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The Regulation of Sovereign Wealth Funds: The Virtues of Going Slow

Richard A. Epstein[†] & Amanda M. Rose^{††}

Any symposium on private-equity firms and the going private phenomenon would be incomplete without discussion of Sovereign Wealth Funds (SWFs). These government-owned investment vehicles have and will continue to play an important role in the going private phenomenon. SWFs have not only helped fuel that phenomenon through their participation as limited partners in private-equity funds and hedge funds, but their massive capital infusions into ailing financial institutions and private-equity firms in the wake of the subprime mortgage crisis may, in a very real sense, save it. It is not hyperbolic to suggest that the future of private equity—including the going private phenomenon—and the future of SWFs are inescapably intertwined. Misguided regulation of the latter will, quite foreseeably, operate to the detriment of the former. And the scope of potential mischief is broad.

SWFs have existed for decades, but today they face heightened scrutiny due to their recent rapid growth and a concomitant shift in their investment strategy from primarily conservative debt instruments to higher risk/reward equity investments. This shift in strategy has stoked fears in the United States and Europe that these funds—which find home primarily in the Middle East and Asia—will use their economic clout to pursue political goals. This type of rhetoric has led some to call for increased regulation of SWFs.

In this Article we argue against imposing any additional burdens on investments by SWFs in the United States, at least at present. In our view, at this point a policy of watchful waiting is preferable to any immediate effort to impose special restrictions on SWFs. On the one hand, the nightmare scenarios painted by SWF critics often involve activities that would be caught by existing laws, either as they relate to national security or to various forms of business regulation under the securities and antitrust laws. On the other hand, we do not possess perfect foresight and cannot say that every possible permutation of SWF investment should escape a regulatory response in the future. What we do know, however, says that the burden of proof lies on those who think that further prophylactic regulation is in order at this juncture. To date, SWFs have acted as model investors, and the risk that they may act strategically in the future is significantly mitigated by existing safeguards. A far greater danger to America's economy and security inheres in taking unnecessary action that would encourage SWFs to redirect their investments elsewhere, or to harbor resentment toward the United States that could express itself in a wide range of hostile actions.

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INTRODUCTION

Sovereign Wealth Funds (SWFs) have become a topic of heated debate in Western policy circles. Although these government-owned investment vehicles have been around for decades, they face increased scrutiny today due to their recent rapid growth and a concomitant shift in their investment strategy from primarily conservative debt instruments to higher risk/reward equity investments. This shift in strategy has stoked fears in the United States and Europe that these funds—which find home primarily in the Middle East and Asia—will use their economic clout to pursue political goals. Director of the National Economic Council Lawrence Summers and SEC Chairman Christopher Cox are among those sounding alarm bells. “The logic of the capitalist system depends on shareholders causing companies to act so as to maximise the value of their shares,” explains Summers, and “[i]t is far from obvious that this will over time be the only motivation of governments as shareholders. They may want to see their national companies compete effectively, or to extract technology or to achieve influence.” Cox similarly warns that “[i]nvestors and regulators alike have to ask themselves whether government-controlled . . . 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.”¹ Jeffrey Garten also laments the rise of “state capitalism” and suggests that “the era of free markets unleashed by Margaret Thatcher and reinforced by Ronald Reagan in the 1980s is fading away.”²

This type of rhetoric has led some to call for increased regulation of SWFs. Federal laws already exist in the United States to protect against potential national security threats posed by foreign direct investment, including investments by SWFs; indeed, those laws were recently strengthened after the Dubai Ports World controversy cast popular doubt on their efficacy. But some contend that additional prophylactic regulations are needed to ensure that SWFs do not deviate from the narrow goal of share value maximization, even if that deviation does not present a true security threat. This is believed necessary to protect against what Professors Ronald Gilson and Curtis Milhaupt have dubbed “the new mercantilism”—namely, “government attempts to ensure that company-level behavior results in country-level maximization of eco-

¹ Lawrence Summers, *Sovereign Funds Shake the Logic of Capitalism*, Fin Times 11 (July 30, 2007).

² Christopher Cox, *The Rise of Sovereign Business*, Gauer Distinguished Lecture in Law and Policy at the American Enterprise Institute Legal Center for the Public Interest (Dec 5, 2007), online at <http://sec.gov/news/speech/2007/spch120507cc.htm> (visited Jan 11, 2009).

³ Jeffrey Garten, *How to Live with the Reality of State Capitalism*, Fin Times 17 (Jan 15, 2008).

conomic, social, and political benefits”⁴—and its alleged detrimental impact on our capitalist system. For example, some have argued that SWFs be permitted to invest only through professional money managers, or that they be limited to investing in index funds, or that they be denied the right to vote their equity shares altogether.⁵ Others have advanced the concept of a code of SWF “best practices” concerning issues of fund governance and transparency.⁶

The financial meltdown in the United States has temporarily quieted SWFs’ critics. Western financial institutions burdened by the crisis have clearly benefited from SWF investments, to the tune of billions of dollars, and would welcome more.⁷ Moreover, the United States itself has taken significant equity positions in troubled financial firms. But after the dust settles on Wall Street, and the blame game begins in earnest in Washington, SWFs will in all likelihood find themselves in the regulatory crosshairs once again. In this Article, we argue that it would be a mistake to place additional burdens on investments by SWFs in the United States, at least at present. Although the growth of SWFs may be a symptom of the weakened position of the United States in the global economy,⁸ it is not the cause—and increased regulation of SWFs, not the cure.

