have a distorting effect on a market.

Sovereign wealth funds may prefer not to be transparent in their motivations or operations. This is particularly true if a fund is linked to a nation's foreign exchange reserves. As you are aware, exchange rate policies traditionally are closely tied to matters relating to national sovereignty, trade policy, and the Nation's economy. The point here is that such sovereign wealth funds are not just concerned about making a profit. They potentially may well be willing to operate at a loss or forego a profit if it achieves other national objectives.

The SEC's mandate is focused on investor protection, maintaining fair and orderly markets, and capital formation. Consequently, the SEC has in place several disclosure rules relevant to investments by sovereign wealth funds that address many of the concerns we hear voiced here and in other markets.

First, the SEC requires that any beneficial owner holding 10 percent or more of an issuer's securities disclose this ownership interest and any changes to this interest.

Second, the SEC requires beneficial owners of 5 percent or more of an issuer's equity securities to disclose this ownership, the source and amounts of the funds being used to purchase the securities, and their future intentions with regard to this ownership interest.

And, finally, the SEC requires fund managers who exercise investment discretion over $100 million or more of SEC-registered securities to file a quarterly disclosure of the fund's holdings in these securities, as well as whether they have exercised voting authority over these shares.

As a complementary matter, the Commission has the power to pursue sovereign wealth funds that violate the disclosure and antifraud provisions of the U.S. securities laws. Neither U.S. nor international law shields foreign countries' commercial activities in the United States from the jurisdiction of U.S. courts. The SEC staff has a strong track record investigating cross-border violations of our securities laws, which we do by working closely with our foreign counterparts. The issue that arises with sovereign wealth funds is the possibility that the same government from whom we seek assistance might also be the controlling person behind the entity under investigation. This would present a considerable conflict of interest and might prove challenging.

I should note that the concerns about sovereign wealth funds are not just concerns in the United States. These concerns are shared by other jurisdictions. Currently, the International Monetary Fund, the OECD, and the European Commission are all discussing best practices for sovereign wealth funds that in many ways mirror our own disclosure requirements. I find these international developments comforting because I believe that, at least with regard to the

disclosures that sovereign wealth funds should make, there appears to be widespread consensus that we are on the right track. Indeed, I would argue we are ahead of the curve on this. In the United States, these disclosures are not voluntary but mandatory, at least for any sovereign wealth fund of any size.

Finally, sovereign wealth funds historically have been long-term investors. Many of their recent investments in troubled industries follow this trend. Given their size and the fact that they are owned by governments, the potential for politically driven investments with a concomitant effect on financial stability remains. But I believe that if we were to prohibit sovereign wealth funds from investing in our market for fear they might introduce market distortions, we might actually end up doing precisely this ourselves through the prohibition. A better approach is to address the underlying issues of transparency, independent regulation, depoliticizing of investment decisions, and conflicts of interest.

Thank you for inviting me to appear today, and I would be happy to answer any questions.

Chairman DODD. That was excellent testimony by both of you, and we thank you. You have raised a lot of the very same questions you heard raised by the Members up here as well.

Let me begin, if I can—in fact, Mr. Tafara, at several points in your testimony—I am going to quote your testimony here, but there were several places—I am reading the quote I am going to use here, but there were several other points where you sort of said very similar things, and that is about governments that control sovereign wealth funds and the particular problems raised by that. So I am going to address that. Let me quote you. You said, "Governments that control sovereign wealth funds and sovereign businesses, because they are governments, can in some cases control certain economic events, and . . . governments routinely are privy to certain types of information that most private investors are not." You pose the question: "What if the fund obtains information through its status as a government entity?"

So let me ask both of you here, can we say with any certainty that sovereign wealth funds are operating in U.S. markets without access to non-public information? Mr. Tafara, you can start out.

Mr. TAFARA. I do not know what we can say with any certainty. Certainly, if there is trading activity that is taking place on the basis of information that is not available to the public generally, it usually results in anomalous trading patterns, which would put us in the position as an agency to start inquiring as to what is behind that trading and to begin to build an investigative record.

So I cannot say with certainty that it is not happening, but I believe there are tools in place that would allow us to see that sort of behavior, trading on the basis of information that may not be available to the public, and for us to start going down the line to see what may be behind that trading.

Chairman DODD. Before you respond, Mr. Alvarez, let me add the element here, and that is, because I mentioned in my opening comments about the various agencies of our Federal Government that have pieces of all of this. As I was thinking about that last evening, that is encouraging on one level, but also knowing how many times there is a lack of communication between the various

agencies of governments that are blocks away from each other inquiring about the same sort of conclusions here, to what extent when that occurs are we getting information from those governments about that kind of information so we are better aware of it, not just from looking at the market reactions to it but to what extent do we feel we are getting the full cooperation of sovereign governments that own these funds about that kind of information? Can you respond to that?

Mr. TAFARA. Well, at the SEC, anytime we have an investigation that has international elements to it, we frequently seek the assistance of a foreign counterpart. Some of the information that we may want and need to build that investigative record may be located outside the United States. And we have in place arrangements that date back 20, 30 years that basically amount to a commitment on the part of our foreign counterparts who provide us with the information we need.

Now, I think in my testimony I indicated that when you are asking assistance of a government who may actually also be the subject of the investigation, you worry that there may be some recalcitrance on that government's part. But I will say two things that I think serve to mitigate this potential problem.

One, generally if you are doing insider trading, manipulation, or some fraud of that sort, you leave a pretty large footprint in the United States. So as an agency, we are able to actually gather the information we need within the United States to build an investigative record.

But, second, even if the government is associated with the entity that is under investigation, for reputational reasons they are generally inclined to provide assistance. They do not want to have the reputation of being an authority that—in a world where markets are global and investigation and prosecution is national, they are not willing to be part of a chain of a system. That is a reputation they do not want to have. And, second, I think they are concerned ultimately that if they do not provide assistance, it could have consequences for the ability of their companies to do business in the United States.

You know, there are a number of instances—there is precedent here in that, for example, in Foreign Corrupt Practices Act cases or cases involving companies that are considered to be national champions, we have gotten the assistance necessary from the foreign governments in those cases, which bodes well for the possibility of getting assistance if the investigation involves a sovereign wealth fund.

Chairman DODD. I would feel a lot better about that answer if I did not also consider something Mr. Alvarez said that many of us, I think, on this Committee are concerned about as well, and that is that you see these sovereign funds structure their investments in many instances to avoid the thresholds that would trigger the kind of investigations that normally occur. So you get the sense that people here are doing just the opposite, making sure that, in fact, they are not subjected to the kind of investigation that would occur. And either under the Bank Holding Company Act or the Change in Bank Control Act, the case of Citi, for instance, none of the four sovereign funds on their own acquired more than 5 percent

of ownership. In fact, Abu Dhabi Investment Authority came in at 4.9 percent. An aggregate, however, of these sovereign funds own 10 percent of Citi. So if you apply the law in a very strict sense, obviously they were under the 5-percent threshold. But, clearly, this was not just coincidental that it ended up being 4.9. You are not going to convince me of that.

So, clearly, they were trying to avoid the investigations that would normally occur to determine transparency on these other issues. So I am sitting here as the Chairman of this Committee concerned that, in fact, the very issues raised by Senator Menendez, Senator Reed, and others, Senator Bayh when he had earlier testimony, that we are being gamed a bit on all of this.

And so, Mr. Alvarez, are you satisfied, are both of you satisfied, would you recommend to this Committee that we need more statutory authority, or if you do, that treaties are inadequate, we are going back to 1975 in some cases, the world has changed dramatically, as you point out? And, Mr. Tafara, you are going to maybe have three times the number of foreign investment funds moving around the world today. Do we need more authority here to better control—not to discourage, because I agree with you, I think if you discourage, you can also affect market outcomes here, but to have a better sense of balance between inviting these investment funds in and providing the kind of economic security we are looking for. Do we need more authority? Do you need more authority?

Mr. ALVAREZ. Well, I would point out that sovereign wealth funds are not the only investors that structure their transactions in ways to take advantage of the thresholds in statutes. U.S. private equity funds do the same. Large investors do the same. And there may be a benefit to that in that we are bringing capital into organizations, into the financial organizations, without—because these are structured investment—without any incidence of control. They are agreeing to be passive investors to let their money be used by the current management and organization for its purposes. That I think is helpful and a protection.

I think it is also helpful when you see a number of investors coming at the same time on relatively the same terms at the invitation of the target organization. That suggests less worry about manipulation in stock prices, less manipulation of the market, less likely to be trading on inside information. Everyone is being treated on the same terms and not getting special deals.

There is quite a lot of cooperation among the banking agencies and the SEC in this regard, and I think we all have the same concerns, and we share information and we share concerns and work together on that. So that has also been very helpful. And we have been establishing at the Federal Reserve—and I know the SEC has as well—good relationships with the foreign supervisors to try our best to understand their motives, to understand their regulatory scheme, and how they approach these kinds of investments.

So we are all trying to be sensitive to these concerns. At this stage, I do not think we at the Federal Reserve see a reason to change the law yet. But we are watching carefully. We want to see how this will develop, and we certainly will come to you if we see any trouble.

Chairman DODD. Well, before turning to Senator Shelby, let me thank you for that, and we want to keep you posted on it. We want you to know as well that we invited the Treasury Department to be here this morning, and they declined to have a witness be here this morning, despite a very important role in all of this as well. And we are going to pursue the Treasury Department to respond as well to these questions. But I was disappointed that Treasury decided not to participate in today's hearing.

Senator Shelby.

Senator SHELBY. Mr. Chairman, I think you should pursue, this Committee should pursue Treasury, because Treasury is very involved, as we all know, in the CFIUS and chairs the CFIUS Committee. We cannot let them not be present at the table when we are doing this. You are absolutely right.

Senator BAYH. Mr. Chairman, they also refused to come to our Subcommittee hearing on this topic as well previously. Senator, I apologize for interrupting.

Senator SHELBY. That is OK.

Senator BAYH. But for some reason, Treasury just refuses to be heard on this issue.

Senator SHELBY. Well, Mr. Chairman, you know the rules of the Committee. We can get them up here, and I think that I agree with Senator Bayh. We should not put up with that.

Chairman DODD. As I tell my 6-year-old, we can do it the easy way or the hard way.

[Laughter.]

Senator SHELBY. I think we need to tell the Secretary of the Treasury that, and the Deputy Secretary, and I appreciate that. I agree. The easy way or the hard way, but, Mr. Chairman, I think you are absolutely right having these hearings. They are very much needed, and I hope you will continue.

I want to pick up, if I can, on what Senator Dodd was talking to you about. When we passed this legislation, the Bank Holding Company Act, I do not know that it was contemplated by the Congress, and maybe by the Fed, that we would be dealing with such investors, like sovereign wealth, on the magnitude that we see today, which will be much larger in 10 years, 20 years. And I hope that we will not and the Fed will not be behind the curve. Senator Dodd is absolutely right. He is asking you, as you know—and you are a very able attorney—do you need legislation. This Committee, we are going to very rigorously examine all these issues. But you need to be ahead of the curve rather than behind it. Nobody knows it better than you do.

I am concerned, as Senator Dodd was, and others, let's say you have 10 sovereign wealth funds. There are many more, but—and they want to buy—and we will just use Citicorp since it has been brought up. And they all want to buy 4.9 percent of Citicorp. Well, they might be different countries. They might be this and that, but they can act like we do as investors and do a lot of stuff.

Is there anything to stop that? I do not see anything to stop it.

Mr. ALVAREZ. That is a very good question, and both the Bank Holding Company Act and the Change in Bank Control Act allow us to look to whether folks are acting together. The Bank Holding Company Act——

Senator SHELBY. Let's say they are not acting together when they buy, but they act together as we put sort of—I mean, we put deals together once we are there. We all do it. It happens today in the board.

Mr. ALVAREZ. Sure, and that is a more difficult problem to deal with. Once the investors have already——

Senator SHELBY. Once they are in the house, as Senator Menendez—they are knocking on the door. Once we let them in the door and they are there and enough of them are there, they are basically in control, aren't they? And they have enough of it, sure, they are.

Mr. ALVAREZ. The one protection that we have there—so we have that same problem, not just with sovereign wealth funds, but with private equity funds in the United States. They often have their own agendas as well when they acquire a——

Senator SHELBY. Well, you are not a naive man. Now, you know they are going to have their own agenda. It is just not brand investment. I mean, sure, they want a return on their investment. But why would three or four large sovereign wealth funds invest in one or two or three of our largest banks, financial institutions, or other strategic things? They will control it, wouldn't they?

Mr. ALVAREZ. Well, the——

Senator SHELBY. Sure, they would. You know they would control it.

Mr. ALVAREZ. Well, it depends on the mechanisms and the relationships they have with the organization. So, for example, I think we would look differently at an investor who bought shares and then had no other relationship. We would look at them differently than an investor who buys shares and has director representation on the board of directors, has strong business relationships with the organization, has agreements about seeking approval before the organization can merge or make an acquisition or take various actions. And we have seen in the private investment world all those kinds of arrangements, and we look at those carefully.

The one thing we have in our favor in the banking world that may be different from the rest of the world is that Congress has given the banking agencies authority to issue cease and desist orders and take other action to make sure that the banking organization is operated in a safe and sound manner. And so it is not as it might be in buying a car company where once an investor is in, they can do whatever they want and there is not any supervision. In the banking area, the banking agencies can examine the holding company and the bank. They can prevent unsafe and unsound actions from taking place. They can require business plans to be approved, things like that. We have some——

Senator SHELBY. I understand that. But they cannot stop them from making policy as long as that is a legitimate policy that might not be in the real interest of America.

Mr. ALVAREZ. If they want to exercise control over the bank, we can stop that. They cannot—an investor cannot——

Senator SHELBY. Maybe not control. Influence. What about influence? If four of us had 20 percent or 19 percent or Citicorp, you do not think that is basic control or influence?

Mr. ALVAREZ. I do not disagree with you that there is certainly controlling influence at certain levels, and that is what we have to look for, and that is the statutory standard. If an investor has a controlling influence, then they—before they have a controlling influence—they must get the Federal Reserve's approval. They cannot exercise—even after they have bought the shares—they cannot then exercise a controlling influence without approval.

Now, you are exactly right, there is a gray area there. What is controlling influence? And that can differ from person to person.

Senator SHELBY. Then how do we address that? Do we need to address that gray area statutorily? Or does it need to be done through the regulator? Which you are the regulator. Or what? Because everybody here knows, or knows in the world, that there is going to be probably $10, maybe $15 trillion worth of sovereign wealth, and where do people want to invest it? In the United States of America and in Europe. I mean, that is a given. And with an investment of that magnitude, or let's say half that magnitude, it is going to change this country from everything we know today. Isn't it? It could change foreign policy. It could change a lot of things. Could it?

Mr. ALVAREZ. It could, yes.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Shelby.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and I want to follow on the line of questioning that Senator Shelby raised. I think it is very important. But just to drill down a bit, when you look at one of these proposed transactions, the red line is 4.9 percent, so if they are 4.9 percent, below that then you have to look at the nature of the deal. Would you be looking at the transaction and, for example, if they had a put at any time they wanted, would that be something that you would say might be used and, therefore, would disqualify the transaction? How deeply do you go into the structure of the transaction, not just the ownership level?

Mr. ALVAREZ. We look at all aspects of the investment. So, for example, we would look at convertible shares or warrants or the right to impose restrictions on management through a contract. We look at debt relationships, normal business relationships, attempts to fund affiliates. We look at the entire arrangement that they have in mind.

Senator REED. And you continue that observation on a periodic basis for sovereign wealth funds?

Mr. ALVAREZ. Yes, sir.

Senator REED. With particular emphasis on sovereign wealth funds?

Mr. ALVAREZ. No. For all minority investors, and the threshold for us is really—we look at those investments if they are 24.9 percent or less. Above 25 percent, there is statutory control.

Senator REED. Now, if they trigger a change in control or aspects of the Bank Holding Company Act, the requirement then would be to—and you can take me through this. They would then register as a Bank Holding Company?

Mr. ALVAREZ. Right. So if they are in control——

Senator REED. Would that be the sovereign wealth fund or the Nation of Dubai?

Mr. ALVAREZ. It would be the sovereign wealth fund. The sovereign wealth fund would become a bank holding company. It would be subject to examination, to capital requirements, to all the full authority of the Federal Reserve, subject to restrictions on mixing banking and commerce.

Senator REED. Now, are you prepared organizationally, staffwise, to do this? I raise that question because I do not want to—this is a very important issue, but it is something like, you know, the dog chasing the bus. You catch it and what do you do with it? And that sometimes inhibits the tough call, a close call, like, well, they really do have control, but if we tell them they are a bank holding company, you know, that sets off—and it goes along the line, I think, of Senator Shelby's question. Do we have the legislative framework, the clear authority, do we have the institutional capacity to go and tell a sovereign wealth fund we want you to report everything you are doing and we do not want you to invest in commercial activities?

Mr. ALVAREZ. I think we would have the institutional capacity to deal with that if it were to come up. But the sovereign wealth funds have tremendous incentives not to have that occur. They do not want to have the restrictions on mixing banking and commerce, for example. A sovereignty would not want to have to be subject to the capital rules of the United States in their actions or the cease and desist authority of the Federal Reserve or examination authority. And as a result, they really do try, the sovereign wealth funds, perhaps more so than other private equity funds, to be passive and to provide their funds without strings attached.

Senator REED. Let me raise another question for both you and Mr. Tafara. Senator Schumer made comments that I were very interesting about, you know, there are some sovereign wealth funds that are models of decorum and transportation, and there are others which are highly suspicious. Would you have the authority to ban a sovereign wealth fund based upon your determination that there is no transparency, no accountability, in fact, criminality? There is an interesting story in Business Week about Russian police authorities who basically took down or tried to take down through fraud an American fund, Hermitage Capital Management. But would you have that authority?

Mr. ALVAREZ. Both the Bank Holding Company Act and the Change in Bank Control Act have provisions that allow us to deny the approval if we do not get information that we think is required.

Senator REED. Well, if there is—if you discern a pattern of—I guess the pattern would be illegality or you just do not feel that this fund is responsible, in fact, it clearly engaged in other areas of inappropriate activity, do you have the authority to say, no, you cannot invest?

Mr. ALVAREZ. We have the authority to say they cannot control, because we are empowered to look at the experience, integrity, and competence of the investor. So we do have the authority if they wanted to breach one of the control thresholds based on——

Senator REED. But only if they are at that threshold of 5 percent.

Mr. ALVAREZ. Threshold of 24.9, or they are exercising a controlling influence——

Chairman DODD. Anything less than that, you would not have any authority.

Mr. ALVAREZ. No, less than that, we do not have authority. That is correct.

Senator REED. Let me shift to Mr. Tafara from the SEC. From an investment now—not a financial institution, but a publicly held company in the United States, would you have the authority to say because of the pattern of behavior of this sovereign wealth fund that you are aware of, or the lack of cooperation, you could say no, you cannot invest?

Mr. TAFARA. We, in essence, administer a disclosure-based regime, so——

Chairman DODD. Would you raise that microphone a little?

Mr. TAFARA. I am sorry. We administer, in essence, what is a disclosure-based regime. So we could take action for failure to comply with those disclosure requirements. So we——

Senator REED. You could not peremptorily deny them?

Mr. TAFARA. No.

Senator REED. OK. Just a final, if I may, and this might be something you can provide later. We have been talking in the context of a direct investment into a publicly held company or a financial institution. To what extent do we know—and maybe we do not know—that sovereign wealth funds are using intermediaries, like hedge funds and private equity funds where they are lending tremendous amounts of money to them, and these funds are making the investments? Would that trip any of your—would that lead you back to the sovereign wealth fund, at least knowing that they are behind the investment? Do you have any mechanism to do that? Yes or no.

Mr. TAFARA. Under the securities laws, if you trigger the thresholds, if you have 5 percent or more, part of the disclosure involves disclosure of beneficial owners. So——

Senator REED. But if you are not an owner, you are a lender. Do you miss that?

Mr. TAFARA. You also have to indicate the sources of your funds in that acquisition as well.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator. I apologize, just on that threshold question, I——

Senator REED. No, no.

Chairman DODD. Senator Corker.

Senator CORKER. Mr. Chairman, thank you. I think this, again, has been a great hearing, and thank you, witnesses, for your testimony.

I am still unclear about your ability to request disclosure from sovereign wealth funds. There seems to be a distinction between requiring a corporation that is owned by a sovereign wealth fund and based in another country, them making investments here, versus just a direct investment by a sovereign wealth fund. And it seems to me that that has been a hazy area that, to some degree has been danced around a little bit. Mr. Tafara, there is no question that a

direct investment by a sovereign wealth fund, you all absolutely have the ability to require disclosure.

Mr. TAFARA. To the extent we are talking about an acquisition into a U.S. public company, it is your being the acquirer, the investor, that triggers the disclosure. The form of the entity that is actually making the acquisition is of no relevance, so—by the way, these rules apply to anybody acquiring a U.S. public company, any entity acquiring——

Senator CORKER. Of any kind?

Mr. TAFARA. Of any kind.

Senator CORKER. And to both of you, what is the—they disclose—if you find that, in fact, thresholds have been broken that they have not, in fact, disclosed, what is the actual recourse that we have against entities that do that?

Mr. TAFARA. On our side, the Securities and Exchange Commission, we would potentially bring an action for failure to comply with the disclosure requirements of the Federal securities laws. The remedies——

Senator CORKER. And what would that——

Mr. TAFARA. And the remedies available to us are those that are available to us in any enforcement action that we bring as an agency. It would depend on the facts and circumstances of the case, but it could be a fine, a cease and desist order. We have a whole panoply of remedies that are available to us as an enforcement agency which we could bring to bear should they have failed to comply with the requirements of the law.