In constructing our argument, we seek to avoid two regulatory extremes. There are some who think that the best way to protect the US economy is to allow SWFs free reign in any and all of their activities, just as others think that regulations should be enacted now before some unknown disaster befalls us. We think that both of these positions share a common defect in that they are overhasty to make judgments about the benign or nefarious activities in which these funds could engage. In our view, at this point a policy of watchful waiting is preferable to any immediate effort to impose special restrictions on SWFs. On the one hand, the nightmare scenarios painted by SWF critics often involve activities that would be caught by existing laws, either as they relate to national security or to various forms of business regulation under the securities and antitrust laws. On the other hand, we do not possess perfect foresight, so we cannot say that every possible permutation of SWF investment should escape a regulatory response

⁴ Ronald J. Gilson and Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 Stan L Rev 1345, 1346 (2008) (examining the rise of sovereign wealth funds and proposing a “vote suspension” for equity positions taken by these funds).

⁵ See text accompanying notes 33–35.

⁶ See text accompanying note 38.

⁷ See Table 2.

⁸ The fiscal deficit of the United States and its dependence on foreign oil have contributed significantly to the growth of SWFs. See text accompanying notes 10–12.

in the future. What we do know, however, says that the burden of proof lies on those who think that further prophylactic regulation is in order at this juncture. To date, SWFs have acted as model investors, and the risk that they may act strategically in the future is significantly mitigated by existing safeguards. A far greater danger to America's economy and security inheres in taking unnecessary action that would encourage SWFs to redirect their investments elsewhere, or to harbor resentment toward the United States that could express itself in a wide range of hostile actions.

I. BACKGROUND

A. A Brief Primer on Sovereign Wealth Funds

It is beyond dispute that SWFs have become important new players in global capital markets. The basic statistics concerning their characteristics and recent growth have been well rehearsed and need be only briefly summarized here. For our purposes, it is sufficient to define SWFs as state-controlled investment vehicles funded by foreign-exchange assets but managed separately from official reserves.⁹ For a variety of reasons, countries with accumulated reserves in excess of requirements for exchange-rate management may choose to funnel money into an SWF. For example, major commodity exporters may create SWFs to transfer to future generations wealth derived from the exploitation of publicly owned nonrenewable resources. SWFs also allow oil-dependent economies to diversify their wealth and avoid the so-called "Dutch disease."¹⁰ Some Asian countries, such as Singapore and China, use the funds to recycle their large trade surpluses outside their homelands—including of course in the United States, where they in effect finance our nation's chronic trade deficit.

⁹ For a more detailed account of the increasing power and prominence of SWFs, see Gilson and Milhaupt, 60 *Stan L Rev* at 1354–59 (cited in note 4) (discussing the shift from a relatively small number of conservative SWFs to the current mass of active investment SWFs); Paul Rose, *Sovereigns As Shareholders* 87 *NC L Rev* 101, 103–06 (2008) (describing the growth in SWF assets). For alternative definitions of SWFs, see Mark Allen and Jaime Caruana, eds, *Sovereign Wealth Funds—A Work Agenda* 26–27, 37 (IMF Feb 29, 2008), online at <http://www.imf.org/external/np/pp/eng/2008/022908.pdf> (visited Jan 11, 2009).

¹⁰ See Ashby H.B. Monk, *Recasting the Sovereign Wealth Fund Debate: Trust, Legitimacy, and Governance* *9 (Working Papers in Employment, Work, and Finance WPG08-14, May 2008), online at <http://ssrn.com/abstract=1134862> (visited Jan 11, 2009) (describing the uses of SWFs to avert inflationary pressure from commodity prices and diversify wealth). See also generally Christine Ebrahim-zadeh, *Dutch Disease: Too Much Wealth Managed Unwisely*, 40 *Fin & Dev* 50 (Mar 2003), online at <http://www.imf.org/external/pubs/ft/fandd/2003/03/ebra.htm> (visited Jan 11, 2009) (defining "Dutch disease" as the damaging changes in terms of trade that can accompany rapid increases in wealth based on commodity exploitation).

Due to surging oil prices and the increased accumulation of foreign currency by Asian central banks, the coffers of SWFs have swelled.¹¹ They are currently estimated to run between \$2 trillion and \$3 trillion in the aggregate, up from \$500 billion in 1990, with strong anticipated growth in size in coming years.¹² As listed in Table 1, several SWFs already have estimated assets under management (AUM) that dwarf those of the largest private-equity funds in the world.¹³

TABLE 1

| Name | Country | Year Formed | AUM (billion USD) |
|--|-----------|-------------|----------------------|
| Abu Dhabi Investment Authority (ADIA) | UAE | 1976 | 875.0 |
| Government of Singapore Investment Corporation (GIC) | Singapore | 1981 | 330.0 |
| Government Pension Fund—Global | Norway | 1990 | 301.0 |
| Kuwait Investment Authority | Kuwait | 1953 | 264.4 |
| China Investment Corporation (CIC) | China | 2007 | 200.0 |
| Temasek Holdings | Singapore | 1974 | 134.0 |

Source: *Fund Rankings: Largest Funds by Assets under Management*, Sovereign Wealth Fund Institute (Oct 2, 2008), online at <http://www.swfinstitute.org/funds.php> (visited Jan 11, 2009) (listing forty-five SWFs with a total value of \$3.8 trillion, eleven of which are over \$79 billion).

Still, SWFs represent a relatively small fraction of the overall capital markets, which are currently estimated at \$190 trillion in global financial assets, of which about \$62 trillion is under the control of private institutional investors.¹⁴

¹¹ See Arvind Subramanian and Aaditya Mattoo, *Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization* *12–13 (Center for Global Development Working Paper No 12, Feb 2008), online at <http://ssrn.com/abstract=1131402> (visited Jan 11, 2009) (arguing that the increase in SWF coffers is due in part to exchange rate manipulation by Asian central banks). This trend has recently, at least temporarily, reversed. See Joanna Slater, *States Play Currency Defense—Russia, South Korea Intervene to Stem Weakness vs. Dollar*, Wall St J A9 (Sept 11, 2008) (reporting that falling commodity prices have led some governments with SWFs, including Russia, to spend reserves to shore up domestic currencies).

¹² See Simon Johnson, *The Rise of Sovereign Wealth Funds*, 44 Fin & Dev 56, 56 (Sept 2007) (describing the dramatic growth of SWFs from their inception in the 1950s). See also Edwin M. Truman, *A Blueprint for Sovereign Wealth Fund Best Practices* *2 (Peterson Institute for International Economics Policy Brief No PB08-3, Apr 2008), online at <http://www.petersoninstitute.org/publications/pb/pb08-3.pdf> (visited Jan 11, 2009) (listing information for thirty-three SWFs totaling \$2.9 trillion in size).

¹³ See Rose, 87 NC L Rev at 209 (cited in note 9).

¹⁴ Department of the Treasury, *Report to Congress on International Economic and Exchange Rate Policies: Appendix 2: Sovereign Wealth Funds* 1–2 (Dec 2007), online at <http://www.ustreas.gov/offices/international-affairs/economic-exchange-rates/pdf/Dec-2007Appendix2.pdf> (visited Jan 11, 2009).

Historically, SWFs have invested heavily in conservative debt instruments, like US Treasury bonds (helping to keep long-term US interest rates low). In light of their growth, however, SWF managers have recently—and quite prudently—determined to seek higher returns and greater diversification by investing more heavily in equities.¹⁵ Some of the high-profile investments by SWFs in 2007 are listed in Table 2.

TABLE 2

| Target | Size (million USD) | Percent stake held by SWFs |
|-----------------------|-----------------------|-------------------------------|
| UBS | 9,750 | 9.0% |
| Citigroup | 7,500 | 4.9% |
| Morgan Stanley | 5,000 | 9.9% |
| Blackstone Group | 3,000 | 10.0% |
| Barclays Bank | 2,970 | 3.1% |
| Standard Chartered | 1,416 | 3.8% |
| Carlyle Group | 1,350 | 7.5% |
| London Stock Exchange | 1,274 | 20.0% |
| Och-Ziff | 1,260 | 9.9% |
| EADS | 833 | 3.1% |
| AMD | 622 | 8.1% |

Source: David Marchick, *Sovereign Wealth Funds and National Security* 5 (OECD/City of London Conference on Sovereign Wealth Funds in the Global Investment Landscape: Building Trust, Mar 31, 2008), online at <http://www.oecd.org/dataoecd/38/12/40395077.pdf> (visited Jan 11, 2009).

To date there is little evidence that any SWF has actively sought to lever its investment positions for either political or collateral business purposes. Unable to identify any example where an SWF has in fact acted in this manner, critics of SWFs have pointed instead to Russia's Gazprom, which has been accused of exerting strategic influence through its investments in Western Europe.¹⁶ But Gazprom's behavior has as much to do with its control over Europe's gas pipelines as the Kremlin's control over it.¹⁷ Moreover, state-owned enterprises (SOEs) present different, and more challenging, issues than do SWFs. As Gil-

¹⁵ See Krzysztof I. Rybinski and Urszula Sowa, *Global Reserves Management* *5–20 (May 2007), online at <http://ssrn.com/abstract=985071> (visited Jan 11, 2009) (calculating the opportunity cost of “too conservative” reserve management by central banks).

¹⁶ See Ian Traynor, *Sovereign Wealth Funds Likened to Gazprom As Brussels Calls for Rules: Commission Asks SWFs for Greater Openness: Fears of Growing Wealth Wielded for Political Aims*, *Guardian* (London) 28 (Feb 28, 2008).

¹⁷ See Edward Lucas, *The New Cold War: Putin's Russia and the Threat to the West* ch 7 (Palgrave 2008) (describing the roots of Gazprom's influence in Europe).

son and Milhaupt have observed, “[A] government-controlled operating company may have the power to secure strategic concessions from a foreign company as a precondition to the government company’s commercial purchases from the foreign company or as the price of market entry through a joint venture.”¹⁸ Whatever the appropriate regulatory response to SOEs, however, SWFs present a different picture for they have consistently behaved as model investors. As a US official has described them:

[SWFs] are, in principle, long-term investors that can be expected to stick with a strategic asset allocation despite short-term losses. They are not highly leveraged. They cannot be forced by capital requirements or investor withdrawals to liquidate positions rapidly. They have access to, and frequently make use of, well-regarded private fund managers, consultants, administrators and custodians.¹⁹

Moreover, “From the viewpoint of international financial markets, SWFs can facilitate a more efficient allocation of revenues from commodity surpluses across countries and enhance market liquidity, including at times of global financial stress.”²⁰

B. The Regulatory Status Quo

As it stands currently, in the United States SWFs must abide by the same rules as private pools of capital, such as private-equity funds and hedge funds. For example, they must make disclosures pursuant to § 13(d) of the Securities Exchange Act of 1934²¹ (“Exchange Act”) if they acquire a 5 percent or greater equity stake in a public company,²² but are not subject to the more onerous reporting requirements that burden registered investment companies. As might be expected, disclosure practices vary.²³ Some SWFs—notably Norway’s Government

¹⁸ Gilson and Milhaupt, 60 Stan L Rev at 1367 (cited in note 4).

¹⁹ Remarks by Acting Under Secretary for International Affairs Clay Lowery on *Sovereign Wealth Funds and the International Financial System* (June 21, 2007), online at <http://www.treas.gov/press/releases/hp471.htm> (visited Jan 11, 2009) (discussing both the benefits and the risks attributable to the increased power of SWFs).

²⁰ IMF Survey Online, *IMF Intensifies Work on Sovereign Wealth Funds*, IMF Survey Mag (Mar 4, 2008), online at <http://www.imf.org/external/pubs/ft/survey/so/2008/POL03408A.htm> (visited Jan 11, 2009) (quoting the IMF’s First Deputy Managing Director John Lipsky).

²¹ Securities Exchange Act of 1934 (“Exchange Act”), Pub L No 73-291, 48 Stat 881, codified at 15 USC § 78a et seq.

²² 15 USC § 78m(d)(1); 17 CFR § 240.13d-101.