Mr. ALVAREZ. In the banking area, recall that they need approval prior to buying control of the banking organization. If a sovereign wealth fund or anyone else were to acquire control of a bank without approval, then we could require divestiture of the shares; we could fine the organization, the acquirer; we could prevent their acquisition of other organizations in the United States.

Senator CORKER. I think the questions raised today have been very important, and, fortunately, most Members of Congress have not rhetorically used the fact that investments are taking place here to our detriment. But this is back to a serious issue, and I think as Chairman Dodd mentioned, there has to be a balance that is put in place.

Do either of you see—I know some regulations came out on Monday that have been mostly well received. Do either of you see additional legislation of any type necessary in light of the very obvious and good questions that have been asked by other Members here today?

Mr. ALVAREZ. We do not at this stage, though we are looking very carefully at the issues, and I think we support also the initiatives that the OECD and the IMF have started, which would increase transparency, improve governance at sovereign wealth funds, and we think those are positive steps. We would like to see how that develops as well. But then if in looking at those steps and our experience in the last year or so causes us to need more legislation, we certainly will come to you quickly.

Mr. TAFARA. And my answer would be identical to the one that Mr. Alvarez has given. I think this is an area that has raised our interest as well, and we are giving careful consideration to whether

or not there is anything additional we need in terms of authority to address it.

At this stage, I cannot say that that is the case. There is a fair amount of transparency that is required under the Federal securities laws by any investor, including sovereign wealth funds. But given the size of these investors and the nature of these investors, we are certainly giving some thought as to whether or not we need additional authority.

Senator CORKER. Let me just ask one final question. Obviously, there have been concerns about foreign governments having other concerns other than just direct return on investment, which they do. There have been concerns, other types of concerns that have been raised here today.

What concerns that have not been raised by Members here are some of the ones that as you think about new regulations, as you think about other activities that ought to be taking place as it relates to sovereign wealth funds, what other concerns do you or your staffs have as it relates to huge growth in sovereign wealth investment here in our country?

Mr. TAFARA. I have, I think, in my testimony articulated the one additional concern that I have, and that is the fact that frequently investigation and prosecution of wrongdoing involving foreign entities requires the assistance of a foreign counterpart, and some concern that there may be some recalcitrance on the part of the foreign counterpart to provide assistance when the target is actually its government.

Now, history has demonstrated that that has not been a complete impediment. We have been able to overcome that recalcitrance because we see it in connection with other investigations involving Foreign Corrupt Practices Act cases, involving companies that are viewed as national champions that potentially have fallen afoul of U.S. law. And we have gotten the assistance in those circumstances, so I am inclined to believe that we will get the assistance in connection with the sovereign wealth fund.

But it is something that, in the back of my mind, is a potential concern which I am thinking about to determine whether or not there is anything additional we need to do in my office or as an agency.

Mr. ALVAREZ. Yes, and I think the concerns that we focus on are actually the ones Senator Shelby focused on, what a controlling influence is, and what to do in that gray area, how to assess investments there.

I think we also have some concern that there not be an overreaction. Sovereign wealth funds investments have been a source of useful capital to organizations in a passive way so far. And so far, the funds appear to have been helpful and not hurtful. We want to be vigilant going forward, but not overreact to concerns yet.

Senator CORKER. Mr. Chairman, thank you. I do think that on the one hand we have been very fortunate to have liquidity available to us at a time when it was much needed. I think some of the other comments, you know, talking about our own policies leading to much of the need today for this investment is something not to take lightly. I know all of us are concerned and I hope this is a

time of us growing stronger. Obviously, this liquidity, along with the tremendous mark-to-market issues that are taking place, hopefully will make us stronger, if you will, in the financial markets when this particular turmoil goes by.

I hope this is not the time, on the other hand, of the shrinking giant because of other policies that are in place. And I know you will continue to examine those, and thank you for this hearing.

Chairman DODD. It is one thing to welcome sovereign wealth funds. It is another thing to beg for them. And the whole nature of whether or not I am welcoming those investments to come in the country or whether, because any port in a storm, that you are begging for them, then that equation can change dramatically.

And I want to turn to Senator Bayh right now, but one of the things that occurs to me in response to Senator Corker's question, one that I asked, and Senator Reed and Senator Shelby have raised as well, about whether or not you think we need any more authority. I think the question ought to go, not just a question of whether or not the existing laws, but to the extent there is coordination.

One of the things we did with the CFIUS legislation, as you will recall, was to strengthen the coordination on national security issues and the issue of our economic security issues, whether or not we need something like that.

So it is not necessarily new laws, but requiring that there be better communication between the various agencies of the Federal Government, so that we have a better understanding of what is occurring when these matters arise. You are looking at it from a Federal Reserve perspective. You are looking at it from the SEC. Someone else is from Treasury and Commerce. And whether or not we are looking at it in a holistic way, as to what this means, may be something I would like to explore with you.

Let me turn to Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman, and thank you for having this hearing today. And gentlemen, thank you.

I apologize for not being here for your opening statements. We had a meeting of the Armed Services Committee on a top secret matter, and it was at the same time. So I am trying to be two places at once, and it is just always a struggle. But I am very interested in this topic and I am grateful for your presence here today.

I wish, Mr. Chairman, that Treasury had joined them today. Hopefully, the hard way or the easy way, that will happen at a future time.

My own thoughts on this reflect many of the others you have heard here today at a time when we are running tremendous imbalances. Our current account imbalance, particularly in the energy area, we have to find a way to recycle this capital. And it is good for our country to have it reinvested here. It improves productivity growth, helps to create jobs, strengthens our economy. There are many, many upsides. We want to be a good place for capital investment.

At the same time, I think we would be naive if we did not appreciate the fact that governments are just sometimes different than private investors. And Mr. Chairman, I am struck by the irony of the fact that literally, in the two chairs you gentlemen are occupying today, seven or 8 years ago Alan Greenspan sat there and

Secretary of Treasury O'Neill, back when they were willing to appear before the Committee, sat there. And both of them said that we should never allow our own government to invest in private equities because the risk of political interference was too great.

And so we are now entertaining the question of whether we are more afraid of our own government investing and meddling in our affairs than we are other governments investing in our country and possibly having political agendas other than just purely profit maximization.

So that is kind of the nub of the argument here. We want the capital. There are a lot of advantages. But how do we protect ourselves against the potential, whether our own government or another, has yet not realized but the potential of another agenda, political interference, non-economic motives, those kinds of things.

And Russia has been mentioned, their thuggish behavior with regard to some of their neighbors certainly raises red flags. China, I understand the fellow who is running their sovereign wealth fund is a good person, he is saying all the right things, interested in maximizing profits, making good investments and that sort of thing. But the recent controversies regarding Tibet, for example, do raise the real prospect that occasionally the highest authorities in China have other agenda and perhaps other values that do not correspond with our own. And they have shown a willingness to pursue those agendas and values even in the face of global condemnation.

As I said, we would be naive if we did not at least consider those possibilities.

So, having said all of that, Mr. Alvarez, I would like to start with you and the banking sector. One of the things we are dealing with in this whole financial crisis we are currently trying to work our way through, and I think the Fed is, of course, actively involved in this is that a great deal of lending in our country, a great deal of banking activity over the last 15 to 20 years has been undertaken in what is now called the sort of shadow banking system or an alternative banking system.

Do you have regulatory powers oversight over those entities? Or is it just pure banks?

Mr. ALVAREZ. No, we have authority over banks and companies that own banks. So the lenders that are not affiliated with a bank are not themselves a bank.

Senator BAYH. So the folks we have opened the discount window to, you have regulatory authority over them?

Mr. ALVAREZ. We have opened the discount window to banks. That has always been the case. But we have recently opened the discount windows——

Senator BAYH. I am talking about investment banks.

Mr. ALVAREZ [continuing]. To primary dealers, a subclass of investment banks that we deal with in dealing with monetary policy.

Senator BAYH. Well, these——

Mr. ALVAREZ. We do not have regulatory authority over them by statute.

Senator BAYH. So a 5 percent investment in one of those is not subject to the regulatory structure that you have outlined for us here today?

Mr. ALVAREZ. That is correct.

Senator BAYH. Well, this seems to me to be potentially a significant—I do not know if I would call it a loophole. But if, in fact, banking-like activity is taking place in that area of the economy, but your regulatory structure only applies to traditional banks not these new bank-like entities, is that not an area that we should look at possibly extending this regime to?

Mr. ALVAREZ. Well, that certainly has a lot of ramifications beyond sovereign wealth funds and that is something we are thinking very deeply about and in consultation with the SEC about, because the SEC has regulatory authority over those primary dealers.

So that is part of a larger program and we certainly will be talking to this committee about that.

Senator BAYH. Mr. Tafara, is that——

Mr. TAFARA. That is correct.

Senator BAYH. I understood your testimony, in response to very good questions from Senator Reed, to be that if an intermediary, a sovereign wealth fund invests in a financial intermediary of some kind, an investment fund of some kind, and that investment fund acquires more than a 5 percent stake in a publicly held entity, that they have to report, disclose their beneficial owners and also their sources of capital. Was that a correct understanding of your testimony?

Mr. TAFARA. Yes.

Senator BAYH. Which leads me to the point, and I think Mr. Alvarez perhaps—or perhaps both of you were getting to this. You had both acknowledged that is control the correct notion for us to focus on here? It is certainly possible to exercise considerable influence, short of official benchmarks of control. In fact, that takes place in our own economy all the time.

Mr. ALVAREZ. In the banking world, of course we straddle those terms. Controlling influence is what the statute looks for, so it is more than a simple influence but it is something that has—and it is less than absolute control. It is a gray area that is sometimes difficult to navigate.

But if an investor has a controlling influence, they are subject to——

Senator BAYH. Well, I do not want to get too semantic about it here, and again it is very difficult to define. And it does take place in our own economy. And I see my time is up, so maybe I will wait for a second round.

But if, in fact, the investor can pick up the phone and have a material impact—maybe that is a better way to phrase it—on the decisionmaking of the entity to which they have lent money or invested, is that not the point that we are driving at here, as opposed to some arbitrary definition of control?

Mr. ALVAREZ. The ability to do that is certainly one of the things we look for in any investor and making an investment in a banking organization. Are they going to be able to——

Senator BAYH. So even short of 5 percent you look at that kind of thing?

Mr. ALVAREZ. Under 5 percent, the statute presumes you do not have controlling influence. That is by law.

Senator BAYH. I have exceeded my time, so I will let the Chairman get on with it. But my point is——

Chairman DODD. There are very few of us here. We do not have to—I am not trying to be rigid. Senator Shelby has some questions.

Senator BAYH. My point is that what we are after, if there are sovereign entities that can have a material impact in the decisionmaking of our financial sector, then it seems to me what we are after. And it is possible to have that kind of material influence somewhat short of just an arbitrary 5 percent standard. I mean, at a moment of financial crisis, these are growing entities, we want the capital, and it is a good thing that they have stepped in at this moment of instability to stabilize our financial market. That is a good thing.

But it seems to me if that is one of the greatest sources of capital in the globe today, that even if you are short of 5 percent, you are going to take that phone call, of course. And that person's opinion, although—they may not even have a seat on the board. But you are going to listen pretty carefully to what they have to say if you know that when the going gets tough this is one of the people you can turn to for additional capital, they are going to have some impact on your decisionmaking, in all likelihood, it seems to me.

So that is how to—I know what the statute says. What we are asking for, we are grappling with this. We have not reached any conclusions. Neither have you. But it seems to me that something short of this arbitrary 5 percent standard, we may need to look for a different definition to try to handle this. That is the point I wanted to make.

Mr. ALVAREZ. Fair point.

Senator BAYH. Thank you, Mr. Chairman.

Senator SHELBY. Mr. Chairman.

Chairman DODD. Yes, in fact, this is a line of questioning that Senator Shelby had.

Jack Reed has a very good question that he wants to——

Senator SHELBY. Go ahead.

Chairman DODD. No, go ahead.

Senator SHELBY. I defer to Senator Reed.

Chairman DODD. The 24 percent and the 4 percent, I want you to clear this up, too. Jack raised the question.

Senator REED. Mr. Alvarez, there are two thresholds. Could you just amplify the consequences of the thresholds, first the 5 percent threshold and then the 25 percent threshold?

Mr. ALVAREZ. Sure. There are a lot of different numbers here and different things happen at different levels, and there is a 5 percent threshold that the SEC worries about, which is different than ours.

So there are two thresholds to worry about on numbers, 25 percent, if you own more than 25 percent of the shares of a bank, you become a bank holding company, no ifs, ands, or buts about it.

If you buy more than 10 percent, then you are subject to review under the Change in Bank Control Act. Again, that is in the regulations.

There is a 5 percent threshold in the Bank Holding Company Act that says if you own less than 5 percent, you are presumed not to have a controlling influence.

Senator REED. Unless you have some type of arrangement beyond your ownership that would give you——

Mr. ALVAREZ. You are presumed by law not to have a controlling influence unless the Federal Reserve Board, by a preponderance of evidence, can overcome that presumption. That presumption is just below 5 percent. Between 5 percent and 25 percent, the Board could find you have a controlling influence, and you look at all the facts and circumstances. And we, in fact, have regulatory presumptions that under certain circumstances, you are in control. So the presumption switches the other way when you go above 5 percent.

Senator REED. If I can just follow up, and I do not want to—because my colleagues have questions, also.

Are you saying, though, these transactions are specifically structured at 4.9 percent. So the burden of proof is on the Federal Reserve to say that there is something else going on out there that is not represented by the stock ownership?

Mr. ALVAREZ. Correct.

Senator REED. And that is a fairly high burden of proof?

Mr. ALVAREZ. That is absolutely right.

Senator REED. And in your review you told, you said you look at all the different instruments, do they have puts? Do they have special consultative arrangements, et cetera. But if you challenged this ownership and went to court or tried some court action, you would have a significant burden to prove if they stay at 4.9 percent?

Mr. ALVAREZ. Yes, sir.

Senator REED. I think what that does, that implicates some of the issues that both the Chairman and Senator Bayh and Senator Shelby have raised, which is in this safe harbor of less than 5 percent, your instincts might say they have this influence and it could be problematic. But we really do not have the kind of legal authority to go in and second guess the investment. Is that fair?

Mr. ALVAREZ. That is correct. I would add just two small points. One is we have not seen that so far. There has not been any under 5 percent investment we have been particularly worried about. And second, this rule applies to everyone, not just sovereign wealth funds. So other private investors are in the same position.

Senator REED. Thank you.

Chairman DODD. I just wanted to now turn to Senator Shelby. I asked my staff, and I have submitted a copy to my two colleagues to look at this. This is in my hand, the form required if you have more than 5 percent interest. There are 12 questions. Are you familiar with this?

Mr. ALVAREZ. Which form is it?

Chairman DODD. The 5 percent or less, excuse me. This is the—I do not know what—this is specifically——

Mr. ALVAREZ. This is a Federal Reserve form?

Chairman DODD. It is the SEC form, excuse me. And it is a—I filled out a form this morning for my 3-year-old to go to preschool over here. Believe me, I answered a lot more questions than this one here requires about it. And I am just sort of stunned. In terms of to determine whether or not abiding by SEC standards, it is a rather simplistic set of questions.

I just wondered if you have any response to this at all. I am not trying to point a finger at you specifically, but it just seems to me

at a time when we talk about an issue of this magnitude that we would have a questionnaire with some very simple responses, and that is all we get out of it.

You are familiar with this, obviously?

Mr. TAFARA. Not intimately, but certainly there are—there is basic information that is sought once you have got 5 percent or more because that is viewed as having enough influence over—potentially having enough influence over a company that information about you should be made available to the public.

In essence, what we get is we get the name and other identifying information about the beneficial owners of the shares, the sources and the amounts of the funds and other consideration used to purchase the securities, the purpose for which you are acquiring control, any plans or proposals you have with regards to future action, the number of shares beneficially owned, and any other shares that the purchaser has the right to acquire similar to the inquiry that is conducted by the Fed, and information about any contracts or other arrangements with regard to any securities of the issuer.

That is four or five items or six items but pretty important piece of information that, if public, give you a sense of what that investor could be up to in connection with a particular company.

So I am not sure that the simplicity of the form should necessarily indicate that there is inadequacy there. But certainly, if there are more things that people think we should be asking in this context, that is something we are prepared to——

Chairman DODD. One of the questions that has been raised by our colleagues here, about given the world we live in today and the potential influence that can exist, it seems to me there may be a bit more information we would want to know before making a determination that just—if you are at that 4.9 percent, it seems to me there may be a bit more we would want to know to determine whether or not we are abiding, in effect, by the spirit if not the letter of the law when it comes to the kind of controlling influence, the language of controlling influence that could be important.

Anyway, let me turn to Senator Shelby.

Senator SHELBY. Mr. Alvarez, what is roughly the market capitalization of your top 10 banks that you regulate, just roughly, all together today or in the last month? What is their capitalization? In other words, what are they worth together on the market, just roughly?

Mr. ALVAREZ. I could not tell you the market capitalization. The assets, though——

Senator SHELBY. No, we are talking about their stock.

Mr. ALVAREZ [continuing]. Something on the order of maybe a trillion dollars.

Senator SHELBY. What is their stock worth? What is their market capital?

Mr. ALVAREZ. I do not know.

Senator SHELBY. It would not be a trillion dollars, would it, the 10 top banks?

Mr. ALVAREZ. I am not certain. I would have to——

Senator SHELBY. Can you get that for the record?

Mr. ALVAREZ. I can certainly get that for you.

Senator SHELBY. If these sovereign wealth funds are going to grow, as some people predict, to $15 trillion they are going to have the money as we export our wealth, buying oil and buying goods and so forth, to these countries who are looking for places to invest. You can see that we are just scratching the surface now on what is going to flow toward us and also toward Europe.

And your challenge is going to be a lot greater than probably maybe you do think you are going to have. But I worry about it. We better worry about it. This panel is serious about it.

I do not know the answer to it because we do not generate enough savings in this country. We do not have a surplus of savings to invest collectively in this country. And money, at the end of the day, will find its best investment. What I am afraid of, we are going to be owned and controlled and influenced by countries, sovereign wealth countries. And I believe it was Senator Bayh that made a good point earlier, we have always tried to say in this country, and I believe the policy has been basically, keep the government out of business. Let the private market work. Let the market work.

But we are now inviting sovereign wealth funds, countries that own these and have got the money, to buy up and buy parts and a lot of times buy up whole companies. That has got to be a real challenge for this country, emotionally, financially, politically, and otherwise in this country.

Who is going to influence this country? Will it be the American people? Or will it be other people that own us? We know what will happen. The people who own, Senator Bayh brought this up. If you are investing, you are not going to be a passive investor, not long. I mean, you know, you are influencing whoever is on that board some way because you have got the clout, you have got the money. Let us be honest about it.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very, very much.

Any additional questions?

Senator BAYH. I just had two but Senator Reed comes first.

Senator REED. I had just one question, if I may, excuse me.

You indicated, in response to questions Senator Bayh and I both had, that you would be able to essentially track the lending of a sovereign wealth fund to an investor in a publicly held company because that investor would have to disclose their source of financing.

Do you have those statistics? Could you tell us—not just today, but could you tell us what percentage, what activity sovereign wealth funds have, not just direct investment but in lending to investors in our economy and publicly held companies?

Mr. TAFARA. I certainly can inquire. I do not know how we would collect the information in the way you are suggesting. Certainly, when you are a 5 percent beneficial owner of a company, one of the things you are supposed to disclose is the sources of those funds. I will have to check back at the SEC as to whether or not there is a way of gathering the information because you are talking about lending that could be done to a whole host of entities——

Senator REED. Right.

Mr. TAFARA [continuing]. That then go on to purchase interest in U.S. companies. I do not have the answer for you now.

Senator REED. It would seem to me that that is something, that is information that I think you would want to have, we would want to have. And it is something that would focus more attention perhaps on who is lending to these investors.

I get the sense—I do not want to trivialize this—but it might be sort of formulaic that they submit their forms, which you are in the disclosure business. They check the box, borrowed $2 billion from the government of X or the sovereign wealth fund. That does not set any bells or whistles off because they are disclosing it. But collectively it might set off lots of bells and whistles. And I think you better begin, I would suggest, to think about collecting the information and then looking at it.

Mr. TAFARA. And I think the further issue we will have to consider is that this could be part of a chain. In other words——

Senator REED. Exactly.

Mr. TAFARA [continuing]. Will you be able to get all the way back to the original, original source of the funds? I am not sure about that. But it is certainly something where we will inquire about that.

Senator BAYH. Senator, if I could follow up on your question, are you getting at the point where let us say, Mr. Tafara, there are three or four intermediaries, investment banks let us say, and a lender to each of them were to acquire 4 percent, 4 percent through intermediary A, B, C, and D. So through each of those entities they would be below the 5 percent threshold. But when you aggregate them together to the lender, they would be well in addition to that? Is that what you were driving at?

Senator REED. Well, I think that is possible, but in effect, this is the question of who is influencing who. If you have an investor in a public company or a financial institution who appears to be a private investment fund something like this, but his sole course of—he has got $2 million in equity and $1 billion in borrowings, I would suspect he would be very responsive to his lender and that might translate.

So again, I think at this juncture having that information is something as we go forward, you consciously have to think about doing it in a systematic way.

Senator BAYH. Gentlemen, I just had two other quick questions. You are familiar with the notion of reciprocity, I am sure. Do you find it ironic that some of the countries restrict investment by U.S. private investors in some of these sectors in their own countries and yet seek to invest in some of these sectors in our own? Is that something we should consider as policymakers, the notion of reciprocity and asking if they open their markets to investment?

Mr. ALVAREZ. The decision on reciprocity is clearly your decision to make, and there has been a conscious decision through the years in the banking area to focus on national treatment as opposed to reciprocity. So we treat foreign investors in the United States in the same way that we treat domestic investors and not based on reciprocity.

Senator BAYH. But when it is a government entity making the investment and that government's policy is to restrict U.S. investors, is that not a fair consideration for us to take into our deliberations?

Mr. ALVAREZ. I think it is certainly a fair consideration for you to take into account. I think the notion of national treatment, as opposed to reciprocity, is based on the idea of us being an open market and wanting to invite funds and investment opportunities as much as possible with the hope that success here would be an inspiration to other countries that they should be open, as well.

But that is clearly a decision for the Congress to make.

Senator BAYH. My last question, Chairman, is are either of you gentlemen familiar with the debate about best practices being defined under the auspices of the IMF on a voluntary basis? There is some positive movement there, and I must say the Gulf countries and the Singapore entity have been exemplary in their behavior, as far as I know. They have not pursued a political agenda or that kind of thing. My guess is that there may be some rallying around of that sort of thing.

My questions to you—which I would view as a positive development.

My question would be, just two or three related to that. What do we do about outliers, people who just chose not to participate in the best practices? No. 2, what about those who say they will abide by them? How do we verify that they are actually doing that? And No. 3, what should the consequences, if any, be for noncompliance?

In other words, might we not have a bifurcated system where those who we can verify were abiding by the best practices might be subject to one regulatory regime and those that did not might be subject to somewhat different scrutiny?

Mr. TAFARA. As I said, I think the good news from our perspective is that the IMF initiative and the OECD initiative actually mimic the requirements we already have as a mandatory matter in the United States when it comes to transparency and disclosure. So we have a way of giving effect to what is a voluntary code by virtue of the requirements that are built in to the Federal securities laws. And in that sense, I think we are ahead of the curve.

This may be a more important issue for other jurisdictions that are going to be relying on this voluntary code, as opposed to statutory requirements in place in those jurisdictions.

Now there will be an issue as to a couple of things that may be in this code that are not part of our statutory framework, which we think are good and would like to see these funds abide by. We will have to see if there are any outliers and what the consequences could be for those outliers. It ultimately may end up being a decision for you.

Senator BAYH. I am a little more concerned, Mr. Tafara, let us take for instance the issue of intellectual property. Some countries have passed intellectual property protections but gee, unfortunately they are just not enforced very vigorously. So what do we do about countries that say oh, of course we will abide by the practices. Don't we need to trust but verify? And what do we do if they are not living up to their word?

Mr. TAFARA. As I said, the good news for us is those are practices that are built into our laws. So we have a way, we have an obligation to verify and we have a way of enforcing. So in that respect, I think we are in a better place than some of our friends in other parts—in the rest of the world.

Senator BAYH. Anything from you, Mr. Alvarez, about best practices or compliance and that kind of thing?

Mr. ALVAREZ. I think we endorse the efforts to have best practices but whether a wealth fund complies with the best practices or not, if they need approval from the Federal Reserve, they are going to have to meet the informational requirements of the Federal Reserve to grant that approval and they will be subject to the same laws as everyone else.

So we will have some mechanism to enforce compliance across the board. I think there will also be tremendous pressure on sovereign wealth funds that choose not to comply with those best practices to comply, because I think the worldwide pressure is going to build.

Senator BAYH. Well, I agree with that, but as I observed with regard to the situation in Tibet, you know occasionally global pressure does not affect some countries' behavior because they have other values and agenda that they might find to be appropriate for themselves but we would look at and simply have a difference of opinion about.

Mr. TAFARA. The one thing I might add is that I suspect, given that this is being developed by the IMF and it is a membership organization, one of the means the IMF may have available to it for enforcing its codes would have to do with the administration of membership. And there is pressure that can be brought to bear there. I take your point that pressure does not always work, but there may be tools available to the IMF to actually give teeth to this voluntary code that they are coming up with. I suspect that is something that is under consideration by the organization.

The one other piece of information I wanted to add, I do not have the numbers on the market capitalization of the financial sector, but we have looked at market capitalization in the United States generally speaking as against sovereign wealth funds and the capitalization is at $56 trillion to $60 trillion now and sovereign wealth funds are at 2.5. Now that is going to grow, as we know, over the course of the next years. But that gives some context to what we are talking about here.

Chairman DODD. Senator, thank you very much. Excellent questions, by the way. And we thank both of you very much, and there may be some additional questions that members may have that were here or those who were not able to be here this morning.

Senator SHELBY. Mr. Chairman, I have a number for the record, that I would like to submit.

Chairman DODD. They will be submitted and we would ask both of you, if you could, in a timely fashion to share with us your observations and responses to those questions.

And we thank both of you very much. It was very, very informative, very, very helpful. And it is—the Federal Reserve, I want to say, has been very, very responsive. Chairman Bernanke has been here. Don Kohn has been up to this Committee. We have had, over the last number of months since January, we have had you here a lot on various subject matters.

The SEC, Christopher Cox was up several times before the Committee, as well. And we are very grateful, knowing everything else

you have got to deal with here, to be here and come before the Committee.

And I will express once again my disappointment that Treasury, given its important role in this subject matter, could not, was not willing to submit and have a witness here this morning. It is very disappointing to me.

Senator SHELBY. Mr. Chairman.

Chairman DODD. And they will be before this Committee, I promise them, one way or another. And it will not be a warm welcome either, because I am not happy about the fact they could not be here on a subject matter of this importance.

Senator SHELBY. Mr. Chairman?

Chairman DODD. Yes.

Senator SHELBY. Mr. Chairman, on the subject matter of Treasury not showing up today, I would hope that when you invite the Secretary of the Treasury, Hank Paulson, that we work with all the time, that he will come. But also the Deputy Secretary Kimmitt, because if we are going to deal in CFIUS, and we are, and foreign investment in the U.S., I think we need them both here.

I think you would agree with that, would you not, Senator Bayh?

Chairman DODD. Very good. We thank both of you very much.

Let me jump to our second panel, and we have got some very important witnesses here in the second panel. We appreciate their patience. Let me introduce them if I can.

Jeanne Archibald is a partner at Hogan and Hartson—let me start with—let me get Paul Rose. Let me start with Paul. Paul Rose is Assistant Professor of Law at the Moritz College of Law, Ohio State University, previously a Visiting Assistant Professor in Securities and Finance at Northwestern University. Before that, he practiced law in Covington & Burling, San Francisco office. Professor Rose's areas of research include corporate governance, securities regulation, institutional investors, and comparative corporate law.

David Marchick is the Managing Director and Global Head of Regulatory Affairs for the Carlyle Group. Prior to joining the Carlyle Group, Mr. Marchick was a partner in the law firm of Covington & Burling. In addition, he served under the Clinton administration for 7 years in positions within the White House. He was Trade Representative at the Department of State.

Then we have as our next witness is Jeanne Archibald, as I mentioned, a partner at Hogan and Hartson. She currently directs Hogan and Hartson's International Trade Group. She brings with her a wealth of experience in the field of international trade law, having served as the General Counsel for the Treasury Department, where she helped draft the regulations governing the Committee on Foreign Investment, the CFIUS legislation we have been talking about, and negotiated the first CFIUS-related mitigation agreement. Prior to her service in the Treasury Department, Ms. Archibald served in the Office of the U.S. Trade Representative. She joined Hogan and Hartson in 1993.

Dennis Johnson is the senior portfolio manager in charge of global corporate governance for the California Public Employees' Retirement System, otherwise known as CalPERS. Mr. Johnson is

chiefly responsible for the strategy and day-to-day management of CalPERS' corporate governance activities. His 26 years of experience in investment management include serving as the Managing Director for Citigroup Global Markets and managing global equity and fixed-income investment portfolios. In addition to his duties at CalPERS, Mr. Johnson chairs the Board of Directors for the National Council of Institutional Investors and serves on the Board of Directors of the National Association of Corporate Directors of Northern California Chapter.

We welcome all four of you, very distinguished backgrounds and service to the country and to the institutions you are now associated with. So we thank you very much for being with us, and, of course, you had the wonderful opportunity to be enlightened by the previous witnesses here. So let me introduce you in the order in which I introduced you. And, again, your statements and supporting information will be made a part of the record. I would ask you to keep your remarks to 5 or 6 minutes, if you could.

I would tell my colleagues as well, there is at least one or two votes we are going to have beginning at 12:15. So we will try and get through your presentations, take a few minutes' break, and then come back for the question-and-answer period.

Mr. Rose.

**STATEMENT OF PAUL ROSE, ASSISTANT PROFESSOR OF LAW, MORITZ COLLEGE OF LAW, OHIO STATE UNIVERSITY**

Mr. ROSE. Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to speak to you today on the regulatory framework for sovereign investments and how such investments impact U.S. financial stability.

Sovereign investment takes many forms, including stabilization funds, endowment funds, pension reserve funds, development funds, and sovereign wealth funds. Sovereign wealth funds may be narrowly defined as "government investment vehicles funded by foreign exchange assets and managed separately from official reserves."

SWFs are increasingly important players in our capital markets. The size and impact of SWFs may be given context through comparison with other major investment vehicles such as institutional funds, private equity funds, and hedge funds. If we assume on the high side approximately $3 trillion in sovereign wealth fund assets, sovereign wealth funds manage roughly one-seventh the amount managed by pension funds, one-sixth the amount managed by mutual funds, and one-sixth the amount managed by insurance company funds. On the other hand, as Chairman Dodd mentioned, sovereign wealth fund assets under management are approximately twice that of hedge funds, and roughly three times that of private equity funds. Furthermore, as noted by Treasury Under Secretary David McCormick, SWFs "are set to grow at a much faster pace" than these other investment vehicles.

SWFs also often control relatively larger concentrations of wealth. For example, the largest SWF, the ADIA fund, is more than twice as large as the ten largest hedge funds combined.

Since July 2007, sovereign wealth funds have made a number of investments in U.S. financial institutions, most of which occurred

since the Committee's hearings in November. These investments alone provided approximately $39 billion in much needed capital for the financial institutions. The investments involve less than 10 percent, and typically less than 5 percent, of the banks' outstanding capital, with no control rights. Each investment was designed to be a passive investment, and the sovereign funds and banks have made a point of reassuring the public, other investors and regulators that these are stable, long-term investments.

Three sets of regulations governing SWF investments in financial institutions have shaped the structure of these investments.

The first set of regulations governs the CFIUS process, which, among other things, targets transactions in which a sovereign wealth fund would gain the ability to exercise functional control over a target company.

The other two set of rules are the Bank Holding Company Act, the Change in Bank Control Act, which has been discussed, and also the SEC's disclosure scheme under Section 13(d) of the Exchange Act.

While this framework encourages commercial, non-political investment by SWFs, there are some limitations to the framework.

With respect to SEC enforcement, SEC Chairman Christopher Cox has expressed concern that the SEC may not be able to regulate SWFs as it does other investors, and that considerable conflicts of interest might impair SEC efforts to obtain cooperation from the sovereign that controlled a fund under investigation.

Additionally, sovereign wealth fund investment in financial institutions may create unique systemic risks. For example, sovereign wealth funds could cause significant turmoil if, for reasons of national exigency, a sovereign wealth fund was required to liquidate its positions. Given the importance of financial institutions to the overall economy, the risks created by quick divestment by sovereign wealth funds, although perhaps not likely, could be especially acute.

Another concern with sovereign wealth fund investment that may be amplified by investment in financial firms is the potential for abuse of informational disparities. Easier access to financial firms, which are awash in material, non-public information, enhances the risk of exploitation of unfair market advantages.

While recognizing that the concerns with sovereign investment in financial firms are significant, I do not believe that these concerns need be answered by adding to or amending existing statutes and regulations. First, as Deputy Treasury Secretary Robert Kimmitt has noted, SWFs "have not caused significant financial market disruption and . . . even for investments that do involve control, there is little evidence of any ulterior foreign policy motives in practice." Second, imposing additional regulations on SWFs beyond the reasonable framework now in place may create other, more significant problems, such as a shift in sovereign wealth fund investment away from the U.S. The result of such a shift would be detrimental both because U.S. firms would miss the capital investments, and because the funds may flow to other jurisdictions that may be underregulated. Arguably, this could increase the danger that sovereign wealth funds would be used as political tools to harm our

national interests and make it less likely that our regulators could effectively work against such activities.

In balancing these concerns, I believe the Treasury has ably worked to buttress our regulatory framework by promoting voluntary standards by working directly with sovereign wealth fund, in the case of Abu Dhabi and Singapore, and by encouraging efforts by the IMF to work with sovereign wealth funds on a set of best practices. The IMF's efforts are also supported by the Financial Stability Forum, which is particularly focused on the health of financial institutions and markets.

A robust set of best practices essentially encourages sovereign wealth funds to act like institutional investors: to operate transparently, to maintain adequate risk management structures, to provide adequate disclosures, and to create accountability to regulators, and, we should hope, the citizen beneficiaries of sovereign wealth funds.

The primary limitation of voluntary best practices is, of course, the lack of an enforcement mechanism—other than the possibility of retaliatory economic and political responses, which is, I believe, a quite significant enforcement mechanism. On the other hand, it is not realistic to hold out for the successful negotiation of a multilateral foreign investment agreement that might provide a formal dispute resolution mechanism. Sovereign wealth fund are investing now, and they are here to stay. I believe we can rely on the regulatory tools currently at our disposal while continuing to encourage the creation of best practices for sovereign wealth funds and long term continuing to work on domestic and international initiatives that will ensure the stability of financial institutions and the capital markets.

Thank you.

Chairman DODD. Thank you, Mr. Rose.

Mr. Marchick.

**STATEMENT OF DAVID MARCHICK, MANAGING DIRECTOR AND GLOBAL HEAD OF REGULATORY AFFAIRS, THE CARLYLE GROUP**

Mr. MARCHICK. Thank you very much. Mr. Chairman, Senator Shelby, it is great to be back here before the Committee. I am going to be very brief because I think there has been a thorough discussion. I am just going to address three or four points. I know how busy you are.

Let me start by complimenting the two of you for your leadership on the FINSA. Senator Shelby, you were all over this issue well before Dubai Ports, focused on the importance of having a robust foreign investment screening process for national security. And if you think about the number of pieces of legislation that have passed the Congress in the last few years that affect billions of trillions of dollars of economic activity that were done in a bipartisan way, you can count them on your hands, and you all were really at the forefront of that. So I congratulate you.

Just a few points. The first is I think we need to keep the size of sovereign wealth funds in perspective. One can say that they are large by comparing them to certain things or say that they are small by comparing them to other funds; $3.2 trillion is a huge

amount of money, but compared to the combined size of pension funds and mutual funds, which is about $55 trillion, it is fairly small. Second, even though the investment activity coming from sovereign wealth funds has grown significantly, it still represented about 1.5 percent of overall global M&A last year, so it is fairly small.

Second, I think that there is consensus on the Committee that basically we want this investment in the United States, as opposed to elsewhere, so long as there is not a problem with a particular investment. So we want the investment if it is made for commercial purposes, if it is not going to compromise our national security, if it is not going to compromise our banking system, et cetera. So then the question is: If we want the investment, are our laws adequate to address any government interests that we have with particular investments? So if a sovereign investment fund invests in a Play-Doh factory for our 6- and 4-year-olds or 3-year-olds, you know, who really cares? If they invest in something that affects national security, we have FINSA, which was strengthened under your leadership. If they invest in a defense company, you not only have CFIUS, you have defense regulations that protect the defense supply chain and protection of classified information. If they invest in the chemical sector, there are more than a dozen chemical statutes that govern and five Federal regulatory agencies that govern chemical safety, security, et cetera. And so from my perspective, there is a robust regulatory structure that is adequate to deal with any legitimate government interest.

Third, I think the professor highlighted the importance of the transparency initiatives. I think that you are familiar with those. I hope that you would support those.

Fourth, equally important is just as there is responsibility for the sovereign wealth funds to have a code of conduct and behave appropriately, it is equally, if not more important, that recipient countries remain open to investment, unless there is a particular problem with a particular transaction.

There is cause for concern. If you look at in the last 2 years alone, countries that represent 40 percent of the—that are the recipients of 40 percent of global investment have either passed or are debating laws that limit investments. Some of this is narrowly tailored on national security, like the law that you passed. Some of it goes beyond. But China now regulates investment in a number of sectors. Russia regulates investment in 43 sectors. France regulates investment in 19 sectors, including gambling. Hard to see how that is a national security issue. And there is danger of a downward spiral.

Finally, let me just reflect on Carlyle's experience with sovereign wealth funds or with funds affiliated with government institutions. We have two investors that own a piece of the Carlyle partnership: one is CalPERS, which in 2000 bought 5.5 percent of Carlyle; and last year a fund based in the UAE called Mubadala Development Corporation bought 7.5 percent. Both of these investments are structured exactly alike—completely passive, they wrote us, they made a big investment in us. We work hard to provide an adequate return, strong return. So far we have done fairly well for CalPERS, and hopefully we will continue to do so. They have no control or

no influence over what investments we make. They have no control or influence over how we manage our investments. And they have no control or influence over when we exit. So they are completely passive. We control all our investment decisions.

So that is an example in my view of a positive experience with two different entities affiliated with either the State of California or the state of the UAE in Abu Dhabi. And we are grateful for the confidence that CalPERS and Mubadala has shown us, and hopefully we will be good stewards of their money.

So thank you very much.

Chairman DODD. Thank you very much.

Welcome to the Committee, Ms. Archibald.

**STATEMENT OF JEANNE S. ARCHIBALD, DIRECTOR OF INTERNATIONAL TRADE PRACTICE, HOGAN AND HARTSON LLP**

Ms. ARCHIBALD. Thank you, Chairman Dodd, Senator Shelby. Let me begin by saying that I am not here appearing on behalf of any client. I am here in my personal capacity sharing views that are based on 20 years or more of having looked at the issue of national security with respect to foreign direct investments, either in the Government or in the private sector. And let me just cut right to the chase. I think the issue has been framed well in this hearing so far this morning. People recognize the benefits to the U.S. of an open investment policy, but at the same time, they are trying to ensure that such investments, particularly from foreign government entities, are done in a way that does not endanger national security.

And so the question is: Do we have the tools to give ourselves that assurance? And let me run through some.

CFIUS is obviously a clear one. I do not need to tell anybody sitting in this room today what CFIUS has done in the past and also what it is going to be doing in the future in light of the strengthened statute that was put into place last year. But let me talk about some of the other regulatory schemes that are out there. Mr. Marchick has already referred to a few of them.

Consider, for example, acquisitions in the telecommunications sector. The Communications Act of 1934 absolutely prohibits any foreign government or representative of a foreign government from holding a broadcast or common carrier radio license. The act also imposes an absolute limit of 20 percent on direct holdings by any foreign company, and it has a waivable limit of 25 percent on indirect holdings by foreign companies. In other words, if they establish a subsidiary in the U.S., they can own 25 percent. They can even own above that if there is an approval from the FCC.

Now, it is true that broadcast and radio common carrier licenses are not as important today as they were in the past. But the SEC now has a practice—it is not codified, but it is a consistently applied practice with respect to any application involving telecommunications services by a foreign entity, but they do not approve the application without having it first looked at by the Team Telecom agencies—the Department of Justice, the FBI, the Department of Homeland Security, and, as appropriate, the Department of Defense.

Investors are aware of this practice, and, in fact, with my clients when they are investing in telecommunications, we know that we have to talk to Team Telecom and make sure that if they have any national security or law enforcement concerns, we need to work those out. And typically we attempt to do that before we even approach CFIUS with respect to their review because they will help make the CFIUS process go more smoothly.

Another example, companies that have facility security clearances. Essentially, any company that is doing classified work for the U.S. Government, there is an obligation on the part of the U.S. entity that has a facility security clearance if it is, in fact, negotiating with a foreign entity and that entity is going to obtain foreign ownership, control, or influence over that facility security clearance holder to notify the Department of Defense and, indeed, they will have to work out a plan to mitigate the impact of that foreign ownership control or influence. And if they do not do so, then the facility security clearance will be suspended, and that company will not be able to bid on further classified contracts.

Now, the requirements that are imposed by the Defense Department can be pretty significant. You either enter into a special security arrangement which would allow the foreign entity to have perhaps board representation, but would put in very strict controls to protect the security of the classified work. In other types of cases, when the contracts involved prescribe information, there is a requirement to establish a proxy agreement. And essentially the foreign entity can have an economic interest in the U.S. company, but it can have no management involvement in the company. The company is turned over to a proxy board that is made up solely of U.S. citizens whose appointment is approved by the Department of Defense.

Similar types of restrictions apply in the nuclear power industry. Manufacturers of goods or technology that are made for military purposes require—the manufacturer is required to have a registration under the International Traffic in Arms Regulations. In those instances, if someone is going to take ownership or control, a foreign entity is going to take ownership or control of such a company, again, they are going to have to work with the State Department to ensure that ITAR registration is either amended as necessary or is going to be continued.

I would also note that under the International Investment and Trade in Services Survey Act, there is a requirement for all foreign investments in U.S. business enterprises with assets of $3 million or more—a very small threshold—in which a foreign person owns a voting interest of 10 percent or more, they are subject to a reporting requirement and have to submit information about that investment within 45 days of the completion of the investment.

This is just a very small sampling of what is out there. There could be a much longer list developed. But I think the point is that there are many aspects of U.S. regulation in industries particularly that are sensitive for national security purposes where there are very clear rules and clear opportunities for the U.S. Government to pay close attention to what is happening by way of foreign investment.

I will stop there. Thank you.

Chairman DODD. Thank you very, very much.

Mr. Johnson, thank you for being with us.

**STATEMENT OF DENNIS JOHNSON, DIRECTOR OF CORPORATE GOVERNANCE, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM**

Mr. JOHNSON. Chairman Dodd, Senator Shelby, I am pleased to provide the perspective of an institutional investor on the virtues of transparency and the principled practices of the California Public Employees' Retirement System, which I represent.

CalPERS is the largest public pension plan in the Nation with more than $244 billion in assets under management. We provide retirement and health benefits to 1.5 million members who work in State and local government.

Given our responsibility as a trustee and the fact that our investments span domestic and international markets, not only do we require transparency from our portfolio companies, we believe that we should lead by example in providing transparency into the activities related to our investment portfolio.