²³ See Cornelia Hammer, Peter Kunzel, and Iva Petrova, *Sovereign Wealth Funds: Current Institutional and Operational Practices* 7–8, 13 (IWG Secretariat Sept 15, 2008), online at <http://www.imf.org/external/pubs/ft/wp/2008/wp08254.pdf> (visited Jan 11, 2009) (reporting the findings of a survey of twenty countries with SWFs and noting the relative diversity of operational structures, styles, and goals for the SWFs).

Pension Fund—disclose significant amounts of information voluntarily.²⁴ Many do not.

Just like domestic investors, SWFs are also subject to the antifraud provisions of the securities laws, the antitrust laws, and state corporate law.²⁵ If, as some have worried, an SWF were to engage in industrial espionage, it could be held accountable in the United States under a variety of legal theories. As SEC Chairman Cox has observed, “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.”²⁶

In addition to the foregoing laws of general applicability, various US statutory regimes restrict foreign control in certain sensitive industries, like nuclear energy and airlines.²⁷ Moreover, foreign investments in domestic companies are also subject to review by the interagency Committee on Foreign Investment in the United States (CFIUS), as recently codified in the Foreign Investment and National Security Act of 2007²⁸ (FINSAs). Under the general CFIUS process, any transaction that could result in a foreign entity’s “control” of a company engaged in interstate commerce in the United States is subject to a thirty-day review to determine the effects of the transaction on national security; unless it is determined at the Deputy Secretary level or above that the transaction will *not* impair national security, an additional forty-five day investigation is required of all transactions involving foreign gov-

²⁴ See Arild Strømme, *Transparency and Trust: Keys to the Norwegian Pension Fund* (Norway Jan 24, 2008), online at <http://www.norway.org/policy/gpf/norwegian+pension+fund+global.htm> (visited Jan 11, 2009) (providing an overview of the Norwegian SWF’s governance structure).

²⁵ For example, SWF investments in US banks would trigger the same scrutiny as any other investment. See Turmoil in the U.S. Credit Markets: Examining the U.S. Regulatory Framework for Assessing Sovereign Investments, Hearing before the Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong, 2d Sess (Apr 24, 2008) (testimony of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System), online at <http://www.federalreserve.gov/newsevents/testimony/alvarez20080424a.htm> (visited Jan 11, 2009).

²⁶ Cox, *The Rise of Sovereign Business* (cited in note 2).

²⁷ See, for example, Federal Aviation Act of 1958 § 101, Pub L No 85-726, 72 Stat 731, 737–38; Atomic Energy Act of 1954 § 103(d), Pub L No 83-703, 68 Stat 919, 937, codified at 42 USC § 2133; See also Michael Hagan and Heidi Johanns, *Sovereign Wealth Funds: Risks, Rewards, Regulation and the Emerging Cross-border Paradigm*, 8 M&A J 1, 5 (June 2008) (providing an overview of current SWF oversight in the United States and examining various regulatory proposals for increasing SWF regulation).

²⁸ The Foreign Investment and National Security Act of 2007 § 3, Pub L No 110-49, 121 Stat 246, 252, codified at 50 Appx USCA § 2170(k) (establishing CFIUS by statute and instituting annual reporting requirements). Technically, FINSAs amends the 1988 Exon-Florio Amendment, officially known as the Omnibus Trade and Competitiveness Act of 1988 § 5021, Pub L No 100-418, 102 Stat 1107, 1425–26, which itself amended the Defense Production Act of 1950, Pub L No 81-774, 64 Stat 798. Exon-Florio authorizes the president to suspend or prohibit transactions that could result in foreign control of US companies based on national security concerns; the president has delegated the job of reviewing individual transactions to CFIUS.

ernment-controlled entities (which includes all SWFs).²⁹ If a transaction does raise security concerns, CFIUS may block it or enter into a “mitigation agreement” with parties to the transaction, requiring that steps be taken to address those concerns³⁰ (for example, the SWF could commit to passivity, or the company could agree to withhold certain sensitive information from the SWF). Whatever decision is reached, the president is required to announce it publicly.³¹ Although parties to a proposed transaction that falls within CFIUS’s jurisdiction are under no legal obligation to notify the committee, they do so as a matter of course so as to avoid the possibility that their transaction will be undone later as a result of a sua sponte CFIUS review.³²

C. Calls for Additional Regulation

Notwithstanding SWFs’ clean track record under these preexisting safeguards, many vocal politicians and pundits have warned of the dangers SWFs pose to our capitalist system and, somewhat paradoxically, have advocated for increased regulation. As noted at the outset, some have suggested that SWFs be permitted to invest only through financial intermediaries, whereas others have suggested SWFs be limited to investing in global index funds.³³ Alternative proposals include that SWFs be stripped of their voting rights,³⁴ that they be for-

²⁹ Department of the Treasury, *Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons*, 73 Fed Reg 21861, 21862 (2008) (explaining FINSA and the CFIUS oversight process). Proposed regulations implementing FINSA define “control” broadly as the

power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity.

Id at 21869 (emphasis added).

³⁰ Id at 21862.

³¹ 50 App USCA § 2170(d)(2).

³² For a more extensive description of the CFIUS review process, see Rose, 87 NC L Rev at 126–30 (cited in note 9). For a description of comparable regimes in other nations, see Government Accountability Office, *Foreign Investment: Laws and Policies Regulating Foreign Investment in 10 Countries*, GAO-08-320, 3–21 (Feb 2008), online at <http://gao.gov/new.items/d08320.pdf> (visited Jan 11, 2009).

³³ See, for example, Joshua Aizenman and Reuven Glick, *Sovereign Wealth Funds: Stumbling Blocks or Stepping Stones to Financial Globalization?* 2–3 (Federal Reserve Board of San Francisco Economic Letter No 2007-38, Dec 14, 2007), online at <http://www.frbsf.org/publications/economics/letter/2007/el2007-38.pdf> (visited Jan 11, 2009) (describing the rise of SWFs and the fears that SWFs will destabilize the global economy and advocating that SWFs invest in diversified global equities to prevent destabilization).