We also believe it is crucial to have a principle-based approach for exercising our rights as shareowners in over 8,000 publicly traded companies around the world.

That is why the CalPERS Board of Administration annually reviews and approves the CalPERS' Global Principles of Accountable Corporate Governance.

Our principles create the framework by which CalPERS executes its proxy voting responsibilities in addition to providing a foundation for supporting the system's corporate engagement and governance initiatives. To promote transparency, the CalPERS Policy Subcommittee and Investment Committee discuss and approve the principles in open public sessions. In addition, we maintain a current edition of our principles on the CalPERS website.

There are numerous ways that CalPERS provides transparency for its investment and related activities. Some of the methods for promoting transparency include but are not limited to the following:

The CalPERS Board of Administration has a fiduciary duty to employees, contracting public agencies, and retirees of the pension fund. As a public government entity, this stewardship entails public reporting.

The California Constitution and case law clearly establishes that the CalPERS Public Employees' Retirement Fund is a trust and that the board acts in a fiduciary capacity as the body responsible for managing and administering that trust. Article XVI, Section 17, of the California Constitution provides that the assets of a public pension and retirement system are trust funds and that the retirement board responsible for administration of the retirement system has the sole and exclusive fiduciary responsibility for those assets.

The 13 members of the Board of Administration are either elected by members of the system, appointed, or are designated by law to be on the CalPERS Board of Administration. The board has established various committees that review issues and recommend actions to the full board. The board meets monthly in Sacramento,

but holds one meeting a year in Southern California. Each CalPERS trustee is identified on the CalPERS website.

The Constitution requires that CalPERS assets are held in trust for the exclusive purposes of providing benefits to system members and their beneficiaries, and to defray reasonable expenses of administering the system.

Board members, individually, are responsible for maximizing investment returns to the pension fund, thereby minimizing contributions required of active State, public agency, and school employees and California taxpayers who support employer contributions to the fund. As of June 30, 2007, CalPERS assets included $3.3 billion in employee contributions, $6.4 billion in employer contributions, and investment returns on all such contributions through the 2006–07 fiscal year. Investment income pays 75 cents of every pension dollar received by CalPERS retirees.

CalPERS also posts its investment portfolio in public printed reports and on-line on its website. CalPERS records are readily accessible.

Investment performance results are made available to the public on-line and in printed materials. This includes a Comprehensive Annual Financial Report, the annual Investment Report, monthly Consolidated Investment Activity reports, a Total CalPERS Fund Quarterly Report, and detailed quarterly reports of sub-asset classes, monthly activity reports, and all investment transactions. The CalPERS website also has a complete report of our Alternative Investment Management Program showing investments in hundreds of private equity funds, and their performance.

Proposals to contract with external portfolio managers are also publicly reported, as are investment allocations, commitments, and deployment of capital into the market.

The CalPERS Investment Committee meets in open session, and all policies are presented first in the Policy Subcommittee, then in the full committee, which comprises all 13 board members. Agendas are made available for the public prior to open session meetings. Minutes from the previous meeting are also included in the agenda package.

We appreciate the opportunity to share our experience as a major investor. We hope that this account of our practices regarding transparency, accountability, and our unique fiduciary responsibility to our members will help in addressing the difficult questions that are before this Committee.

Thank you.

Chairman DODD. Thank you very, very much, and I am going to turn to Senator Shelby for some questions. Then Senator Reed will be coming back, and I will have a few questions myself. And we will find we will not have to delay too long as a result of these votes.

Senator SHELBY. Thank you, Mr. Chairman.

Ms. Archibald, in your testimony you write that some regulatory regimes can, and I quote you, "provide an avenue by which the U.S. Government can be made aware of a contemplated or completed investment." Would you give the Committee an example of how this would occur specifically in the financial services sector we are focusing on today? And do you think that the regulatory agen-

cies often find out about sovereign investments in this manner? Or in your experience, did most potential investors come directly to CFIUS?

Ms. ARCHIBALD. Let me try to answer both those questions. An example of how agencies can learn about investments either before or after the fact, one was the Investment Survey Act that I mentioned, where within 45 days of making the investment, there is a requirement to fill out a form notifying the Department of Commerce. You heard the witnesses this morning talk about the requirements when certain thresholds are triggered to notify, for example, the SEC in the acquisition of a public company when it is a percent holding. So there are these various statutes out there that do require disclosure.

In my own experience, I have found that most of the foreign companies that I represent in U.S. acquisitions, in fact, do want to make a CFIUS filing, and they do that in part because if they are planning on making more than one acquisition, or if even the single acquisition is likely to get public attention, they want to be seen as good corporate citizens who are following through on the regulatory structures of——

Senator SHELBY. So transparency is very important here, is it not?

Ms. ARCHIBALD. I think being seen as cooperative and wanting to abide by the regimes that the U.S. Government is setting up is important to them.

Senator SHELBY. OK. Mr. Johnson, your CalPERS, as we all know—and you represent them here—is a huge investor. But do you believe as the Director of Corporate Governance for your pension fund, do you feel that your fund has a level playing field in its competition with sovereign investors?

Mr. JOHNSON. Senator, I am not in a position to say, but I would just indicate that we obviously have a fiduciary duty to our members to maximize the returns for our portfolio, and our board works very vigorously——

Senator SHELBY. When you speak of your members, it would be the members of the California pension fund.

Mr. JOHNSON. That is correct.

Senator SHELBY. State pension fund.

Mr. JOHNSON. That is correct.

Senator SHELBY. OK. Mr. Marchick, do you have concerns about the increasing size of the sovereign wealth funds and the ability of our current regulatory system which we talked about here today to be able to effectively monitor their activities? You heard the questions earlier, and you are very familiar with them.

Mr. MARCHICK. I guess my concern about the size of the sovereign wealth funds——

Senator SHELBY. Turn your microphone on. Is your microphone on?

Mr. MARCHICK. Sorry, sir. I think my concern focused on less the fact that they are getting larger and more—it is indicative of some fundamental problems in the U.S. economy with our deficit going through the roof, current account deficits in China and elsewhere.

Senator SHELBY. Lack of savings?

Mr. MARCHICK. Lack of savings. And so when you have oil prices that are so high and you have China and a few other countries with huge external surpluses, they have to do something with the money. And so, you know, they are growing. I guess my focus is that if they are going to invest the money, I would rather have it invested in the United States than anywhere else, so long as a particular investment does not present a problem.

Senator SHELBY. OK. Professor Rose, in your testimony you quote Under Secretary McCormick's statement that sovereign wealth funds are set to grow at a much faster pace than other investment vehicles. Do you believe that the growth in size of sovereign wealth funds are a greater policy challenge than the fact that they are government owned? Or how do you differentiate here?

Mr. ROSE. Well, the growth certainly does worry me. When you look at present investment levels, I feel comfortable with the regulations that we have in place. I think that the hearing today and the witnesses have done a good job of spelling those out. And if we are thinking about, say, banking, financial services, the testimony seems to have been, well, right now we feel comfortable. If they keep growing, they keep investing, we start to have not just one 5-percent shareholder but, as you mentioned, a number of them, well, then I think maybe the ability to monitor those is diminished and we may need to revisit the regulations that are in place. And I think this Committee is obviously attuned to that issue and is prepared to continue to make sure that the Federal Reserve Board and the SEC are doing their jobs and monitoring it.

Senator SHELBY. And this Committee?

Mr. ROSE. Yes, this Committee.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

You know, I raised the issue before just as a thought. You mentioned the CFIUS legislation. What did you call it, Ms. Archibald? Team——

Ms. ARCHIBALD. Team Telecom.

Chairman DODD. Team Telecom, sort of an example where instead of talking about new authority per se, you get a sense of at least requiring some coordination that goes on, and done expeditiously. One of the things we have tried to do—and I appreciate, Mr. Marchick, your kind comments about the efforts on the CFIUS legislation; Senator Shelby and I were deeply involved in that here—is to make sure that we structured that in a way that would allow you to get answers but do it quickly, and so you do not end up becoming a drag in terms of that very welcomed investment to occur in the country.

It occurs to me here, as I was looking at the various Federal agencies and departments that have some piece of all of this, that we might want to structure something similar to that. If this is going to be a growing issue and you end up with an example that will happen, a Dubai Ports that provokes the kind of public reaction without understanding the issue maybe as thoroughly as we should have at the time, but, nonetheless, it certainly provoked us taking a harder look at CFIUS and structuring it in a way, I think, that satisfied everyone involved. There may be an anticipation of something like that occurring, which may not always be fair, but,

nonetheless, provokes the kind of public response, where the pendulum can swing, as we have seen, periodically, that we might want to look at something like Team Telecom or the CFIUS structure.

I wonder if any of you have any particular comments on that idea. Mr. Marchick?

Mr. MARCHICK. I think it is a very good idea for the following reasons: First, there were two major problems with Dubai Ports. One was just the facts and the politics, and the second was that, notwithstanding Senator Shelby's great efforts when he was the Chairman and he had a hearing on this before anybody else frankly cared about it, there was not enough communication with the Congress so that when a hard case came, nobody had visibility into the process and nobody had confidence in it. And so when you have bad facts and lack of transparency, the system broke down.

So it seems to me that there could be some type of interagency coordination among all the agencies that have any relationship with sovereign wealth fund activity to monitor it, to make sure that they look to see that every government concern is addressed adequately, and if not, they should communicate with you.

So, to my knowledge, there has not been a sovereign wealth fund investment in the United States that has been problematic in 50 years, and some of these funds have been around for 50 years. Does that mean that there are not holes in the system? You know, nobody knows, but they need to be vigilant in this type of coordination and communication not only internally but, equally important, with you and your colleagues so that people up here have confidence in what is going on down there. That is a good idea.

Chairman DODD. Ms. Archibald? Anybody else?

Ms. ARCHIBALD. I agree with that, and one thing I would add to it is perhaps it would be worth considering whether or not one structure to use for that would be to look at this on an industry basis, because sometimes the national security issues will vary industry by industry. So perhaps in the banking and finance industry, you want to get the agencies—and there are many of them in the banking area—to be working together and, in fact, sharing knowledge with each other about these investments.

I do note that one of the changes I have seen in the proposed regulations on CFIUS for foreign government acquisitions, which would include sovereign wealth funds, is the requirement to talk about agreements that the investor may have with others that would get at one of the issues that I know was of concern to Members here, which is the idea of cooperation and acting in concert to beat a particular threshold.

So I think you have got mechanisms in place, and if you just applied them in a couple of other areas, even in an informal way, you will have a much greater sense of confidence that the investments are being monitored in a way that will properly protect national security.

Chairman DODD. Professor Rose.

Mr. ROSE. Well, I agree with both of those comments. I think one argument for a quite broad interagency communication framework would be that, you know, if you have a sovereign wealth fund investor in financial services that starts behaving badly, then cer-

tainly the telecommunications folks should know. These are going to be diversified investors with investments all over companies in the United States and, frankly, I think that having that made public will also help investors in—or, rather, regulators in other countries become aware of this problem. And I think this is part of the important policing effect, I think, that this kind of interagency communication could have.

Chairman DODD. Mr. Johnson.

Mr. JOHNSON. Chairman Dodd, this is an interesting idea, and CalPERS would welcome the opportunity to support you and this Committee in this effort in any way.

Chairman DODD. Well, thanks. Let me ask about the definitions. Treasury Deputy Secretary, despite the fact they are not here today, which we will constantly remind them of this, they defined—Bob Kimmitt defines "sovereign wealth" as "government investment vehicles funded by foreign exchange assets and managed separately from other reserves." Mr. Alvarez in the first panel defines "sovereign wealth" as "an investment fund that is owned by a national or state government."

Is CalPERS a sovereign wealth fund?

Mr. JOHNSON. CalPERS is not a sovereign wealth fund, Chairman Dodd. As I stated in my testimony, we receive assets from the members that we represent, and only a small percentage of——

Chairman DODD. So you are not owned by the State of California?

Mr. JOHNSON. We operate under the Constitution of the State of California.

Chairman DODD. But you are not owned by them?

Mr. JOHNSON. That is correct.

Chairman DODD. Distinguish for me, if you can, these two definitions. Is there something that we as a Committee ought to be—our ears ought to be particularly sensitive to? Is it the last part of this thing, that it is managed separately from official reserves in the Treasury definition as opposed to the Federal Reserve definition? Or is it a distinction without a difference?

Mr. ROSE. Well, I think the Treasury—you know, that was his definition. I do not know if the Treasury has an accepted—if this is their accepted——

Chairman DODD. I do not know either.

Mr. ROSE. I know that the European Union defines "sovereign wealth funds" quite broadly, and they will include these other categories that I mentioned in my statement in there.

I think that the reason why these distinctions can matter is because the different funds may perceive risk differently. They may have different kinds of investment strategies. And for regulators, those differences could matter.

Mr. MARCHICK. The first thing I will do is agree with CalPERS since they are a good investor in Carlyle.

The second thing I would say is I think you have to look at control and who controls the decisions. So if you have an organization like CalPERS, which I think the majority of the board members are not government officials, but they are elected or appointed by their members, that control is not with the government. There are other pension funds where the government in Canada and elsewhere ap-

points all the members or a majority of the members. So, therefore, you know, you have control.

So sovereign wealth funds have been—you know, SWFs, they are almost like a four-letter word now, even though it is just three. I think the key thing is, you know: Is there control? Is there government direction? Are they making decisions for economic reasons or for non-economic reasons? If they are non-economic reasons, how do we react? When an investor invests in the United States, the United States is sovereign, not them. And are our laws and regulations adequate?

Chairman DODD. Let me ask you——

Senator SHELBY. Mr. Chairman, can I ask him one thing along that line?

Chairman DODD. Certainly.

Senator SHELBY. Excuse me.

Chairman DODD. No. Go ahead.

Senator SHELBY. What if they are both? In other words, you are investing for a return, obviously, but you are also going to influence how that institution is run. Two different things, aren't they?

Mr. MARCHICK. It is a very good question——

Senator SHELBY. One is benign, one is not.

Mr. MARCHICK. Right. You take Norway. OK? Everybody is saying Norway is the panacea of transparency. Norway does make some decisions—this is their oil fund—for non-pure economic reasons. They invest in, for example, broadband in Norway, and they say we are doing this because we want broadband to be ubiquitous in Norway. Is that a problem? I do not know. If they invested in the United States and were making investments for reasons that were not perfectly economic, as long as it did not undermine important government interests or trigger any particular regulation or law that does not create problems—you know, that indicates a problem, I guess I would rather—I would love to have their investment in the United States.

Chairman DODD. Well, you raise an interesting point. Let me raise this question with you. It might require a longer answer than the time will permit us at this juncture. But Carlyle is both a recipient of foreign investment funds and an investor, benefiting from——

Mr. MARCHICK. Absolutely.

Chairman DODD [continuing]. Those protections and from the protections of the U.S. securities laws. How would you recommend addressing the conflicts cited if they limit the ability of U.S. authorities to investigate or prosecute insider trading, for example, market manipulation, or other misconduct by rogue sovereign funds?

Mr. MARCHICK. That is not my area of expertise, securities law. I would say that in our case, all of our investors are completely passive, so there is no real issue in terms of how they impact any decisions that Carlyle makes because our investment professionals, whether they are in the United States or Europe or Asia, make their investment decisions based on what they believe is the best opportunity for increasing return for our investors. And if we do a good job, hopefully our investors will keep investing. But I do not have a particular answer to your——

Chairman DODD. Well, I would like you to raise that with folks at your shop.

Mr. MARCHICK. Sure, absolutely.

Chairman DODD. Because it raises that issue for us on this side of the panel here.

Do you have any comment on that question?

Ms. ARCHIBALD. Not that I am in the business of trying to encourage lots and lots of mitigation agreements in the context of a CFIUS review, because there are places where they are proper and useful, and you could get carried away. But if there is an area where you are really concerned about a sovereign investor in a particular industry and where there may be a concern about willingness to work cooperatively with law enforcement when issues do arise, you know, that could always be something that is included as part of a mitigation agreement which is imposed as a condition of agreeing to the investment.

So, again, I think there is a tool—not that it would be used in every case, but there is something that is available there.

Chairman DODD. And, of course, the ideal situation would be to know that in advance to be talking about it, rather than have something come up after the fact.

Ms. ARCHIBALD. That is exactly right. But, again, this may be an area where it is worthwhile getting a little bit of experience. Certainly once there ever were such an issue, I think someone mentioned before the agencies should share this kind of information. It could certainly become a requirement thereafter.

Chairman DODD. Professor Rose, any comments on this?

Mr. ROSE. No. I agree with those comments. It certainly is a problem, I would imagine—I would hope—that the banks would be aware of this and that they might just as a sort of market mechanism structure deals so that they would prevent this kind of activity.

Chairman DODD. Mr. Johnson.

Mr. JOHNSON. No comment, Mr. Chairman.

Chairman DODD. Well, there will probably be some additional questions I may have for you. We are going to take a slight recess here. Senator Reed is coming back to complete his questioning. He will be a few minutes because there are two votes here. I want to make the first vote and the second vote. But I am very grateful to all of you for being a part of this discussion. And when I said at the outset of my comments—and, that is, striking the balance here, again, I think your point, Mr. Marchick, again, is this is a large amount of money. It depends how you look at it in the context of other resources. And, of course, particularly now because we find ourselves vulnerable with our economy being what it is, the foreclosure issues, the seizing up of capital and credit, and so they are going out and seeking capital elsewhere. And there are different motivations that are involved here, and as a result, that is raising some additional concerns that otherwise probably would not be present, at least at this juncture.

So it is important to understand the context in which we are talking about this, not so much the size of it at this juncture, although that is a legitimate issue to raise, but the potential ability for those funds to have a greater influence than they might other-

wise have since your ability to shop elsewhere has been limited by what we are dealing with. And that is a concern I have as Chairman of the Committee.

So I thank you all very, very much. You gave excellent testimony, and it is tremendously helpful.

The Committee will stand in recess for a few minutes.

[Recess.]

Senator REED [presiding]. Chairman Dodd has asked me to reconvene the hearing and, on my behalf, thank you for your testimony and participation. And let me ask a few questions. The Chairman is returning, I assume in a few minutes, and he will ask other questions and wrap up. But thank you very much.

Mr. Marchick, you explained that Carlyle Group has received investments from two government-affiliated entities—a State employees' pension fund and a sovereign wealth fund. Can you describe the extent of information that is available to you about these funds? And would it be useful to you as a company to have additional information that is readily accessible?

Mr. MARCHICK. Thank you for your question. I will call you "Mr. Chairman" for the moment. We are very comfortable with the level of information that we have. Obviously, before taking an investment, we spend a lot of time doing due diligence on the investors, and they spend a lot of time doing due diligence on us, and we get to know each other. We get to know their culture, their goals. Obviously, CalPERS is very well known. They have a phenomenal track record of being good investors and responsible stewards for the pensioners of California. And we have enjoyed that relationship for many, many years, and the investment they have made has been a fantastic investment. When that is realized, it is going to be worth quite a bit of money for the pensioners of California. So we are pleased with it, and hopefully they are pleased with it.

With respect to Mubadala, we did not know much about them. We got to know them last fall, and we are very impressed with them. We got to know their business, their people. What was interesting to us is that most of their leadership are people that either grew up in the United States that are of origin in that region or were trained in the United States, you know, at some of our best institutions—Harvard, Stanford, and others, either for undergrad or business school. And most of the senior leadership at Mubadala spent a number of years at some of our finest institutions, you know, Citibank and Goldman Sachs and others.

So we have a good comfort level with both of our investors and feel very good about their investments and are grateful that they have confidence in us, and hopefully we can continue to enjoy their confidence.

Senator REED. In line with the questions I was addressing to the SEC, just trying to get a handle on the amount of either equity or debt that a sovereign wealth fund is investing in a private equity fund or a hedge fund, that then in turn invests in any publicly held company or financial institution, is that something that you think would be easily obtained or willingly given?

Mr. MARCHICK. It is a good question. We have a number—if you look at the typical investors in private equity funds, the biggest chunk by far are public pension funds like CalPERS and Rhode Is-

land Pension and others. There are also institutional funds, say insurance companies, other private pension funds, pension funds endowments, foundations, et cetera. Then there are individual investors, oftentimes wealthy individuals who either invest directly or invest through aggregators like a Merrill Lynch will raise money from a hundred different wealthy individuals and invest in Carlyle or Blackstone or others. And then, finally, you know, a sovereign wealth fund.

Most of our clients, most of our investors prefer or demand confidentiality. Some of our investors do not. CalPERS for their own purposes discloses every investment they make, and if they are comfortable disclosing it, then we are comfortable disclosing it.

In certain regulatory instances where there is a sensitive investment, some regulators have asked us for a list of investors, and we obviously comply with that if there is a reason for them to be focused on the list of investors. In my view, it does not really matter because all of our investors are completely passive. So it is just like when you invest in your 401(k) or TSP, you put your money in, someone else manages it, and hopefully they do a good job for you. In our case, they invest with us. We hopefully will do a good job. We have a pretty good track record, and if we are good shepherds of their money, then they will keep investing with us.

But who invests with us does not matter in terms of, you know, how the investments are made. When we invest in a particular sector, we are subject to the regulations in that sector. So a telecom company, we are under FCC jurisdiction.

Sorry for going on.

Senator REED. No, no. It is quite helpful. Thank you.

Mr. Johnson, from your perspective, this issue of the level and identity of investors, sovereign wealth funds in particular, any comments?

Mr. JOHNSON. Senator Reed, I would just promote the point that CalPERS advocates disclosure and transparency by investors at large. We try to lead by example. We try to advance this in the marketplace with the development of our own principles in this area.

Senator REED. Thank you.