³⁴ Although Professors Gilson and Milhaupt view this as a “minimalist” approach, see Gilson and Milhaupt, 60 Stan L Rev at 1346, 1352 (cited in note 4), others have pointed out that it “negates the essential nature of equity investment.” Rose, 87 NC L Rev at 139 (cited in note 9). See also Truman, *A Blueprint for Sovereign Wealth Fund Best Practices* at 12 (cited in note 12) (observing

bidden from taking controlling positions in domestic companies,³⁵ and that they be subjected to mandatory disclosure and governance rules.³⁶ In Germany, protectionist forces have proposed the creation of a fund, financed by “German saving banks, co-operative banks and insurance companies,” which would acquire blocking minority positions in companies deemed at risk of falling under foreign control.³⁷

Thus far, Western policymakers have not adopted such extreme measures but have instead called for the promulgation of a code of voluntary “best practices” to govern SWF investments. In October 2007, the G-7 Finance Ministers announced that they “see merit in identifying best practices for SWFs in such areas as institutional structure, risk management, transparency and accountability,” and, in a temporizing move, called on the International Monetary Fund (IMF) to examine these issues.³⁸ The G-7 also asked the Organization for Economic Cooperation and Development (OECD) to examine best practices for countries that receive SWF investments, building on principles of nondiscrimination, transparency, predictability, and accountability.³⁹

The IMF responded to the G-7’s entreaty by opening a dialogue with SWFs to identify best practices.⁴⁰ In November 2008 the IMF held

that this approach, if applied uniformly in the United States, would “disenfranchise as much as several trillion dollars of investments by U.S. state and local government pension funds”).

³⁵ See Truman, *A Blueprint for Sovereign Wealth Fund Best Practices* at 13 (cited in note 12) (noting that some observers have suggested that SWFs not take controlling stakes except in real estate projects where control is essential).

³⁶ See Evan Bayh, *Time for Sovereign Wealth Rules*, Wall St J A26 (Feb 13, 2008); Service Employees International Union, *Sovereign Wealth Funds and Private Equity: Increased Access, Decreased Transparency* 8–9 (Apr 2008), online at <http://www.behindthebuyouts.org/storage/Sovereign%20Wealth%20Funds%20and%20Private%20Equity%20Final%20Report%20April%202008.pdf> (visited Jan 11, 2009).

³⁷ See Bertrand Benoit, *Berlin’s Takeover Defence Fund Plan Faces Collapse*, Fin Times 2 (Nov 8, 2007) (reporting that banks and insurance companies did not embrace the protection fund); Paul Betts, *Will Deutschland AG Battle with the Giant Locusts*, Fin Times 14 (Nov 8, 2007) (reporting that some German politicians are nostalgic for the old “Deutschland AG system of corporate control” that protected Germany’s corporate jewels and are searching for new ways to restrict foreign investment). See also Monk, *Recasting the Sovereign Wealth Fund Debate* at 26–28 (cited in note 10) (suggesting that reform could come through “the implementation of a qualified foreign institutional investors (QFII) program for the 40 or so SWFs seeking to invest [in the United States]”).

³⁸ Department of the Treasury, *Statement of G-7 Finance Ministers and Central Bank Governors* (Oct 19, 2007), online at <http://www.treas.gov/press/releases/hp625.htm> (visited Jan 11, 2009) (calling on the IMF and World Bank to adopt policies regarding SWF “non-discrimination, transparency, and predictability”). See also Lesley Wroughton, *IMF Endorses Wealth Fund Guide Plan*, (Reuters Mar 22, 2008), online at <http://uk.reuters.com/article/ousiv/idUKN2149803220080322> (visited Jan 11, 2009) (discussing the “best practices” the IMF planned to encourage SWFs to adopt).

³⁹ Department of the Treasury, *Statement of G-7 Finance Ministers and Central Bank Governors* (cited in note 38).

⁴⁰ *Communiqué of the International Monetary and Financial Committee of the Board of Governors of the IMF* ¶ 6 (IMF Oct 20, 2007), online at <http://www.imf.org/external/np/cm/2007/102007a.htm> (visited Jan 11, 2009) (announcing the International Monetary and Financial Commit-

a Roundtable of Sovereign Asset and Reserve Managers during which “discussion was held with the SWFs to learn from their experience and views.”⁴¹ The IMF held another meeting in late April 2008 during which the International Working Group of Sovereign Wealth Funds (IWG) was created, consisting of representatives from twenty-five IMF member countries.⁴² In September 2008, the IWG reached a preliminary agreement on a draft set of “Generally Accepted Principles and Practices” designed to “guide the appropriate governance and accountability arrangements, as well as the conduct of appropriate investment practices by SWFs.”⁴³ These voluntary guidelines were presented at a meeting of the International Monetary and Financial Committee, the IMF’s policy-guiding body, in October 2008.⁴⁴ The OECD, for its part, held a conference in London in March 2008, which reportedly “provided an opportunity for representatives of [SWFs], private financial institutions, and recipient governments to share views on what steps SWFs and recipient governments can take to build mutual confidence and trust.”⁴⁵ The OECD promises “a menu of best practices” governing recipient countries’ treatment of SWFs by mid-2009.⁴⁶

tee’s support for continued dialogue between SWFs and recipient countries to avert protectionism and instability).

⁴¹ IMF, *IMF Convenes First Annual Roundtable of Sovereign Asset and Reserve Managers* (Nov 16, 2007), online at <http://www.imf.org/external/np/sec/pr/2007/pr07267.htm> (visited Jan 11, 2009).