Let me shift gears for a moment. Professor Rose and Ms. Archibald, we have talked a lot about the Federal securities laws, the Change in Bank Control Act, the Bank Holding Company Act, but there are State laws which are implicated at certain times. Can you comment, Professor, first on any implications that State laws have with respect to these sovereign funds, or either what they are doing now or what they may do?

Mr. ROSE. Well, the only thing that I could offer that I think would be of value is if you were thinking about a sovereign wealth fund and worrying that they would be controlling a company—maybe it is at a level that falls under 4.9 percent—I frankly would be concerned about whether fiduciary duties would be implicated, frankly, if they are acting as a controlling entity and, I suppose, pushing around a board. So from that angle, conceivably you could have State laws implicate. As far as perhaps insurance laws or other State regulations, I do not have as much experience, and I cannot offer any comments on those.

Senator REED. Thank you.

Ms. Archibald, your perspective?

Ms. ARCHIBALD. Yes, I would have to say the same thing. I am not aware of any specific State law that is directly aimed at sovereign wealth funds. Certainly for some of the sectors that we have talked about this morning that are subject to regulation generally, there are State regulations that must be adhered to at the time of a change in control or an acquisition by a foreign entity. But I am not aware of any that are specific to sovereign wealth funds.

Senator REED. Shifting back again to the Federal forum, last year we took action on the Foreign Investment and National Security Act, and it requires that Treasury propose new rules, which also talks about the definition of "control." And under these regulations, the presumption is that 10 percent would be considered a controlling stake. Is that your view, Ms. Archibald? Or I do not want to—this is not a final exam.

Ms. ARCHIBALD. No. Actually, I am glad you asked this question. I was discussing during the break that there has been a misunderstanding, I think, about the regulations that have been in effect for some time.

It is not quite correct to say that there is a presumption that anything that is over 10 percent is controlling or that everything under 10 percent is not controlling. The test that has always been in the regulations but I think is clarified to a much greater degree in the proposal that was issued this week is that where an investment is at or below 10 percent and is purely for passive purposes, then the presumption is that there is not control.

Now, the proposed regulations go on to make very clear that in order to be purely for passive purposes, there can be no action that is taken by the investor that would be inconsistent with a purely passive investment. And so, for example, it would appear that having a single board seat, even if there are no minority shareholder protections, even if there is no special class voting, et cetera, that that is an action that is considered inconsistent with a passive investment. That simply means then that the transaction is appropriate for review by CFIUS. They may still determine that it is not a controlling share, but it is certainly a reviewable transaction.

Senator REED. Well, that circles back to the point that Professor Rose suggested, that on the other side of the transaction, if, in fact, an investor disregards the passive nature, there would be a duty by the directors and the management to resist any measures like that to publicize them. Do you think that would be, you know, under standard corporate law where the fiduciary duty is to ensure—or is there no duty on the other side of the transaction?

Ms. ARCHIBALD. I do not want to hold myself out as an expert on all the rules that apply to public corporations, but certainly in any instance in which an investment was made with the approval of the other shareholders of the company that was purely for passive purposes and there is behavior that is inconsistent with that, I would certainly expect the management of the company to share that information with the rest of the board and to determine what action, if any, was appropriate and available.

Senator REED. I have exhausted my questions, but I do not see the Chairman. So I hesitate to stand in recess for a moment.

We are trying to clarify his—I have guidance that we should stand in recess for a moment. But don't mill around. Hopefully he will be here in a moment. Thank you. The Committee stands in recess.

[Recess.]

Senator REED. Just if I may for a moment reconvene the hearing, Senator Dodd has just informed the staff that he is unable to return. So I want to thank all of you on behalf of the Chairman and the Ranking Member, Senator Shelby, and all of my colleagues for your testimony and for your participation today and for your good work outside this hearing room. Thank you very, very much.

The hearing is adjourned.

[Whereupon, at 1:01 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

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Statement of

Scott G. Alvarez

General Counsel

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

April 24, 2008

Chairman Dodd, Senator Shelby, and members of the Committee, I am pleased to appear today to provide the Committee with information on the regulatory framework that applies to investments by sovereign wealth funds in U.S. banks and bank holding companies. The Board commends the Committee for holding this hearing and for considering the important public policy issues raised by these investments.

As requested, I intend to focus my testimony on the recent sovereign wealth fund investments in U.S. financial institutions and their financial implications, the regulations applicable to investments by these funds in U.S. banking organizations and in foreign banking organizations with U.S. banking operations, and the tools available to the federal banking agencies to ensure that these investments comply with U.S. law. I will begin with some general information about sovereign wealth funds and U.S. banking organizations and a summary of recent investments by sovereign wealth funds in U.S. banks and bank holding companies. Then I will describe the relevant U.S. banking laws applicable to investments by sovereign wealth funds in banks and bank holding companies and the treatment under those laws of these funds by the Federal Reserve.

**Sovereign Wealth Funds**

Broadly speaking, a sovereign wealth fund is an investment fund that is owned by a national or state government. Globally, there are about 30 to 40 sovereign wealth funds at this time. Many sovereign wealth funds were originally set up to help stabilize revenues from the sale of a commodity, such as oil, natural gas or other commodities. They also provide a way to preserve and grow wealth for future generations. Chile, Botswana and Kiribati have established sovereign wealth funds based on their revenues from the sales of copper, diamonds, and

phosphate. Examples of governments that have established funds using oil revenues include Norway, Kuwait, Qatar, and the state of Alaska.

Some developed nations have established sovereign wealth funds using social security or government pension fund surpluses and contributions from taxes and other government revenues. These types of funds invest in a wide range of domestic and foreign assets with the aim of supplementing the financing of social security or government pension programs. Countries with this type of fund include France, Australia, and New Zealand. Other sovereign wealth funds have been established to make profitable use of foreign exchange accumulated as the result of trade imbalances or foreign exchange intervention. Countries with this type of fund include Singapore, Korea, and China.

To achieve their objective of preserving and growing wealth for future generations or of profiting from often temporary surpluses of foreign exchange, sovereign wealth funds--like any investment fund--seek to earn an appropriate risk-adjusted return on the funds that they invest. Sovereign wealth funds apply many of the same kinds of strategies that other investment funds apply. Some funds, such as Norway's, engage solely in making small portfolio investments--i.e., their equity investments are typically below 10 percent of the voting shares of a firm. Others, such as Singapore's Temasek Holdings (Temasek), take substantial stakes in firms in selected domestic and foreign industries.

One of the reasons that sovereign wealth funds have attracted more attention in the past year is their size. The largest funds are very large. For example, Norway's sovereign wealth fund reports total assets of over $350 billion; China's fund and Singapore's two funds each manage assets of at least $100 billion. This places sovereign wealth funds among the largest investment funds worldwide. However, while the estimated $2 to $3 trillion sovereign wealth

funds manage exceeds the $1.4 trillion managed by hedge funds, it is much less than the over $15 trillion managed by pension funds, the $16 trillion managed by insurance companies, or the $21 trillion managed by investment companies.[1] It is an even smaller fraction of global debt and equity securities, which exceed $100 trillion.

Another factor that has made sovereign wealth funds stand out in recent years has been their rapid growth. Estimates suggest that sovereign wealth funds have been growing at a remarkable pace in recent years, possibly quadrupling in size between 2003 and 2007. This rapid growth arises from the growth in revenues from the sale of oil and other commodities, following significant increases in commodities prices. It also arises from the rapid accumulation of foreign exchange reserves and persistent current account imbalances.

A third reason that sovereign wealth funds have attracted attention in the United States recently has been their investments in U.S. financial institutions, which is what I will talk about today.

**Investments of Sovereign Wealth Funds in U.S. Financial Services Companies**

The U.S. banking system is being challenged by current market conditions. Insured commercial banks have experienced deterioration in asset quality and earnings, much attributable to the effect of the slowing residential housing market on the quality of residential mortgage and construction loans. Fortunately, banks encountered these conditions after a sustained period of strong earnings and capital accumulation that strengthened the financial condition of the industry, and should reduce potential threats to their solvency from current market conditions. Several large U.S. banking organizations have also recently raised new capital. That capital has come from a broad range of sources, including public offerings, private investors, private and

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[1] The figures for assets managed by pension funds, insurance companies, and investment companies are for OECD countries only.

public equity firms and sovereign wealth funds. The ability of U.S. financial institutions to raise large amounts of capital from a diverse domestic and international investor base under stress conditions evidences market confidence in the transparency and ultimate resiliency of these institutions. The Federal Reserve has welcomed and encouraged capital raising initiatives that buttress the financial strength of U.S. financial institutions and better positions these institutions to weather the current financial turmoil.

Since August 2007, U.S. banking organizations have raised approximately $100 billion in new capital. During this period, sovereign wealth funds have been an important source of capital for U.S. financial institutions. Sovereign wealth funds made direct investments totaling more than $30 billion in U.S. financial firms, including approximately $17 billion in commercial banking organizations.

The recent wave of sovereign wealth fund investments in U.S. financial institutions consists of noncontrolling investments below 10 percent (and often below 5 percent) of voting equity. For example, Citigroup recently received a capital infusion from the Kuwait Investment Authority (KIA), the Abu Dhabi Investment Authority (ADIA), and the Government of Singapore Investment Corporation (GIC), one of Singapore's two sovereign investment funds. None of these funds acquired more than 5 percent of Citigroup's total equity. Three sovereign wealth funds, the Korea Investment Corporation (KIC), Temasek, and KIA, each made similar noncontrolling investments in convertible preferred stock in Merrill Lynch and Co. These are all passive investments that have not triggered formal review under U.S. banking law, as I will explain in a moment. The press releases from the financial institutions announcing each of these recent investments have generally emphasized that these sovereign investors will not seek to

exercise control over the target company and will not have representation on the target company's board of directors or take part in its management.

**Thresholds for Federal Reserve Review**

As a general matter, the same statutory and regulatory thresholds for review by the federal banking agencies apply to investments by sovereign wealth funds as apply to investments by other domestic and foreign investors in U.S. banks and bank holding companies. These requirements are established in two federal statutes, the Bank Holding Company Act (BHC Act) and the Change in Bank Control Act (CIBC Act).[2] The BHC Act requires any company to obtain approval from the Federal Reserve before making a direct or indirect investment in a U.S. bank or bank holding company if the investment meets certain thresholds. In particular, the BHC Act requires Board review when a company acquires: (1) ownership or control of 25 percent or more of any class of voting securities of the bank or bank holding company, (2) control of the election of a majority of the board of directors of the bank or bank holding company, or (3) the ability to exercise a controlling influence over the management or policies of the bank or bank holding company.

A formal determination that a company exercises a controlling influence over the management or policies of a bank or bank holding company may only be made after the Board has provided notice to the company and offered an opportunity for a hearing. In determining whether an investor may exercise a controlling influence over the management or policies of a U.S. bank or bank holding company for purposes of the BHC Act, the Board considers the size of the investment, the involvement of the investor in the management of the bank or bank

[2] A third federal statute, the Savings and Loan Holding Company Act, governs investments in companies that control savings associations. The thresholds and standards for review of investments in savings associations established in that act are administered by the Office of Thrift Supervision and are nearly identical to those established by the BHC Act.

holding company, any business relationships between the investor and the bank or bank holding company, and other relevant factors indicating an intent or ability to significantly influence the management or operations of the bank or bank holding company. The BHC Act presumes that an investor that controls less than 5 percent of the voting shares of a U.S. bank or bank holding company does not have a controlling influence over that bank or bank holding company, and the Board generally has not found that a controlling influence exists if the investment represents less than 10 percent of the bank or bank holding company's voting shares.

A company that meets any of these thresholds is called a "bank holding company" and, in addition to the prior approval process, is subject by statute to supervision by the Federal Reserve, including examination, reporting, and capital requirements, as well as to the Act's restrictions on the mixing of banking and commerce. Moreover, a company that makes an investment that causes it to be a bank holding company is subject to a prior review requirement at a lower threshold for any investments in additional banks or bank holding companies. If a company already controls one U.S. bank, the company is required by statute to obtain approval from the Federal Reserve prior to acquiring more than 5 percent of the voting shares of another U.S. bank or bank holding company.

There is one additional requirement governing the applicability of the BHC Act that is noteworthy. The BHC Act applies only to investments in banks and bank holding companies that are made by "companies." The definition of "company" in the Act specifies a number of types of entities that fall within the definition, including corporations, partnerships, and trusts. However, the definition of a company does not reference governments. On this basis, the Board has long held that the provisions of the BHC Act do not apply to direct investments made by the U.S. government or by any state or foreign government.

The BHC Act specifically excludes from its coverage a corporation controlled by the United States or by a state government. Thus, investment companies controlled by the states of Alaska and New Jersey, for example, are specifically excluded from the requirements of the BHC Act. The exclusion does not, on its face, apply to companies controlled by foreign governments and, as I will discuss in more detail below, the Board has not extended this exclusion to companies controlled by foreign governments that make investments in U.S. banks and bank holding companies. Foreign governments to date have primarily invested through sovereign wealth funds that are companies controlled by the foreign government. The effect of the Board's long-standing interpretation is that a sovereign wealth fund that seeks to make an investment in a U.S. bank or bank holding company that exceeds the thresholds in the BHC Act would be required to obtain Board approval prior to making the investment and would become subject to the other provisions of the BHC Act, but its parent foreign government would not.

Investments by sovereign wealth funds that do not trigger the requirements of the BHC Act may nevertheless require approval from a federal banking agency under the CIBC Act. Prior approval from the Federal Reserve under the CIBC Act generally is required for any acquisition of 10 percent or more of any class of voting securities of a state member bank or bank holding company. Unlike the BHC Act, which imposes ongoing restrictions on the nonbanking activities of corporate owners of banks as well as ongoing reporting, examination, capital, and other requirements, the CIBC Act does not impose any activity limitations or any ongoing supervisory requirements on owners of banks.

When an investor applies for the prior approval of the Federal Reserve to make an investment in a bank or bank holding company that triggers the review thresholds under the BHC Act or the CIBC Act, the Federal Reserve evaluates the application under the statutory

requirements of those Acts. The BHC Act mandates that the Federal Reserve consider a number of factors when acting on BHC Act applications, including competitive, supervisory, financial and managerial factors (the last includes consideration of the competence, experience, and integrity of the officers, directors, and principal shareholders of the company or bank). The CIBC Act also requires the federal banking agency to consider specific factors, including competitive and informational standards as well as whether the transaction would jeopardize the financial stability of the bank, prejudice the interests of the depositors of the bank, or result in an adverse effect on the Deposit Insurance Fund.

Most sovereign wealth funds, like many other investors including U.S. investment banking firms, hedge funds, and private equity pools, have structured their investments so as not to trigger the thresholds for review and approval under either the BHC Act or the CIBC Act. Instead, sovereign wealth funds have limited their investments to amounts that represent less than 10 percent of the voting shares of the banking organization and have designed their investments to be passive and without the connections or relationships that might allow the sovereign wealth funds to control the U.S. banking organization.

**Investments of Sovereign Wealth Funds in Foreign Banking Organizations**

Several sovereign wealth funds, including some that have attracted attention with their recent investments in U.S. financial institutions, also have interests in foreign banks with U.S. operations. The levels of ownership range from well below 10 percent to, in some cases, interests that indicate control of the foreign bank. These foreign banks generally conduct their U.S. banking operations through direct offices--branches and agencies; none controlled by a sovereign wealth fund currently controls a U.S. bank subsidiary. U.S. branches and agencies of foreign banks do not have all of the powers of U.S. bank branches. Specifically, U.S. branches

of foreign banks are not permitted to accept retail deposits (i.e., deposits less than $100,000), except for a small number of grandfathered cases. Agencies operated by foreign banks cannot accept deposits from citizens or residents of the United States. Sovereign wealth funds with interests in foreign banks that operate U.S. branches and agencies include Temasek, GIC, China Investment Corporation (CIC), Central Huijin Investment Company (Huijin),[3] KIA, and ADIA.

After 1991, the International Banking Act (IBA) provided that any foreign bank seeking to establish a U.S. branch or agency must apply to the Federal Reserve for prior approval. All foreign banks controlled by sovereign wealth funds that have U.S. branches or agencies established those branches or agencies before the IBA was amended in 1991 to require Federal Reserve approval of the establishment by foreign banks of new U.S. branches and agencies.[4] Any future applications by foreign banks controlled by sovereign wealth funds to establish U.S. branches and agencies would be evaluated by the Federal Reserve pursuant to the standards in the IBA. An important factor the Federal Reserve is required to consider under the IBA is whether the foreign bank is supervised on a comprehensive consolidated basis by its home country supervisor. The Federal Reserve also examines how the supervisor monitors relationships and transactions between the foreign bank and any related party, including controlling sovereign wealth funds and other controlling shareholders. A number of additional

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[3] Huijin, a Chinese company with a mandate to improve corporate governance and initiate reforms in the state-owned financial sector, was created to act as a government holding company for Chinese state-owned banks acquired as a result of capital injections by the Chinese government. Huijin is expected to be acquired by CIC in the near future.

[4] Huijin acquired its controlling interest in one foreign bank, Bank of China, after the IBA was amended, but also after the establishment of Bank of China's U.S. branches. When a company makes a controlling investment in a foreign bank that already has U.S. branches or agencies, under Federal Reserve regulations the foreign bank is required to notify the Federal Reserve within ten days of the investment and report the shareholding in annual filings with the Federal Reserve.

factors are also considered, including the anti-money laundering regime of the foreign bank and its supervisor, the consent of the appropriate home country authorities, the financial and managerial resources of the foreign bank, and whether the foreign bank and any controlling company (including any controlling sovereign wealth fund) have made adequate assurances concerning provision of information to the Federal Reserve about its operations and activities.

**The Federal Reserve's Approach to Foreign Government Ownership**

As I noted above, the Federal Reserve has drawn a distinction between foreign governments themselves, which are not treated as "companies" subject to the BHC Act, and government-owned entities such as sovereign wealth funds, which are treated as companies and are subject to the BHC Act.

The position that the BHC Act does not apply to foreign governments themselves is long held by the Board.[5] It noted this view and revisited the reasons for this position in 1982 in connection with an application by an Italian government-owned bank to acquire a controlling interest in a U.S. bank.[6] At that time, the Board reiterated its view that the BHC Act should not be applied to the Italian government. At the same time, the Board noted that significant policy issues were raised by foreign government ownership of a U.S. bank, including in particular issues related to the mixing of banking and commerce and to interstate banking in the United States (which was largely prohibited at the time). The Board invited Congress to address the

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[5] Governor John P. LaWare discussed this position and other issues related to foreign government ownership of foreign banks operating in the United States in testimony before the House Committee on Banking, Finance and Urban Affairs in 1992. 78 Federal Reserve Bulletin 495 (1992).

[6] Banca Commerciale Italiana, 68 Federal Reserve Bulletin 423 (1982).

issue and noted that the concept of national treatment could justify applying the BHC Act to foreign government-owned entities.[7]

In 1988, an Italian bank controlled by the Italian government again applied to the Federal Reserve to acquire a U.S. bank. The Board carefully considered the applicability of the BHC Act to foreign governments and foreign government-owned entities and reiterated its earlier conclusion that, as a legal matter, foreign governments were not themselves "companies" for purposes of the BHC Act and were therefore not covered by the Act. The Board found, however, that the investment fund controlled by the Italian Government, the Istituto per la Ricostruzione Industriale (IRI), was structured as a corporate vehicle and was therefore a company under the Act and subject to the Act.[8]

At the same time, the Board indicated its willingness to grant exemptions from the nonbanking restrictions in the BHC Act to IRI for its commercial investments, citing IRI's status as a nonoperating instrumentality for holding government interests. The Board also expressed its willingness to apply exemptions available under the BHC Act to the nonbanking investments of other foreign government-owned companies of a character similar to that of IRI, as long as their foreign bank subsidiaries conducted banking in the United States only through branches and agencies and not through U.S. subsidiary banks. This approach limited the extraterritorial effects of U.S. economic regulation on foreign companies in recognition of the fact that foreign countries may choose to organize their economies differently from the United States. It also kept

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[7] Later in 1982, a subcommittee of the House Committee on Government Operations held hearings on foreign government and foreign investor control of U.S. banks. *Hearing on Foreign Government and Foreign Investor Control of U.S. Banks, before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations*, 97 Cong. 2 Sess. (Government Printing Office, 1982). No legislation, however, was proposed.

[8] Letter from William W. Wiles, Secretary of the Board, to Patricia S. Skigen (August 19, 1988).

the United States open to a significant number of foreign banking organizations whose U.S. banking activities might otherwise have been severely curtailed. Notwithstanding the availability of this exemption for government-owned companies (including sovereign wealth funds) that control foreign banks with U.S. banking operations, the U.S. operations of foreign banks controlled by government-owned companies are subject to the same degree of U.S. regulation and supervision as the U.S. operations of other foreign banks.

**Regulation of Bank Holding Companies**

Since a sovereign wealth fund is a company for purposes of the BHC Act, if a fund were to acquire control of a U.S. bank or bank holding company, it would be treated as a bank holding company and would be subject to the U.S. regulatory regime applicable to such companies. If a foreign bank that is owned by a sovereign wealth fund were to acquire control of a U.S. bank, that foreign bank would also be subject to the regulatory regime applicable to other bank holding companies. This regime is designed in significant part to help ensure the safety and soundness of U.S. bank subsidiaries of bank holding companies. Under the BHC Act, the Board has broad authority to prevent bank holding companies from engaging in unsafe or unsound practices. As part of the regulatory and supervisory process, the Board may examine bank holding companies and their subsidiaries where necessary or appropriate to protect the U.S. bank affiliates and has the authority to require periodic and annual reporting in many areas, including on ownership, risk management and financial condition.

Among the most important tools that U.S. bank regulators have to protect the safety and soundness of U.S. banks are the legal restrictions that limit the ability of a bank to lend to affiliates. Section 23A of the Federal Reserve Act provides that a bank may not lend more than 10 percent of its capital to any one affiliate or more than 20 percent of its capital to all affiliates

combined. Of equal importance, any loan to an affiliate must be either fully collateralized by cash or U.S. Treasury securities or overcollateralized by other assets in an amount of 10 to 30 percent, depending on the type of asset or instrument used to secure the loan. Section 23A also prohibits the purchase of low-quality assets by a U.S. bank from its affiliates. Section 23B of the Federal Reserve Act requires that all transactions between a bank and its affiliates be conducted only on an arms-length basis. These restrictions are designed to limit the ability of an owner of a bank to exploit the bank for the benefit of the rest of the organization.

With respect to a U.S. bank or bank holding company that might be owned by a sovereign wealth fund, these restrictions on transactions with affiliates would apply to transactions by the bank with the sovereign wealth fund itself as well as to transactions with companies controlled by the sovereign wealth fund. Moreover, the restrictions would apply to companies controlled by the same government through other sovereign wealth funds of that government. Thus, a U.S. bank controlled by a sovereign wealth fund would not be permitted to fund substantially the operations of other companies controlled by the same sovereign wealth fund or its government owner, or provide any uncollateralized loans to such companies, or purchase low-quality assets from those companies. In this regard, it would be important for any U.S. bank that might come to be controlled by a sovereign wealth fund to have information on which companies are controlled by the fund and by the government that owns the fund. This type of transparency would be necessary to allow the bank to comply with the affiliate transaction restrictions of sections 23A and 23B.

**Conclusion**

Sovereign wealth funds have recently made significant investments in U.S. financial institutions, thereby improving the capital position of these firms and demonstrating confidence

in the viability of these U.S. firms. These investments have also attracted much attention and there is no doubt that sovereign wealth funds are growing in size and number and are making increasingly significant investments in financial services organizations worldwide. But foreign government-owned entities, including sovereign wealth funds, have owned foreign banks with U.S. operations for many years. The Board has long taken the position that while foreign governments themselves are not companies subject to the BHC Act, foreign government-owned corporations such as sovereign wealth funds are companies. Thus any proposed controlling investment in a U.S. bank or bank holding company by a sovereign wealth fund would be subject to Federal Reserve approval.

Sovereign wealth funds, like private investment funds, U.S. state investment vehicles, hedge funds, private equity firms, and many other investors, have generally made investments at levels that are not large enough to trigger the thresholds for review and approval by the federal banking agencies under the federal banking laws. If a sovereign wealth fund were to make an investment in a U.S. banking organization that triggers one of these thresholds, the application would be evaluated by the Federal Reserve or other appropriate federal banking agency under the relevant statutes with no preference or handicap relative to other investors. Any sovereign wealth fund controlling a U.S. bank or bank holding company would be required to operate subject to the limitations on affiliate transactions in sections 23A and 23B of the Federal Reserve Act and the bank or bank holding company would be subject to the full range of regulatory and supervisory tools available to the Board.

I appreciate the opportunity to explain these issues to the Committee.

The Regulatory Framework for Sovereign Investments

Testimony
Before the Committee on Banking, Housing, and Urban Affairs
United States Senate

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By
Ethiopis Tafara
Director, Office of International Affairs
U.S. Securities and Exchange Commission

Chairman Dodd, Senator Shelby, and Members of the Committee:

Thank you for inviting me to speak before today's hearing on the regulatory framework applicable to foreign government investment in the U.S. economy and financial sector.

I should state at the outset that, as Chairman Cox, Secretary Paulson, and others have noted on many occasions, the United States welcomes foreign investment. I know that is a view widely shared and supported by members of this Committee as well. You have asked me to speak to the particular issues that arise not from foreign investment, but from foreign government investment in the United States, from the standpoint of the Securities and Exchange Commission. There are some important differences between the two.

A bit of history to begin. As others have noted, government ownership of investment funds and businesses is not new, but the scale on which today's sovereign wealth funds and sovereign businesses are operating is new – as is their remarkable growth over the past few years. Today, sovereign wealth funds hold, by some estimates, more than $2.5 trillion in assets. That is more than all the world's hedge funds combined. And sovereign business is challenging in size even the very largest privately owned companies: witness PetroChina's for a time eclipsing ExxonMobil as the world's largest company by market value. It is typical of today's publicly held state-owned enterprises in that PetroChina has offered just 12% of its shares to the public, according to regulatory filings.

There are important differences between sovereign businesses and sovereign wealth funds, as well. Unlike the case of sovereign wealth funds, whose portfolio investment may be purely passive, a sovereign business is controlled by the government whose assets comprise a majority of its ownership. Any analysis of foreign government investment in the U.S. economy and financial sector, therefore, should include consideration not only of sovereign wealth funds, but also of the equally significant and potentially even more thorny issues surrounding sovereign businesses, whose minority interests are owned in part by U.S. investors, because both trends are manifestations of a serious blurring of the distinction between the role of the market and the role of the state.

What should be of even greater interest than the current status of these forms of state

ownership is the projected growth of sovereign ownership in global public markets. One investment bank has forecasted, for example, that sovereign wealth funds will increase five-fold by the middle of the next decade. That could make these funds, collectively and perhaps individually, the largest shareholders in many of the world's biggest companies that are today privately owned. At the same time, because of the growth in sovereign business, many more of the world's biggest public companies could be directly controlled by governments.

The reasons behind the rapid growth of state-controlled investment funds and state controlled businesses are still being debated among academics and policymakers. The superficial reasons are clear enough: rapid economic growth in some developing markets, large trade surpluses with the United States, and rising oil prices have generated U.S. dollar surpluses in East Asia, the Middle East, Norway, and Russia. But the fact of rapid economic growth and the influx of dollars alone does not ameliorate potential concerns regarding the fact that governments, rather than private market actors, have the power to control the investing of this newfound wealth and may not have the same, market-sensitive set of incentives that characterize the private sector.

To note, over the past few decades, many of the command economies of the past have embraced market-based economics, at least in some areas. Greater international trade that has resulted from this liberalization could have been expected to give rise to greater wealth in private hands, and a proliferation of market participants. But instead, in many cases, a chief effect of broader trade has been growth in government-held foreign exchange reserves. Sovereign wealth funds have emerged as a way for governments, rather than individuals and privately owned firms, to invest the foreign exchange that has been generated by expanded trade. The growth in sovereign business may also be attributed, at least in part, to the effects of liberalization in nations which had a very circumscribed private sector in the past. These nations are embracing part of the free enterprise model – securities exchanges and public capital raising – while hanging on to state control.

Sovereign wealth funds consisting of foreign exchange reserves have always tended to invest abroad, since their capital was based on a foreign currency. What is new, in addition to the increase in the amount of their capital, is their emphasis on investing in companies around the world, rather than just investing in foreign government bonds. In this sense, they are now competing with other diversified investment vehicles, including mutual funds, pension funds, and hedge funds in the United States.

Sovereign wealth fund investment in the U.S. capital market – like cross-border investment generally – potentially offers benefits. Through their competition for investments in the United States, sovereign wealth funds can help offer U.S. companies a lower cost of capital and a more liquid market for their securities than might otherwise be available. But those same benefits would likely accrue to U.S. companies and markets if the foreign investment were privately directed, rather than government directed. And so it is necessary to inquire into the special consequences that ensue when it is not just a foreign individual or entity but a foreign sovereign doing the investing – or in the case of sovereign business, a foreign sovereign which is outright owning and controlling companies in the public markets.

A sovereign investor or controlling person behind a business raises a number of potential

concerns for regulators and other market participants. Because the fund manager or business owner is a government, it may have different and more complex incentives than those that normally drive private sector marketplace participants to make decisions. Sovereign wealth funds, and sovereign businesses, may therefore have a distorting effect on market. If government-controlled companies and investment funds increasingly direct the investment of business and capital, what will be the effect on the pricing of assets and the allocation of resources?

The SEC's mandate is focused on investor protection, maintaining fair and orderly markets, and promoting capital formation. Accordingly, the SEC has in place several rules that require disclosure of certain sovereign wealth fund activities and sovereign business activities that could raise many of the concerns we hear in our own and other markets. None of these disclosure requirements was designed with sovereign wealth funds or sovereign businesses in mind, but they are nonetheless of value in this context to the extent that many of the concerns that sovereign investing raises are similar to concerns about other types of investment.

For example, the SEC requires through Form 3 under Section 16(a) of the Securities Exchange Act ("Exchange Act") that an issuer's officers and directors, as well as any beneficial owner holding 10% or more of an issuer's equity securities, disclose their ownership interest. If one of these persons or entities buys or sells securities in the issuer, this change in ownership interest must be disclosed through a Form 4 filing within two business days.

Among other things, this disclosure requirement is designed to provide the market with information about the purchase and sale of issuer securities by individuals and entities who may be in a privileged position with regard to important information about the company. This could include both sovereign wealth funds and governments or government officials who own securities in a public company. Trading on the basis of material non-public information, of course, is prohibited by the Commission's Rule 10b-5 under Section 10(b) of the Exchange Act. Nonetheless, Forms 3 and 4 strengthen the integrity of our markets by providing information about the investments of insiders and large shareholders – including sovereign wealth funds – in the companies they run or may have control over.

Likewise, the SEC requires beneficial owners of more than 5% of an issuer's equity securities to file Form 13D under Section 13(d) of the Exchange Act. This disclosure must be made within 10 days of the purchase and is designed, among other things, to disclose possible takeover attempts of an issuer. Form 13D also requires the beneficial owner of the securities to disclose the source and amount of funds being used to purchase the shares, and announce whether the purpose of the purchase is to acquire control as well as any plans or proposals with regard to future actions by the purchaser.

In some cases, investors who do not intend to control or influence control of the issuer may file Form 13G instead. This disclosure is often used by institutional investors such as mutual funds and state pension funds, but is also available to sovereign wealth funds that are passive, albeit sizable, investors in a public company.

Finally, the SEC requires institutional investment managers who exercise investment discretion over $100 million or more of U.S. exchange-traded equity securities to file a Form

13F. The form requires a manager to disclose the name of each reportable issuer in the manager's portfolio as of the end of each calendar quarter, as well as the number of shares and the market value. It also provides some information about the manager's voting authority. Entities that may not be registered with the SEC – such as managers of pension funds, endowments, and domestic and offshore hedge funds – often are required to file Form 13F. The same reporting standard applies to sovereign wealth funds.

These and other examples make the point that SEC rules that apply to investors in the U.S. capital market also apply to sovereign wealth funds and sovereign businesses. That said, laws and regulations can be rendered meaningless without an effective enforcement mechanism. One of the significant concerns about sovereign wealth funds and sovereign businesses is not that they are foreign, but that their managers are sovereign. While request for cross-border enforcement assistance might be readily honored by a foreign government with respect to private actors in the market, help may not be as forthcoming if the subject of the request is the government itself.

Governments that control sovereign wealth funds and sovereign businesses, because they are governments, can in some cases control certain economic events, and they may have information advantages over private market participants. Governments routinely are privy to certain types of information that most private investors are not. What if the fund obtains information through its status as a government entity?

In addition to questions of market efficiency, transparency, enforcement, and information disparity, sovereign businesses and sovereign wealth funds raise other issues as well. One is the increased opportunity for political corruption. When individuals with government power also possess enormous commercial power and exercise control over large amounts of investable assets, the risk of misuse of those assets, and of their conversion for personal gain, rises markedly.

The SEC is not without tools, however, when it comes to enforcement. If the SEC were to pursue wrongdoing by a sovereign wealth fund or a sovereign business, and the jurisdiction in which it is based did not cooperate in our investigation, our Commission's response would be firm. And even in the face of a lack of cooperation from the country in which the foreign actor is based, we know from experience that market manipulation, insider trading, and other illegal activities that take place in the American market often leave sufficient evidence that the SEC can proceed with an enforcement action against the offender.

Nor does the fact that a fund or a business is owned by a foreign government shield it from liability under U.S. federal securities laws. It is a well-established principle of American jurisprudence and international law that sovereign immunity does not extend to a state's commercial activities in another jurisdiction. And while SEC enforcement cases involving a foreign person or entity are, all things being equal, somewhat more complicated than those with no cross-border nexus, SEC staff have a strong track record investigating such cases and working closely with our foreign counterparts in collecting evidence abroad.

Just this past year, the SEC sent more than 550 requests for assistance to foreign regulators, and we received more than 450 in return. The SEC expects this number to grow, as

cross-border securities activity grows, and as it becomes easier for investors to move assets across borders. To cite just one example, this past year, approximately 34% of the insider trading cases brought by the SEC's Division of Enforcement involved the SEC's Office of International Affairs seeking assistance from the SEC's foreign counterparts.

Furthermore, the ability to provide this type of cross-border regulator-to-regulator cooperation in enforcement investigations is now an international expectation. In 2002, in the wake of the attack of September 11, the International Organization of Securities Commissions created the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, which is a multilateral arrangement through which the MOU's signatories agree to share enforcement-related information. Today, this arrangement has 47 signatories, with another 15 publicly committed to obtaining the legislation they need to provide this information to others. Furthermore, in 2005, IOSCO's membership agreed that by 2010 the ability to sign on to this MOU would become a criterion for continued membership in the organization. Most of the governments that have sovereign wealth funds that invest in the United States are members of IOSCO, and many have already signed on to the MOU.

Shared international support for fair and transparent markets is also driving cooperation on the development of best practices for sovereign wealth funds. The International Monetary Fund currently is developing a set of voluntary best practices for sovereign wealth funds. And the European Commission has proposed a common EU approach for a code of conduct for sovereign wealth funds. Although discussions are ongoing, it is contemplated that sovereign wealth funds would disclose such things as:

- The investment positions and asset allocations, particularly where they have majority ownership;
- The exercise of ownership rights;
- The use of leverage;
- The size and source of their resources; and
- A disclosure of their home country's regulation and oversight that governs the sovereign wealth fund.

These international developments are encouraging. The United States is already ahead of the curve on this subject – in our country, these disclosures are already mandatory for any sovereign wealth funds of significant size.

Finally, if we were to prohibit sovereign wealth funds from investing in our market for fear they might introduce market distortions, there is a risk we might actually end up doing precisely this ourselves through the prohibition. A better approach might be to address the underlying issues of transparency, independent regulation, de-politicizing of investment decisions, and conflicts of interest.

I hope this brief overview of the issues surrounding foreign government investment in the U.S. economy and financial sector from the perspective of the Securities and Exchange Commission is helpful to you. I will be happy to answer your questions.

**Written Testimony Prepared for the**
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**Paul Rose**
**Assistant Professor of Law, Moritz College of Law, Ohio State University**

Chairman Dodd, Ranking Member Shelby, and members of the Committee, thank you for the opportunity to speak to you today on the regulatory framework for sovereign investments, and how such investments impact U.S. financial stability.

**Defining and Contextualizing SWFs**

Sovereign investment takes many forms, including stabilization funds, endowment funds, pension reserve funds, development funds, and sovereign wealth funds (SWFs).[1] SWFs may be defined as "government investment vehicles funded by foreign exchange assets and managed separately from official reserves."[2]

SWFs are increasingly important players in our capital markets. The size and impact of SWFs may be given context through comparison with other major investment vehicles such as institutional funds, private equity funds, and hedge funds. If we assume approximately $3 trillion in SWF assets, SWFs manage roughly 1/7th the amount managed by pension funds, 1/6th the amount managed by mutual funds, and 1/6th the

[1] The differing purposes served by these forms of sovereign investment imply different objectives and risk tolerance; for example, a SWF that was not created to address a particular liability will likely have a higher risk tolerance than a sovereign pension fund that was created to fund social security benefits (a defined liability).

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

amount managed by insurance company funds. On the other hand, SWF assets under management are approximately twice that of hedge funds, and roughly three times that of private equity funds. Furthermore, as noted by Treasury Undersecretary David McCormick, SWFs "are set to grow at a much faster pace"[3] than these other investment vehicles.

SWFs also often control relatively larger concentrations of wealth. For example, the largest SWF, the ADIA fund, is more than twice as large as the 10 largest hedge funds combined.

**Recent SWF Investment in Financial Services Firms**

Since July 2007, SWFs have made a number of investments in U.S. financial institutions, most of which occurred since the Committee's hearings in November.[4] These investments alone provided approximately $39 billion in much-needed capital for the financial institutions. The investments involve less than 10% (and typically less than 5%) of the banks' outstanding capital, with no control rights. Each investment was designed to be a passive investment, and the sovereign funds and banks have made a point of reassuring the public, other investors and regulators that these are stable, long-term investments.

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

[4] SWF investments in U.S. financial firms since July 2007 include: ADIA's investment in Citigroup; Temasek's (Singapore) investment in Merrill Lynch; CIC's (China) investment in Morgan Stanley; GIC's (Singapore) investment in Citigroup; Kuwait Investment Authority's investment in Citigroup; and Korea Investment Corporation and Kuwait Investment Authority's investment in Merrill Lynch.

**The Regulatory Framework Governing SWF Investment in Financial Institutions**

Three sets of regulations governing SWF investments in financial institutions have shaped the structure of these investments.

The first set of regulations governs the CFIUS process, which, among other things, targets transactions in which a SWF would gain the ability to exercise functional control over a target company.[5]

The second set of rules, specific to banks and bank holding companies, is the regulations under the Bank Holding Company Act and the Change in Bank Control Act, which require Federal Reserve Board approval of investments that result in control by the investor of a U.S. bank or bank holding company such as Citigroup.[6]

The third set of rules is the SEC's disclosure scheme under Section 13(d) of the Exchange Act. For investors owning more than 5% of a company's voting securities that

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[5] Although some have interpreted the regulations and CFIUS practice as suggesting that deals involving less than 10% of a company's voting securities would not trigger a CFIUS investigation, the Treasury Department's proposed regulations make clear that control is not defined in terms of numerical bright lines such as percentage of shares owned or numbers of board seats. As stated in the Treasury's discussion of the proposed rule, "all relevant factors are considered together in light of their potential impact on a foreign person's ability to determine, direct, or decide important matters affecting a company." Department of the Treasury, Proposed Rule: Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, April 21, 2008. Thus, even an investor owning 9% of a company's stock could fall under the statute and regulations if the investor has bargained for rights that allow it to direct the company's affairs. Conversely, an investor acquiring more than 10% of a company's shares but not acquiring any incidents of control will not be deemed a control person for purposes of CFIUS.

[6] The Federal Reserve Board presumes that investments of less than 5% of the company's stock do not require approval, and has generally not found indicia of control where the investment amounts to less than 10%. If control is found, however, the acquiring entity will be subject to the approval requirement, and, if approved, will be subject to regulation as a bank holding company (including, *inter alia*, reporting requirements, examination by the Federal Reserve Board, and capital requirements). The Change in Bank Control Act also generally requires approval of transactions in which an entity acquires 10% or more of the voting securities of a state member bank or bank holding company.

are not considered passive investors,[7] Schedule 13D requires detailed disclosures by the investor including, among other things, a discussion of "the purpose or purposes of the acquisition of securities." A reasonable reading of the statute would thus seem to require SWFs with designs on control to disclose any non-commercial purposes for the investment, including political purposes.

While this framework encourages commercial, nonpolitical investment by SWFs, there are some limitations to the framework.

With respect to SEC enforcement, SEC Chairman Christopher Cox has expressed concern that the SEC may not be able to regulate SWFs as it does other investors, and that considerable conflicts of interest might impair SEC efforts to obtain cooperation from the sovereign that controlled a SWF under investigation.[8]

Additionally, SWF investment in financial institutions may create unique systemic risks. For example, SWFs could cause significant turmoil if, for reasons of national exigency, a SWF was required to liquidate its positions. Given the importance of financial institutions to the overall economy, the risks created by quick divestment by SWFs (although perhaps not likely) could be especially acute.

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[7] For passive investors, defined under Rule 13D as persons not seeking to acquire or influence control of the issuer and who own less than 20% of an issuer's outstanding securities, SEC rules mandate a short-form disclosure of identifying information and require certification that "the securities . . . were not acquired and are not held for the purpose of or with the effect of changing or influencing the control of the issuer of the securities and were not acquired and are not held in connection with or as a participant in any transaction having that purpose or effect." *See* Schedule 13G, Item 10 (2008).

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

Another concern with sovereign wealth investment that may be amplified by investment in financial firms is the potential for abuse of informational disparities.[9] Easier access to financial firms, which are awash in material, non-public information, enhances the risk of exploitation of unfair market advantages.[10]

**Addressing Risks Created by Sovereign Investment in Financial Firms**

While recognizing that the concerns with sovereign investment in financial firms are significant, I do not believe that these concerns need be answered by adding to or amending existing statutes and regulations. First, as Deputy Treasury Secretary Robert Kimmitt has noted, SWFs "have not caused significant financial-market disruption and . . . even for investments that do involve control, there is little evidence of any ulterior foreign policy motives in practice."[11] Second, imposing additional regulations on SWFs beyond the reasonable framework now in place may create other, more significant problems, such as a shift in SWF investment away from the U.S. The result of such a shift would be detrimental both because U.S. firms would miss the capital investments, and because the funds may flow to other jurisdictions that may be under-regulated. Arguably, this could increase the danger that SWFs would be used as political tools to

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[9] Because of their ties to a sovereign, SWFs have particular informational advantages that may not be available to other investors, or, in some cases, even to company insiders. For example, a SWF may receive knowledge of a pending action against a corporation through government channels. Or, the sovereign could be in the position to bring an action against the competitors of one of its investments.

[10] Granted, so long as sovereigns are using their funds for wealth creation rather than political purposes, such activities would seem to be against their own interests as diversified investors to the extent that such activity depresses markets overall. Again, however, if SWFs do engage in manipulative activities, the SEC may have difficulty bringing an action against the SWF and its managers.

[11] Kimmitt, *Public Footprints in Private Markets*, *supra* n. 2.

harm our national interests, and make it less likely that our regulators could effectively work against such activities.