⁴² IMF, *International Working Group of Sovereign Wealth Funds Is Established to Facilitate Work on Voluntary Principles* (May 1, 2008), online at <http://www.imf.org/external/np/sec/pr/2008/pr0897.htm> (visited Jan 11, 2009). The IWG’s members are: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, South Korea, Timor-Leste, Trinidad and Tobago, the UAE, the United States, and Vietnam; Saudi Arabia, the OECD, and the World Bank participate as observers. Id. The Director of the IMF’s Monetary and Capital Markets Department and a senior representative of ADIA were selected as co-chairs of the group by the participating SWFs. See id.

⁴³ IWG, *International Working Group of Sovereign Wealth Funds Reaches a Preliminary Agreement on Draft Set Generally Accepted Principles and Practices—“Santiago Principles”* (Sept 2, 2008), online at <http://www.iwg-swf.org/pr/swfpr0804.htm> (visited Jan 11, 2009).

⁴⁴ IWG, *Sovereign Wealth Funds: Generally Accepted Principles and Practices—“Santiago Principles” 7–9* (Oct 2008), online at <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf> (visited Jan 11, 2009).

⁴⁵ OECD/City of London Conference, *Sovereign Wealth Funds in the Global Investment Landscape: Building Trust* (Mar 31, 2008), online at http://www.oecd.org/document/38/0,3343,en_2649_201185_40098406_1_1_1_1,00.html (visited Jan 11, 2009).

⁴⁶ OECD Investment Committee, *Sovereign Wealth Funds and Recipient Country Policies 6* (OECD Apr 4, 2008), online at <http://www.oecd.org/dataoecd/34/9/40408735.pdf> (visited Jan 11, 2009). See also Meeting of the Council at Ministerial Level, *OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies* (OECD June 5, 2008), online at [http://www.ois.oecd.org/ois/2008doc.nsf/LinkTo/NT000032DE/\\$FILE/JT03247225.pdf](http://www.ois.oecd.org/ois/2008doc.nsf/LinkTo/NT000032DE/$FILE/JT03247225.pdf) (visited Jan 11, 2009); Carolyn Ervin, *Sovereign Wealth Funds*, 267 *OECD Observer* 21, 22 (May/June 2008).

The European Commission expressed its support of the IMF's and OECD's efforts in a communiqué in early 2008.⁴⁷ Although it acknowledged that SWFs are already subject to a comprehensive regulatory regime at both the EU and member-state levels, and that "SWFs have behaved so far as reliable investors and their activities have not resulted in problems for the functioning of the internal [European] market," it stressed the need "to obtain greater clarity and insight into the governance of SWFs" and to "deliver greater transparency on their activities and investments."⁴⁸

The US Treasury Department has likewise endorsed the work of the IMF and OECD. Former Treasury Secretary Henry Paulson met with officials from Abu Dhabi and Singapore in March 2008 and agreed on a set of "policy principles for SWFs" and countries receiving SWF investment; these principles "are intended to support the processes underway in the [IMF] and [OECD] to develop voluntary best practices for SWFs and inward investment regimes for government-controlled investment in recipient countries."⁴⁹ The policy principles agreed to for SWFs include the following:

SWF investment decisions should be based solely on commercial grounds, rather than to advance, directly or indirectly, the geopolitical goals of the controlling government. SWFs should make this statement formally as part of their basic investment management policies.

Greater information disclosure by SWFs in areas such as purpose, investment objectives, institutional arrangements, and financial information—particularly asset allocation, benchmarks, and rates of return over appropriate historical periods—can help reduce uncertainty in financial markets and build trust in recipient countries.

SWFs should have in place strong governance structures, internal controls, and operational and risk management systems.

SWFs and the private sector should compete fairly.

⁴⁷ Commission of the European Communities, *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: A Common European Approach to Sovereign Wealth Funds* 4–5 (Feb 27, 2008), online at http://ec.europa.eu/commission_barroso/president/pdf/COM2008_115_en.pdf (visited Jan 11, 2009).

⁴⁸ *Id.* at 5–6, 8–9.

⁴⁹ Department of the Treasury, *Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi* (Mar 20, 2008), online at <http://www.ustreas.gov/press/releases/hp881.htm> (visited Jan 11, 2009).

SWFs should respect host-country rules by complying with all applicable regulatory and disclosure requirements of the countries in which they invest.⁵⁰

II. DISCUSSION

We fear that this movement toward “best practices” will be the proverbial camel’s nose under the tent, leading to the adoption of more onerous regulations like those discussed above. In our view, imposing such burdens on SWF investments would be a mistake. Regulations are costly to create and implement, and often have unintended consequences. It is reasonable to require that those proposing their adoption demonstrate, at minimum: (1) that there is in fact a problem, (2) that existing tools are inadequate to deal with that problem, and (3) that the proposed regulatory response will not cause more harm than the problem itself presents. In our view, the case that has been made for imposing additional regulatory burdens on SWFs fails each prong of this simple test.

A. The (Ostensible) Problem

The articulated justification for the regulatory proposals discussed above is that an SWF might, at some point in the future, act to advance its nation’s strategic interests rather than to simply maximize its investment returns. This is couched not as a threat to our national security—as explained previously, the CFIUS review process was recently reformed to deal with those concerns—but rather as an affront to our capitalist system. Capital markets will be inefficient, the argument goes, when they are sullied with players who have collateral, non-profit-maximizing objectives. In our view, this is a weak rationale for additional regulation of SWFs.

As an initial matter, the ability of SWFs to distort the capital markets in this manner is limited. Assume that SWFs do begin to invest based on strategic interests rather than investment fundamentals. What could they do to influence the price at which securities are valued? They will bid up the price of some securities and let the price of others fall. In and of itself, this may look to be a distortion, but that ignores the corrective steps that other players, freed of such inhibitions, can play in the market. (Recall that the \$2–3 trillion under management of SWFs is matched by \$62 trillion in global assets under the control of private institutional investors.⁵¹) These other players can make sub-

⁵⁰ Id. For additional background, see generally Bryn Morgan, ed, *Economic Indicators, July 2008: Sovereign Wealth Funds* iii–xvi (House of Commons Library Research Paper 08/59, July 2008), online at <http://www.parliament.uk/commons/lib/research/rp2008/rp08-059.pdf> (visited Jan 11, 2009).