In balancing these concerns, I believe the Treasury has ably worked to buttress our regulatory framework by promoting voluntary standards by working directly with SWFs (in the case of Abu Dhabi and Singapore) and by encouraging efforts by the IMF to work with SWFs on a set of best practices. The IMF's efforts are also supported by the Financial Stability Forum, which is particularly focused on the health of financial institutions and markets.

A robust set of best practices essentially encourages SWFs to act like institutional investors: to operate transparently, to maintain adequate risk-management structures, to provide adequate disclosures, and to create accountability to regulators and, we should hope, the citizen-beneficiaries of SWFs.

The primary limitation of voluntary best practices is, of course, the lack of an enforcement mechanism (other than the possibility of retaliatory economic and political responses, which is, I believe a quite significant enforcement mechanism). On the other hand, it is not realistic to hold out for the successful negotiation of a multilateral foreign investment agreement that might provide a formal dispute resolution mechanism. SWFs are investing now, and they are here to stay. We can rely on the regulatory tools currently at our disposal while continuing to encourage the creation of best practices for SWFs and continuing to work on domestic and international initiatives that will ensure the stability of financial institutions and the capital markets.

Thank you.

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# SOVEREIGNS AS SHAREHOLDERS

Paul Rose*

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

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* Assistant Professor of Law, Moritz College of Law, Ohio State University. Thanks to Steven Davidoff, Dan Chow and Dale Oesterle for their helpful comments.

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## I. INTRODUCTION

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

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

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

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

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

[4] *Id.*

[5] *Id.*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[16] STATE CAPITALISM at 4.

[17] *Id.*

[18] *Id.*

[19] *Id.* at 5.

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

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

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

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

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

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

[21] STATE CAPITALISM at 5.

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

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

## II. SOVEREIGN WEALTH FUNDS: DEFINITIONS AND CONCERNS

### A. *Defining and Contextualizing Sovereign Investments*

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

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

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

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

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

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[23] Andrew Rozanov, *Sovereign Wealth Funds: Defining Liabilities* (May 2007), *available at* http://www.ssga.com/library/esps/Soverign_Wealth_Funds_Andre_Rozanov_4.27.07rev2CCRI11 82371372.pdf.

[24] *Id.*

[25] *Id.*

[26] STATE CAPITALISM at __.

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

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

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

[Insert CHART 1]

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

[Insert CHARTS 2-5]

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

B. *Benefits of Sovereign Investment*

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

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

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

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

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

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

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

C. *Concerns with Sovereign Investment*

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

1. Political Risk

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

2. Economic and Regulatory Risks

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

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

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

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

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

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

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

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[42] Cox, *supra* note 35.

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

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

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

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

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[44] Cox, *supra* note 35.

[45] *Id.*

[46] *Id.*

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

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

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

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

## III. REGULATION OF SOVEREIGN WEALTH FUNDS

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

### A. *Political and Economic Factors*

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

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

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

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

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

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

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

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

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

[55] Romano, *supra* note 56.

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

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

B. *State Corporate Laws*

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

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

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

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

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

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

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

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

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

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

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

### C. *Federal Regulation*

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

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[60] *See, e.g.*, MBCA § 8.30(b).

[61] *See, e.g.*, MBCA § 8.30(a).

1. Securities Regulation

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

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

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

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

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

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

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

2. Committee on Foreign Investment in the United States

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

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

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

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

[68] *Id.*

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

[70] 31 C.F.R. § 800.204 (2008).

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

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

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

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

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

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

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

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

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

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

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

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

a. Concerns with the CFIUS Process

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

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

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

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[77] Corr, *supra* note 67.

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

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

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

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

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

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

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

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

[84] *Id.*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[100] Corr, *supra* note 67.

[101] *Id.*

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

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

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

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

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

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

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

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

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

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

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

[107] Corr, *supra* note 67.

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

[109] Corr, *supra* note 67.

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

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

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

### D. *Expectations of Sovereign Wealth Funds as Shareholders*

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

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

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

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

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

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

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

[114] *Id.*

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

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

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

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[115] *Id.*

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

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

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

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

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

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

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

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

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

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

[Insert CHART 6]

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

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

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

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

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

[126] *Id.*

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

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

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

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

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

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

[130] http://UNPRI.org.

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

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

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

## IV. INTERNATIONAL STANDARDS FOR SOVEREIGN INVESTMENT

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

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

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

A. *Individual Country Responses*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[140] *Id.*

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

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

B. *Multilateral Agreements*

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

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

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

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

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

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

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

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

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

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

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

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

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

### C. *Voluntary Codes of Conduct*

Ideally, detailed best practices would be created by or in connection with sovereign investors. However, host nations are already working toward outlining best practices for SWFs. In the U.S., Treasury officials have informally suggested a

framework for best practices.[148] More formally, the Commission of the European Communities has recently set out some major governance principles for sovereign investors:

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

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

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

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

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

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

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

1. Structure

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

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

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

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[152] Rozanov, *supra* note 23.

[153] *Id.*

[154] *Id.*

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

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

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

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

[157] ERISA §§ 402(c)(3), 405(c).

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

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

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

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

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

[161] Bradsher, *supra* note 159.

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

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

2. Risk Management

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

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

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

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

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

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

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

3. Transparency

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

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

[167] Cox, *supra* note 35.

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

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

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

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

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

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

[171] *Id.*

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

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

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

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

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

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

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

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

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

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

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

4. Accountability

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

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

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

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

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

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

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

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

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

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

## V. CONCLUSION

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

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

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

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

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

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

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

CHART 1
Assets by Investor Type

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

CHART 2
10 Largest Institutional Investors

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

CHART 3
10 Largest Sovereign Wealth Funds

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

CHART 4
10 Largest Private Equity Funds

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

CHART 5
10 Largest Hedge Funds

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

CHART 6
Market Reactions to Selected SWF Investments

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

**Testimony of David Marchick**
**Managing Director and Global Head of Regulatory Affairs**

**The Carlyle Group**

**before the United States Senate --**

**Committee on Banking, Housing, and Urban Affairs**

**April 24, 2008**

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Chairman Dodd, Ranking Member Shelby, Members of the Committee:

Let me start by complimenting the Chairman, the Ranking Member, and this Committee for your leadership on the Foreign Investment and National Security Act (FINSA). Mr. Chairman, you and Senator Shelby deserve credit for being focused on the importance of a strong national security review mechanism long before Dubai Ports brought the issue into the national spotlight.

I worked on foreign investment issues during my time in government and for the past six years before I joined Carlyle. I am speaking as much from my previous experience as from my current perspective at Carlyle.

I would like to focus on four issues in my testimony:

1. Why the focus on SWFs?
2. The many layers of laws and regulations that protect important governmental interests related to foreign investment;
3. Third, the important work on transparency being led by the Treasury and IMF;
4. The importance of maintaining an open market for foreign investment in the United States.

First, why all the focus on SWFs?

The new attention on sovereign investments can be traced to a number of factors. There has been a rapid growth in the number and size of SWFs. Much of this growth has occurred in the developing world, including China, Russia, and the Middle East, and there have been more high-profile investments from government-affiliated entities. The growth in SWFs has come at a time of overall growth in outward investment from developing nations: for example, from 2000-2006, outward FDI from China grew 6.9 times, from Russia 5.9 times, and from some Middle Eastern states more than 35 times. The last time the US saw such large increases in FDI was with Japan in the 1980s. Congress passed the Exon-Florio Amendment into law, creating a national security review process for foreign investment. While there was an uproar in the 1980s with respect to Japanese investment, today, Japanese investment is part of the fabric in large and small communities around the country.

While the number and size of SWFs has grown in the past few years due to high oil prices and growing current account surpluses, sovereign wealth fund investments represent a small slice of the global investment market: in 2007, the value of SWF mergers and acquisitions (M&A) activity represented only 1.6 percent of total global M&A volume. The percentage may be larger in 2008, but overall will still represent a small component of global investment.

Sovereign wealth funds have a lot of money - $3.2 trillion according to some estimates – but are tiny compared to the $52 trillion in global pension and mutual funds. Further, while there have been a number of high profile investments, the vast majority of SWF investments are for passive, minority stakes. SWFs have, in fact, served as an important source of stability at a time of great uncertainty in financial markets.

Second, the United States has a robust, layered set of laws and regulations that protect important governmental interests associated with any investment, sovereign or otherwise. FINSA protects against threats to national security, and CFIUS has demonstrated its willingness to block or mitigate problematic investments. DOD has its own set of regulations to protect the defense supply chain and classified information. Hart-Scott-Rodino triggers antitrust reviews for any significant acquisition. And in any sensitive sector, there are a host of laws and regulators that provide additional protection. In the chemicals industry, for example, there are five federal regulators focused on safety, security, transportation and other issues; several state-level regulators; and more than a dozen federal statutes that impose various, wide-ranging controls on chemical investments and operations. The Fed, Treasury, OCC and OTS scrutinize investments in the banking sector. Similar laws and regulatory oversight exist in the telecommunications, energy, pharmaceutical, and transportation sectors, among others. Even if there were cause for concern associated with sovereign wealth funds, our existing legal and regulatory structure should capture and fix – or block – any problematic investments. Bottom line: when a foreign entity invests in the United States, the US is sovereign, not them.

Third, the United States and international community are making progress on improving transparency associated with SWFs. The Treasury's recent announcement with Singapore and Abu Dhabi was a very important step. In that agreement, two of the largest host countries for sovereign wealth funds confirmed that investment decisions should be based solely on commercial grounds, not political purposes. They also highlighted the importance of greater disclosure of financial information, including asset allocation, as well as appropriate governance and risk management systems. I would encourage this Committee to support the Treasury and IMF's efforts to improve and enhance transparency through a voluntary code of conduct.

Fourth, just as sovereign wealth funds have been asked to establish codes of conduct, countries receiving investments from sovereign wealth funds need to act responsibly as well, and the United States needs to lead the way. One can legitimately ask the question whether there is a greater risk that receiving countries will block legitimate investments for political reasons, or that a sovereign wealth fund will make an investment for political reasons.

In fact, there is cause for concern that countries are moving to tighten up rules on investment. In the last two years alone, more than a dozen countries representing more than 40% of global inward foreign direct investment have adopted or are debating new investment restrictions. There is cause for concern:

- For the first time in its history, Canada blocked a U.S. acquisition of a Canadian satellite company;
- New Zealand blocked a potential investment from Dubai in the Auckland airport.
- Australia announced stricter guidelines for foreign government investment.
- Japan blocked an investment by a European hedge fund in a power company, citing national security reasons.
- Several European countries have blocked investments from other European countries in the energy sector.
- China has tightened its rules and rejected a number of proposed investments.
- France now scrutinizes investments in 11 sectors; Russia scrutinizes investments in 43 sectors, and Germany is considering its own new foreign investment restrictions.
- And CFIUS has dramatically increased the number of reviews and the number and scope of mitigation agreements imposed on foreign investors.

If the United States is not welcoming to investment, it could contribute to a broader wave of protectionism to the detriment of U.S. investors and our economic health. As the largest source of investment in the world, we lose more than any other country if investment protectionism grows.

There is a real risk that if the regulatory and political environment in the United States creates uncertainty for investors, capital indeed will flow elsewhere. The UK, for example, has demonstrated leadership in publicly welcoming foreign investment. The Chancellor of the Exchequer Alistair Darling welcomed investment from China Investment Corporation in the UK. The CEO of Dubai International Capital -- a $13 billion investment fund -- recently said that because of the political environment in the U.S., he would prefer to pursue deals in the United Kingdom. I would much rather have the investment come to the United States than another country, but if investors think the political or regulatory risk is too high in the US, they will look elsewhere.

Let me be clear: CFIUS should block any investment that threatens U.S. national security and cannot be mitigated. Other parts of the US government should be vigilant in protecting other legitimate interests. But unless a particular investment presents a particular problem, our doors should be wide open to foreign investment.

I'd like to take a moment to explain The Carlyle Group's positive experience with two investments from government-affiliated entities. First, the California Public Employees Retirement System (CalPERS), the largest public pension fund in the world, acquired a 5.5 percent interest in Carlyle in 2000. Second, the Mubadala Development Company, a firm that invests funds on behalf of the government of Abu Dhabi, purchased a 7.5 percent stake of Carlyle in 2007. The terms of these investments are pretty simple: CalPERS and Mubadala acquired passive, limited partner stakes in Carlyle. They exercise no control or influence over our investment decisions. Their investments have allowed us to create strong U.S. companies, grow jobs and spur innovation. CalPERS and Mubadala each receive a quarterly or annual financial report, and we will work hard to produce an attractive rate of return for both entities.

Both CalPERS and Mubadala are sophisticated investors, and we are grateful for the confidence they have shown in us.

In summary, SWFs have been an important source of capital for the US and in recent months they have helped provide stability to our financial markets. The typically passive, minority nature of their investments is important to recognize, while at the same time the United States has a proven set of laws and regulations that protect our national interests associated with any foreign investment. Nonetheless, improved transparency by SWFs will provide additional information and comfort and help forestall rising protectionist sentiments. Barring a particular problem with a particular transaction, our doors should be wide open to foreign investment.

Thank you once again for the opportunity to appear before you today.

U.S. Regulatory Framework for Assessing Sovereign Investments

Testimony by Jeanne S. Archibald

Director, International Trade Practice

Hogan & Hartson LLP

Before the Senate Committee on Banking, Housing and Urban Affairs

April 24, 2008

Mr. Chairman, Senator Shelby and other distinguished members of the Committee, I am honored to have this opportunity to address the Committee on such an important and timely topic. My name is Jeanne Archibald; I am the Director of the International Trade Practice of Hogan & Hartson and former General Counsel of the U.S. Treasury Department.

During my service with the Treasury Department I was directly involved in the consideration of the Exon-Florio Amendment to the Defense Production Act of 1950, supervised the drafting of the regulations implementing that law and provided advice to senior Treasury officials with respect to the implementation of the law for several years following its enactment.

Throughout the last 15 years, I have assisted numerous clients, both U.S. and non-U.S., with respect to national security reviews and investigations before the Committee on Foreign Investment in the U.S. ("CFIUS"). These transactions have involved a wide variety of industry sectors, including, but not

limited to, financial, telecommunications, energy, high tech, and defense. Several of these transactions have involved the negotiation of a mitigation agreement to address national security concerns raised by the acquisition. Some of these transactions included acquisitions by non-U.S. companies in which foreign governments held an ownership interest as well as by sovereign wealth funds. And, as discussed further below, many of the transactions on which I worked implicated regulatory reviews and requirements beyond the Exon-Florio Amendment.

At the outset, I want to note that I am not appearing here on behalf of any client. The views expressed are my own, developed over 20 years of working with the issue of national security aspects of foreign direct investment in the United States.

As several other witnesses who have appeared before this Committee have noted, sovereign wealth funds are not a new phenomenon, the first having been created more than 50 years ago. And the investment capital that such funds bring to the U.S. provides many economic benefits to Americans. At the same time, the recent increase in the number of sovereign wealth funds and their total asset value have raised concerns about the potential impact of investments made by these funds on U.S. national security interests. The relevant question therefore is whether the U.S. has the legal and policy tools in place to ensure that sovereign wealth fund investments do not harm the U.S. national security. I believe the answer to that question is clearly "yes."

One major tool available for this purpose is, of course, the Defense Production Act of 1950 (50 U.S.C. App. § 2170 et seq.), as recently amended by the Foreign Investment and National Security Act of 2007 ("FINSA") (Pub. L. 110-49, 121 Stat. 246). As I consider my experience with CFIUS proceedings, having notified transactions to CFIUS both prior to and following 9/11, prior to and following the Dubai Ports World controversy, and prior to and following the enactment of FINSA, I note that CFIUS proceedings today are more probing than ever before in their examination of a transaction, the parties to the transaction, and its potential impact on national security. Based on my initial review of the proposed regulations to implement FINSA that have just been published for public comment by the Treasury Department, I fully expect that trend to continue.

Although the decision by parties to notify a transaction to CFIUS is voluntary, in my experience most companies choose to notify. There are several reasons for this. First, of course, is the fact that in the absence of a CFIUS "clearance" the foreign acquirer's investment is at risk from a later order of divestment. Therefore, it is in the economic interest of the foreign investor to seek a clearance. Second, filing with CFIUS demonstrates a desire to be viewed as a "good corporate citizen." This can be an especially strong incentive where the target of the acquisition or the identity of the acquirer is likely to draw public attention to the deal. Third, where a financial institution is funding an acquisition, the institution is virtually certain to require that all applicable regulatory approvals be obtained as a condition for providing the financing. Fourth, in instances in which a

foreign investor is taking a minority stake in a U.S. company, the remaining U.S. owners often insist on a CFIUS filing to eliminate the risk from the disruption and possible financial loss that could follow from a future divestment order. Fifth, when CFIUS becomes aware of a proposed transaction, it calls the parties to ask whether they intend to file. I am not aware of any instance in which parties receiving such a call fail to notify the transaction.

But CFIUS is by no means the only regulatory tool available to the U.S. government to protect against national security risks associated with foreign direct investments in U.S. businesses. The U.S. has enacted many regulatory regimes specific to certain industry sectors. Other regulatory requirements are not industry specific but apply to foreign acquisitions. Some of these regulatory regimes directly restrict investments of a foreign investor, or a foreign government-owned investor. Others provide an avenue by which the U.S. government can be made aware of a contemplated or completed investment—thus allowing for a CFIUS review if one has not already occurred.

Consider, for example, acquisitions in the telecommunications sector. The Communications Act of 1934 absolutely prohibits any foreign government or representative of a foreign government from holding broadcast or common carrier radio licenses.. The Act also imposes a strict limit of 20% on direct investment in broadcast or common carrier radio licensees by any foreign entity. The Act provides for a waivable limit of 25% on indirect investment by a foreign entity.

Thus, a U.S. subsidiary of a foreign entity cannot purchase more than 25% in a company holding a broadcast or common carrier radio licensee without a waiver from the Federal Communications Commission ("FCC"), and the FCC has the power to impose conditions on the granting of such waivers. In fact, before the concept of mitigation agreements was codified in FINSA, it was not uncommon for foreign investors to enter into agreements that imposed conditions on their investments in the telecommunications sector in exchange for a promise by the relevant federal agencies not to object to the acquisition in the CFIUS process. In addition to the remedies for breach that were contained in these agreements, compliance with the agreement was also imposed as a condition on the FCC license.

Given changes in technology, common carrier radio licenses are not as significant today as they were previously. However, today, as a matter of policy, the FCC will not grant any application or license relating to telecommunication services to an entity with significant foreign ownership, government or private, without the approval of the Team Telecom agencies, i.e., the Department of Justice, the FBI, the Department of Homeland Security and, as appropriate, the Department of Defense. Because the Team Telecom agencies are also represented on CFIUS, foreign investors in U.S. telecommunications companies will typically discuss their proposed acquisitions with, and resolve any national security concerns of, the Team Telecom agencies in advance of making a CFIUS filing. In my experience, Team Telecom looks very carefully at any foreign investment but is even more sensitive to investments by foreign governments.

Foreign investments in the financial services sector are also subject to extensive regulation. For example, under the Change in Bank Control Act, the Federal Reserve must generally be given 60 days prior written notice of a proposed acquisition of a controlling interest in a member bank or a holding company. A controlling interest is defined as the acquisition of the ownership, control or power to vote 25% or more of any class of voting securities. Some regulated financial companies impose their own limitations on ownership shares or voting interests—applicable to all investors, including investments by sovereign wealth funds.

Another example can be found in foreign investment in companies that hold classified government contracts, which are subject to significant national security regulation under the National Industrial Security Program implemented by the Department of Defense. When a foreign company proposes to invest in a U.S. company that holds a facility security clearance, which would include virtually any company engaged in classified work, the target company is required to notify the Defense Department of the proposed foreign investment and to develop a plan to mitigate the national security risk associated with the acquisition.

Such plans typically take the form of a (i) Special Security Agreement, whereby the foreign owner is permitted to have board representation but a variety of security measures are put in place to protect the security of the classified contracts; or (2) Proxy Agreement under which the foreign owner retains an economic interest in the entity holding the classified contracts but operational control is vested exclusively in a board of directors composed of U.S. citizens

approved by the Department of Defense. Depending on the nature of the classified contracts, a Proxy Agreement may be the only practical means for mitigating foreign ownership, control or influence. In the absence of an approved plan, the facility security clearance will be suspended, thus precluding the company from bidding on further classified contracts. Furthermore, the contracting agencies can terminate existing contracts. In my experience, foreign investors give careful consideration to the impact of these regulatory requirements on the nature and scope of an acquisition.

Similar types of restrictions apply in the nuclear power industry. A change in corporate ownership of an existing holder of a license from the Nuclear Regulatory Commission ("NRC") requires NRC approval to transfer the existing license prior to closing. (*See*, 10 C.F.R. §§ 70.36 and 70.65, and 10 C.F.R. § 40.46.) Where the application for a license transfer involves a foreign entity, the NRC will conduct a foreign ownership or control review. In determining whether the U.S. license holder would be owned or controlled by a foreign entity, the NRC will consider a variety of factors, including whether a foreign interest owns or has beneficial ownership in 5 percent or more of the license holder's voting securities. If the NRC finds that an applicant is considered foreign owned, controlled, or dominated, it can require the applicant to develop a plan to negate the effect of the foreign control as a condition of granting the application.

Manufacturers of goods or technology specifically designed, modified or enhanced for military use are required to register under the International Traffic in

Arms Regulations ("ITAR") (22 C.F.R. Parts 120-130). An ITAR registrant is required to provide 60 days advance notice to the Department of State of any intended sale or transfer to a foreign person of any ownership or control of the registrant or any affiliate of the registrant. For purposes of this provision, "ownership" means that more than 50% of the outstanding voting securities of the registrant are owned by one or more foreign person. "Control" means that one or more foreign persons have the authority or ability to establish or direct the general policies or day-to-day operations of the firm. Control is presumed to exist where foreign persons own 25% or more of the outstanding voting securities if no U.S. person controls an equal or greater percentage. (*See*, 22 CFR 122.)

Under the International Investment and Trade in Services Survey Act (22 U.S.C. 3101-3108), all foreign investments in U.S. business enterprises with assets of at least $3 million in which a foreign person owns a voting interest of ten percent or more are subject to reporting requirements implemented by the Department of Commerce's Bureau of Economic Analysis. The initial report of the investment must be made within 45 days after the date of the initial acquisition.

In addition to the foregoing examples of regulatory schemes that impose specific requirements or limitations on foreign ownership or control, acquisitions by sovereign wealth funds and other foreign investors can trigger other notice requirements, such as Hart Scott Rodino premerger filings (for acquisitions that meet either the size of transaction or size of person threshold tests) or SEC reporting requirements (for acquisitions of greater than 10% of any class of

registered securities). The former filings are available to the Department of Justice, a member of CFIUS. The latter are a matter of public record. Thus these filings provide another source of information about proposed or completed acquisitions by foreign entities that can be tapped by CFIUS for appropriate action, where needed.

I would also point out that the reporting requirement contained in Section 721(k) of the Defense Production Act, which continues in a modified form in FINSA, requires the Department of the Treasury to complete a Quadrennial report on foreign acquisitions of, and espionage activities against, U.S. critical technology companies. Using data on completed transactions by companies from countries most active in mergers and acquisitions with U.S. critical technology companies, the Treasury Department has another opportunity to ensure that foreign investment in the United States is being undertaken solely for commercial purposes and that no pattern is developing with respect to an investor or group of investors seeking to systematically acquire U.S. critical technology companies.

The regulatory regimes described above do not constitute an exhaustive list of restrictions imposed on foreign investment in the U.S. But in addition to reviews by CFIUS, which have been strengthened as a result of the FINSA amendments, they serve to illustrate the robust nature of U.S. regulation relating to foreign investment in sectors of the economy that are significant from a national security perspective. In addition to these regimes, some of the other regulatory requirements I have described provide CFIUS with sources of

information about significant investments that enable CFIUS to follow up with the parties as it deems appropriate. I would be happy to respond to any questions

**Dennis Johnson**
**Senior Portfolio Manager, Corporate Governance**
**California Public Employees' Retirement System**
**Written Testimony Prepared for the**
**U.S. Senate Committee on Banking, Housing and Urban Affairs**
**April 24, 2008**

Chairman Dodd and members of the Committee, I am pleased to provide the perspective of an institutional investor on the virtues of transparency and the principled practices of the California Public Employees' Retirement System, which I represent.

CalPERS is the largest public pension plan in the nation with more than $244 billion in assets under management (as of April 21, 2008). We provide retirement and health benefits to 1.5 million members who work in state and local government.

Given our responsibility as a trustee and the fact that our investments span domestic and international markets, not only do we require transparency from our portfolio companies, we believe that we should lead by example in providing transparency into the activities related to our investment portfolio.

We also believe it is crucial to have a principle-based approach for exercising our rights as shareowners in over 8,000 publicly traded companies around the world.

That is why the CalPERS Board of Administration annually reviews and approves the CalPERS' Global Principles of Accountable Corporate Governance (Principles).

Our Principles create the framework by which CalPERS executes its proxy voting responsibilities in addition to providing a foundation for supporting the System's corporate engagement and governance initiatives. To promote transparency, the CalPERS Policy Subcommittee and Investment Committee discuss and approve the Principles in open public sessions. In addition, we maintain a current edition of our Principles on the CalPERS Web site.

There are numerous ways that CalPERS provides transparency for its investment and related activities. Some of the methods for promoting transparency include but are not limited to the following:

- The CalPERS Board of Administration has a fiduciary duty to employees, contracting public agencies, and retirees of the pension fund. As a public government entity, this stewardship entails public reporting.

- The California Constitution and case law clearly establishes that the CalPERS Public Employees' Retirement Fund is a trust and that the Board

acts in a fiduciary capacity as the body responsible for managing and administering that trust. Article XVI, Section 17, of the California Constitution provides that the assets of a public pension and retirement system are trust funds and that the retirement board responsible for administration of the retirement system has the sole and exclusive fiduciary responsibility for those assets.

- The 13-members of the Board of Administration are either elected by members of the System, appointed, or are designated by law to be on the Board. The Board has established various Committees that review issues and recommend actions to the full Board. The Board meets monthly in Sacramento, but holds one meeting a year in Southern California. Each CalPERS trustee is identified on the CalPERS Web site.

- The Constitution requires that CalPERS assets are held in trust for the exclusive purposes of providing benefits to System members and their beneficiaries, and to defray reasonable expenses of administering the System.

- Board members, individually, are responsible for maximizing investment returns to the pension fund, thereby minimizing contributions required of active State, public agency, and school employees and California taxpayers who support employer contributions to the fund. As of June 30, 2007, CalPERS assets included $3.3 billion in employee contributions, $6.4 billion in employer contributions, and investment returns on all such contributions through that 2006-07 fiscal year. Investment income pays 75 cents of every pension dollar received by CalPERS retirees. The remaining 25 cents is shared by employee and employer contributions.

- CalPERS posts its investment portfolio in public printed reports and on-line on its Web site. CalPERS records are readily accessible.

- Investment performance results are made available to the public on-line, and in printed materials. This includes a Comprehensive Annual Financial Report, the annual Investment Report, monthly Consolidated Investment Activity reports, a Total CalPERS Fund Quarterly Report, and detailed quarterly reports of sub-asset classes, monthly activity reports and investment transactions. The CalPERS Web site also has a complete report of our Alternative Investment Management Program showing investments in hundreds of private equity funds, and their performance.

- Proposals to contract with external portfolio managers are also publicly reported, as are investment allocations, commitments, and deployment of capital into the market.

- Independent audits are conducted on CalPERS by third-party vendors. The full report is made available through the CalPERS Web site.

- The CalPERS Investment Committee meets in "open session," and all policies are presented first in the Policy Subcommittee, then in the full Committee, which comprises all 13 Board members. Agendas are made available for the public prior to open session meetings. Minutes from the previous meeting are included in the agenda package.

- "Closed session" meetings of the Investment Committee are recorded.

- CalPERS contracts with third-party vendors are audited, and reported on the CalPERS Web site.

- CalPERS proxy votes are placed on its Web site on an annual basis.

- CalPERS is subject to the California Public Records Act and the Government Code. CalPERS trustees are subject to disclosure requirements under the Federal Fair Practice Provision. The pension fund also is subject to relevant authority of the U.S. Internal Revenue Service. CalPERS subscribes to the United Nations Principles for Responsible Investing and the Global Sullivan Principles of corporate governance.

We appreciate the opportunity to share our experience as a major investor. We hope this account of our practices regarding transparency, accountability, and our unique fiduciary responsibility to our members will be of help in addressing the difficult questions that are before this Committee.

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## RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ETHIOPIS TAFARA

CONCERN OVER SWF SIZE AND SEC CAPACITY

**Q.1.** Mr. Tafara, there is a wide range in market participants from the small single investor all the way to multi-billion dollar sovereign wealth funds.

Does the SEC take any particular steps to address this broad range and do you have any concerns that, as sovereign investors grow larger, the task of policing the markets will grow more difficult?

**A.1.** In general, the federal securities laws do not distinguish among investors due to their size, but rather offer the same protections to and impose the same obligations on each investor, regardless of the amount of assets it has or its sophistication.

*Holdings in relation to an issuer*

The federal securities laws impose disclosure requirements on investors once their interest in a given issuer reaches a certain size. For example, beneficial owners of more than 5% of a voting class of an issuer's registered equity securities are required to file a Schedule 13D. This disclosure schedule must be filed within 10 days of the purchase and is designed, among other things, to disclose possible takeover attempts of an issuer. Schedule 13D also requires the beneficial owner of the securities to disclose the source and amount of funds being used to purchase the shares, and announce whether the purpose of the purchase is to acquire control as well as any plans or proposals with regard to future actions by the purchaser.

Instead of reporting beneficial ownership of more than 5% of a voting class of an issuer's registered equity securities on Schedule 13D, certain types of beneficial owners are eligible to report their holdings on the abbreviated "short-form" Schedule 13G. These investors are commonly referred to as Qualified Institutional Investors or Passive Investors. When filing a Schedule 13G, an investor must certify that the securities were not acquired and are not held with the purpose or with the effect of changing or influencing control of the issuer. Depending on the facts and circumstances, beneficial owners who report their holdings on Schedule 13G must file that disclosure schedule in as few as 10 days from the date of acquisition or as many as 45 days at the end of the calendar year to the extent their holdings exceeded 5% on the last day of that calendar year.

The federal securities laws also require beneficial owners of more than 10% of a voting class of registered equity securities to file a Form 3 to disclose their share ownership, and a Form 4 if the amount of share ownership changes. Form 3 is due within 10 days of becoming a 10% beneficial owner and Form 4 is due within 2 business days after the transaction that causes a change in beneficial ownership.

*Holdings in relation to the market*

Investors in U.S. exchange-traded equities are required to file Form 13F reports once the size of their discretionary assets under

management reaches a certain amount. Exchange Act Section 13(f) requires institutional investment managers that exercise investment discretion over accounts holding registered securities, the aggregate fair market value of which is $100 million or more, to file quarterly reports of their holdings in SEC-registered securities within 45 days of a quarter's end.

*Enforcement*

With regard to whether policing the markets will become more difficult as sovereign wealth funds grow larger, the SEC has a variety of tools with which to enforce the federal securities laws that allow it to be an effective regulator despite constant evolution in the capital markets. These tools include strong ties with securities regulators around the world that facilitate gathering evidence located abroad, thus allowing the Commission to pursue wrongdoing even if the perpetrators are outside U.S. borders. Even if another government is recalcitrant in its cooperation, illegal activities such as market manipulation and insider trading generally leave sufficient evidence in the United States that the SEC can proceed with its enforcement duties.

SWF HOLDINGS OF U.S. EXCHANGE-TRADED EQUITY SECURITIES

Mr. Tafara, in your testimony you point out that institutional investment managers who control more than $100 million of U.S. exchange-traded securities must file Form 13F at the end of each calendar quarter, which requires a manager to disclose the name of each reportable issuer, the number of shares, and the market value of the manager's portfolio.

**Q.2.a.** How active is the SEC's oversight with respect to ensuring adherence to the disclosure requirements of the Securities Laws?

**A.2.a.** There are over 12,000 companies that are registered with the SEC. SEC staff regularly reviews the filings of those companies, as mandated by the Sarbanes-Oxley Act. SEC staff, primarily in the Division of Enforcement and the Division of Corporation Finance, relies on a variety of public sources of information about registered companies for purposes of conducting surveillance for compliance with the US federal securities laws. In addition, the staff receives, on a continuous basis, information provided from nonpublic sources, such as investor or issuer complaints and tips from purported insiders or other sources. For example, in the context of proxy contests or hostile tender offers, issuers and other investors are the Commission's most common source of information about undisclosed shareholdings. Information indicating a material non-compliance with SEC disclosure requirements could become the basis of an SEC investigation. Once the SEC undertakes an enforcement action, depending on the facts and circumstances, it can seek various remedies, including enjoining further violations of the federal securities laws and imposing fines.

The SEC has taken action against institutional investment managers for not complying with Section 13(f) disclosure requirements. In 2007, the SEC brought actions against two funds for not complying with Section 13(f) reporting requirements, among other things. In August 2007, the SEC filed an administrative action against Quattro Global Capital LLC, a registered investment ad-

viser that failed to file Form 13F reports for a period of five years.[1] This failure to file was discovered as a result of an inspection of Quattro by the SEC's Office of Compliance Inspections and Examinations. Quattro agreed to a cease-and-desist order against further violations of the federal securities laws, as well as to pay a fine of $100,000. In a separate matter, also in 2007, the SEC filed a claim against two persons, Scott Sacane and J. Douglas Schmidt for their failure to file Form 13F reports and other disclosure documents in connection with their alleged fraudulent schemes concerning the purchase and sale of the common stock of two biotechnology companies.[2]

**Q.2.b.** Are there any sovereign investors, either sovereign wealth funds or state-owned enterprises, which file a form 13F and if so, which entities are they?

**A.2.b.** Through the SEC's Electronic Data Gathering and Retrieval system (EDGAR), a search can be conducted on any identified sovereign wealth fund or state-owned enterprise. This search would show all of the public filings that each entity has made, including Form 13F reports. We are aware of some sovereign wealth funds that have filed Form 13F reports, including the following:

- Norges Bank (Norway)
- Temasek Capital (Private) Ltd. (Singapore)
- Temasek Holdings (Private) Ltd. (Singapore)

Please note that this list may not be complete for the following reasons: (1) There is no SEC requirement that 13F filers identify themselves either as sovereign wealth funds or state-owned enterprises. (2) Sovereign wealth funds and state-owned enterprises would be required to file Form 13F only if they manage their assets themselves. If they hire other entities to manage their assets, those entities would be required to file Form 13F if they meet the criteria of Section 13(f) of the Exchange Act. However, those entities are not required to name their clients. (3) There are a large number of entities that have filed Forms 13F, most of which are not sovereign wealth funds or state-owned enterprises. Because Form 13F filers identify themselves only by name and address, a systematic search of EDGAR's Form 13F database for sovereign wealth funds, state-owned enterprises, or any other category of filer is impracticable.

In the past, the SEC staff has undertaken efforts to contact large private funds with US investments that had not filed Form 13F reports. The purpose of this exercise was to determine whether these funds should be filing Form 13F reports, and, if so, to bring them into compliance. Based on the staff's experience with these funds, we believe it is possible that some sovereign wealth funds may not be aware of their Form 13F reporting obligation. SEC staff is

[1] *In the Matter of Quattro Global Capital, LLC,* ADMINISTRATIVE PROCEEDING File No. 3–12725; 2007 SEC Lexis 1807 (August 15, 2007). The SEC administrative proceeding release on this matter is located at *http://www.sec.gov/litigation/admin/2007/34–56252.pdf.*

[2] *SEC v. Scott R. Sacane, et al.,* Civil Action No. 3:05cv1575–SRU (D. Conn., filed October 12, 2005); 2007 SEC Lexis 1929 (August 19, 2007). The SEC litigation release on this matter is located at *http://www.sec.gov/litigation/litreleases/2007/1r20258.htm.*

weighing various options for addressing sovereign wealth funds' compliance with Form 13F reporting requirements.

RECORD OF SETTLED SOVEREIGN INVESTMENT CASES

**Q.3.** Mr. Tafara, the Committee is aware of the inability of SEC staff to comment on the substance of any issue where there may be an ongoing investigation or enforcement action. I would like to ask however, about completed and settled cases.

Do you know of examples of any sovereign investor or state-owned enterprise that has been implicated in an enforcement action in the past?

**A.3.** We cannot report any recent SEC enforcement action against a sovereign investor or state-owned enterprise. Below are two matters in which the SEC brought actions against state-owned enterprises for making unregistered offers of bonds in the United States:

- In 1992, the SEC brought an administrative proceeding against the State Bank of Pakistan in *In the Matter of State Bank of Pakistan*[3] for violations of Section 5(c) of the Securities Act of 1933. The State Bank of Pakistan had offered bearer bonds in the United States without registering them with the Commission. This action was settled after the State Bank of Pakistan withdrew the offer and the SEC instituted a cease-and-desist order against further violations of Section 5 of the Securities Act.
- In 2001, the SEC brought an administrative proceeding against the State Bank of India in *In the Matter of The State Bank of India and Citibank, N.A.,*[4] also for violations of Section 5(c) of the Securities Act. This action was in response to an unregistered US offering of bonds made by the State Bank of India in 1998. In a settled action, the Commission ordered the State Bank of India to cease and desist from further violations of Section 5 of the Securities Act.

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## RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM PAUL ROSE

U.S. APPROACH TO REGULATING FOREIGN INVESTMENT

**Q.1.** The U.S. Government has pursued a transaction and sectoral based system of regulation for sovereign investment, rather than regulating types of investors.

I would like each of the witnesses to comment on the merits of this approach and any concerns you may have.

**A.1.** I believe that the general transaction and sectoral based system of regulation, as applied to all types of investors, has provided a strong framework that has served companies, investors and consumers well. However, sovereign investments do not fall neatly into the regulatory framework and often present risks that are not present with most other types of investment. Nevertheless, it is my

[3] Securities Act of 1933 Release No. 6937; 1992 SEC LEXIS 1041; 50 S.E.C. 980 (May 2, 1992).
[4] Securities Act of 1933 Release No. 8036; 2001 SEC LEXIS 2430 (Nov. 19, 2001). The SEC administrative proceeding release on this matter is located at *http://www.sec.gov/litigation/admin/33–8036.htm.*

opinion that the existing regulatory structure, as recently buttressed through the Foreign Investment and National Security Act, is flexible enough to address these risks. However, improvements could be made in the implementation of the existing regulations. For example, I am concerned that the sectoral focus does not provide a holistic view of a sovereign's investment in U.S. enterprises. The judgment of an agency with regard to a particular transaction could be affected if the agency were aware of the various investments that were approved by other agencies. To my knowledge, there is no formal mechanism (except to the extent certain agencies coordinate through CFIUS) to ensure that information is shared between all agencies, and that this information is relied upon in making judgments about the propriety of particular sovereign investments. At a minimum, a central repository of such information would be helpful for agencies, CFIUS and Congress in regulating sovereign investment.

With respect to regulating types of investors rather than regulating transactions, I have two concerns specific to the application of such a system to investment by sovereign wealth funds. First, sovereign wealth funds vary widely in their investment objectives, risk management systems and transparency. Regulating all investors of a given type in the same way would seem to apply blunt force where precision is needed; that precision is more likely achieved through a transaction-by-transaction approach.

Second, there are real risks that investor-specific regulation would raise the regulatory burden on sovereign wealth funds without correspondingly increasing the benefits of regulation beyond those provided by the existing framework. For example, imposing rules for fund governance (which would most likely be a feature of sovereign wealth fund-specific regulation) would likely drive funds to less-regulated jurisdictions where we would have even less information on and regulatory authority over their activities than we do under our present regulatory system. A useful illustration of this possibility is California's recent efforts to regulate hedge funds. Proposed legislation in California would have required registration of hedge funds if the funds were not already registered with the Securities and Exchange Commission. California abandoned the proposed legislation earlier this month for a variety of reasons, but certainly among them was the fact that California's legislators ultimately recognized that hedge funds would simply move to other jurisdictions like Connecticut and New York, and that California would lose the benefits of the hedge funds' operations within its borders.

For these reasons, I believe that we should address concerns in the present system not by replacing regulation, but instead continuing to ensure that the existing regulation works as intended by Congress. As noted above, this effort should include inter-agency information-sharing and coordination.

## RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DAVID MARCHICK

U.S. APPROACH TO REGULATING FOREIGN INVESTMENT

**Q.1.** The U.S. Government has pursued a transaction and sectoral based system of regulation for sovereign investment, rather than regulating types of investors.

I would like each of the witnesses to comment on the merits of this approach and any concerns you may have.

**A.1.** This answer is partially drawn from a paper that Matt Slaughter, Assistant Dean of the Tuck School of Business, and I have written for the Council on Foreign Relations.

Based on my experience, CFIUS examines a number of factors when evaluation the national security threats (or lack thereof) associated with a particular investment. CFIUS considers the origin of the investment, the individuals that control the foreign entity, past compliance with U.S. laws and regulations by the foreign investor, the sensitivity of the asset being acquired and the ability of the U.S. government to mitigate any national security concerns.

Some countries, including the United States and (if it adopts its new draft law) Germany, use broad-based national security review mechanisms without identifying specific sectors for which reviews are required. Other countries, including France and Russia, have chosen a sector-based approach in which they identify the sectors that require government approval for foreign takeovers.

There are benefits and drawbacks to each approach. Sector-based lists can provide a measure of clarity and predictability for foreign investors because they know with certainty whether an investment requires pre-approval. In the United States, the lack of a sector-based list leaves some investors and their advisors guessing as to which transactions should be filed with CFIUS. FINSA, the new statues governing CFIUS, makes clear that foreign investments in "critical infrastructure" are within the scope of CFIUS reviews. Yet the statute does not define critical infrastructure, and in four different reports in recent years the Department of Homeland Security has used four different definitions. On the other hand, publishing a sector-based list is very difficult for regulators because the facts and circumstances in which a foreign investment may raise national security issues vary significantly. Moreover, the ever-increasing complexity of global business structures makes it very hard to apply clear ex-ante lists to actual transactions. In practice, then, a list that is intended to boost investor certainty can end up actually reducing it. Overall, the possible investor-certainty benefit of sector-based lists is outweighed by the practical implementation problems of sensibly creating and applying these lists. Accordingly, a better approach is for countries not to create such lists. If a government does choose to create a sector-based list, however, it should be tailored to those transactions that are at the core of a government's national security interests. When drafting a sector-based list, regulators—who tend to be cautious and conservative in the first place—may be inclined to draft an extremely broad list that covers every conceivable transaction that could raise national security issues. This tendency should be resisted. For example, while foreign investments in energy have become more sen-

sitive and of greater interest to governments in Europe, Asia and North America, not all energy investments are sensitive. A government has a keen and legitimate interest in regulating nuclear energy, including who owns a nuclear energy company. Alternatively, it is hard to see how a foreign investment in, for example, a wind farm could raise national-security issues. Thus, instead of deeming energy as a broad sector of interest to government regulators, it would be better to identify, as narrowly as possible, those specific subsectors that raise national security concerns.

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## RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DENNIS JOHNSON

U.S. APPROACH TO REGULATING FOREIGN INVESTMENT

**Q.1.** The U.S. Government has pursued a transaction and sectoral based system of regulation for sovereign investment, rather than regulating types of investors.

I would like each of the witnesses to comment on the merits of this approach and any concerns you may have.

**A.1.** CalPERS does not have a policy position on the U.S. Government's system of regulating sovereign investments.