⁵¹ See text accompanying note 14.

tle adjustments in their portfolios to offset the relevant risks. Assuming deep capital markets like those in the United States, in the end the distributional consequences should be minor, and the allocative consequences too small to measure. The reduced rate of return will be borne by those who adopt the non-profit-maximizing strategy, which is hardly a reason for others—who can now be their trading partners—to oppose its use.⁵²

To be sure, SWFs could also attempt to influence firm-specific behavior in order to achieve some tangible or intangible benefit for their home country, other than share-value maximization; if successful, this could cause microeconomic distortions. This appears to be the type of distortion that critics of SWFs are most concerned about. For example, an SWF could attempt to persuade a company in which it is invested to open up a manufacturing plant within its borders in order to alleviate its nation's unemployment, notwithstanding that this would not be the best use of the firm's capital from a profit perspective. Or—as is the case with Norway's Government Pension Fund—an SWF could allow its nation's values (such as they relate to things like human rights, sustainable development, and the environment) to inform its behavior as a shareholder.⁵³ The likelihood that an SWF would actually succeed in convincing a firm to take action that is not in the firm's best interest, however, is slight. Even assuming that the firm's officers and directors would be willing to breach their fiduciary duties to the firm, the reality is that SWFs typically take only small equity stakes in individual companies. One would expect any influence exerted by an SWF to be offset by the majority of other shareholders in the firm who do wish, above all else, to maximize their share value.

But let's assume that SWFs' strategic behavior could in fact distort the capital markets or cause firms to act in non-profit-maximizing ways. This does not in any case warrant imposing unique burdens on their investments. SWFs would certainly not be the first shareholders to make investment decisions based on objectives other than profit max-

⁵² As Gilson and Milhaupt have observed, "equity investments must be sold to a willing buyer in light of any change in circumstances, including the actions of the particular sovereign; SWFs, and their governments, bear the cost of any decline in equity value." Gilson and Milhaupt, 60 *Stan L. Rev* at 1360 (cited in note 4).

⁵³ Norway's fund has a "Council of Ethics" that recommends divestiture if a particular investment creates a risk of the fund's complicity in, for example, human rights violations, serious environmental damage, or "other particularly serious violations of fundamental ethical norms"; its activities have led the fund to exclude Kerr-McGee, Wal-Mart Stores, Inc, and Freeport-McMoRan Copper & Gold Inc from the fund's investment universe, among several other companies. See Simon Chesterman, *The Turn to Ethics: Disinvestment from Multinational Corporations for Human Rights Violations—The Case of Norway's Sovereign Wealth Fund*, 23 *Am U Intl L Rev* 577, 588–93 (2008).

imization.⁵⁴ For example, the Service Employees International Union (SEIU)—whose President Andy Stern is a strong critic of all private-equity firms—just recently proposed that the California Public Employees' Retirement System (CalPERS) not invest in certain companies that fail to meet acceptable labor standards.⁵⁵ CalPERS has also entertained other proposals that it not invest in specific foreign countries, or alternatively that it funnel investments into firms that hire workers from "disadvantaged areas."⁵⁶ These proposals meet with stout resistance by investment professionals who observe simply that any restriction on investment choice is likely to lower a fund's rate of return.⁵⁷ Yet we believe no one would argue that unions and universities and religious organizations should be banned as a matter of law from adopting, for example, divestiture strategies, even if they work against the stated policy of the United States, which these movements are meant to throw into disrepute.

This is, we believe, as it should be. We are as much defenders of capitalist institutions as anyone else, but that hardly puts us in a position to say that state pension funds should not be able to invest their workers' income, and vote their shares, to maximize some political choice that the group as a whole has endorsed. Nor should anyone say that George Soros cannot take a gander on some collateral objective in investing his own money. It may well be that foreign nations would be unwise to make strategic investment decisions—indeed, their refusal to make distributions of their excess wealth to individual citizens to invest through private vehicles, as they individually see fit, may itself be misguided. For its part, the United States has determined not to accumulate sovereign wealth for equity investment purposes based on the belief that private investment is likely to produce greater returns and, as a result, greater national prosperity. If that choice is correct, countries with SWFs may eventually come around to our way of thinking. But that is a matter for *them* to decide, not for the US Congress or

⁵⁴ See generally Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum L Rev 795 (May 1993) (examining the role of activist public funds).

⁵⁵ See Editorial, *California's Stern Rebuke*, Wall St J A16 (Apr 21, 2008), and the response, Stephen Lerner, *SEIU Seeks Ethics, Good Returns*, Wall St J A8 (Apr 26, 2008) (defending SEIU's efforts as "in the footsteps" of the fight against South African apartheid).

⁵⁶ Benn Steil, *California's Sovereign Wealth Fund*, Wall St J A14 (Mar 7, 2008) (criticizing CalPERS for taking the same kind of politicized and fiscally irresponsible actions an SWF could take).

⁵⁷ *Id.* (detailing the expected losses from politically motivated divestments and exclusionary rules). These observations appear accurate. See Romano, 93 Colum L Rev at 798 (cited in note 54) (finding "an inverse relation between the return on funds' investments and the degree of political involvement in their organizational form, and between return on investments and policies favoring social investing").

some governing world body.⁵⁸ So long as an investor's motives are lawful, the host government should not concern itself with them—whether the investor is CalPERS or ADIA. Only such parity of treatment is consistent with the principle of nondiscrimination touted by the G-7, and with America's stated commitment to free and open markets.

It may be argued that the analogy between SWFs and other investors is fallacious, because SWFs can potentially exercise outsized influence relative to their shareholdings—influence that reflects the power of the fund's sovereign over valuable resources or markets. But this argument does not withstand careful scrutiny. Consider the two ways in which an SWF could try to exercise such influence in order to achieve the opening of the unprofitable plant mentioned above (or substitute any course of conduct that advances the SWF's national strategic interests but is not profit maximizing for the firm). First, the SWF might offer the firm some carrot (like tax breaks) to induce the firm to open the plant. But the sovereign need not be an investor in the firm to pursue this strategy, and the plant opening under this scenario would be profit maximizing for the firm in any event (the firm would not take the carrot unless it more than offset the anticipated losses from the plant opening). Second, the SWF might threaten the firm with some stick (like blocking the firm's access to its product markets) to induce it to open the plant. But, again, this strategy in no way requires that the sovereign be an investor in the firm. Indeed, the fact that the sovereign has an equity investment in the firm only reduces the credibility of such protectionist threats (because carrying them out will hurt the SWF's bottom line). The SWF might also threaten to dump its shares in the firm or refuse to invest in it in the future. But this is a stick that *any* large investor could wave; it is in no way attributable to the SWF's sovereign status.

This discussion should make clear that the threat of strategic investing by SWFs presents a fundamentally different issue than a nation imposing tariffs or entry restrictions to help domestic industries, or otherwise playing favorites within its own borders. SWFs operate in the US capital markets, according to market rules; they gain no advantage over other shareholders by virtue of their sovereign ownership. Moreover, it is hornbook law that no foreign nation gets any form of sovereign immunity with respect to its routine commercial activities

⁵⁸ That share-value maximization should be the sole motive for corporate action is not a principle that is accepted by all, even in the United States. See, for example, Kent Greenfield, *The Failure of Corporate Law: Fundamental Flaws and Progressive Possibilities* 41–71 (Chicago 2006) (arguing that corporations should be considered to have duties to their employees as a central tenant of corporate law).

within the United States, including its financial investments.⁵⁹ We therefore should take some measure of relief from the fact that SWFs invest outside their home territories, where they do not have any of the mischievous advantages borne of mixing their commercial and sovereign ventures in their own nation. The great advantage of markets is that people can trade peacefully and successfully with other individuals with whom they share *no* common aspirations. Anyone can bid at an art auction, no matter what his politics. On this ground at least, let anyone play in our markets, with whatever utility function, sensible or stupid, that he possesses.

Once it is conceded that SWFs are not the only investors who may invest “strategically,” it becomes clear that proposals that would place special burdens on SWFs on this ground are unjustified. This includes using diplomatic pressure to impose a code of “best practices” on SWFs concerning their internal governance and transparency. Of course, there are those who believe that governance standards and disclosure obligations should be imposed on *all* pools of capital large enough to have systemic effects on global financial stability—including private-equity funds and hedge funds. But whatever the merit of that position, it cannot justify singling out SWFs for these burdens. The United States has agreed in principle that “SWFs and the private sector should compete fairly,” and that is (or ought to be) a two-way street.⁶⁰ Indeed, this type of discrimination would be particularly unjustified given that SWFs are believed to pose fewer systemic risks than private equity and hedge funds, and in fact may pursue investment strategies that promote financial stability. Although data is limited, it is believed that SWFs most frequently take long positions and rarely place investments with leveraged funds.⁶¹

⁵⁹ Federal law provides:

[A] foreign state shall not be immune from the jurisdiction of courts of the United States or of the States in any case . . . in which the action is based upon a commercial activity carried on in the United States by the foreign state; or upon an act performed in the United States in connection with a commercial activity of the foreign state elsewhere; or upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.

28 USC § 1605(a). See also Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 NYU L Rev (forthcoming 2009) (explaining that sovereign portfolio investing is exempt from taxation under current law as a matter of domestic statutory law, not sovereign immunity).

⁶⁰ Department of the Treasury, *Treasury Reaches Agreement* (cited in note 49) (listing a set of joint policy principles, including the idea that “recipient countries should not discriminate among investors” and that “[i]nward investment policies should treat like-situated investors equally”).

⁶¹ See *Remarks by Acting Under Secretary for International Affairs Clay Lowery* (cited in note 19) (“Sovereign Wealth Funds are, in principle, long-term investors that can be expected to stick with a strategic asset allocation despite short-term losses. They are not highly leveraged.”);

Like most private-equity funds and hedge funds, SWFs may prefer not to publicly disclose their internal decisionmaking strategies, their total wealth, or their portfolio allocations. These could all be regarded as in the nature of trade secrets, which, if disclosed, would allow others to free ride on the investment strategies that they have adopted. Forcing SWFs to reveal this information, while allowing private funds to stay silent, would afford the latter an unfair competitive advantage. It could also compromise SWFs' ability to invest in private firms in the United States. Such firms may similarly believe that it is important to keep information about their operations confidential. (Koch Industries, for example, buys and sell large companies like Georgia-Pacific, and yet the public does not receive the most rudimentary information about its gross sales, net profits, or anything else.⁶²) A set of "best practices" that pressures SWFs to make detailed disclosures about particular investments could discourage their investment in such companies.

B. Existing Safeguards

But let us further assume that strategic behavior by SWFs poses risks to our capitalist system sufficiently different in degree and kind than the risks posed by other investors' strategic behavior, so as to warrant differential treatment. The question would still remain whether existing safeguards are adequate to protect against these special risks. We believe they are.

As discussed above, an SWF's ability to influence corporate behavior is correlated to the size of its stake. If the fund holds only a small noncontrolling position, any attempt to push the company in a self-serving direction should be thwarted by the more powerful constituency of profit-seeking shareholders. If that does not happen, moreover, the company should have ample redress against the disloyal officers and directors under state law. In the rarer case where an SWF has acquired at least a 5 percent stake in a public company, or a potentially controlling stake in *any* US company (public or private), existing laws already require disclosure of that fact, so that a nondiscriminato-

Hammer, Kunzel, and Petrova, *Sovereign Wealth Funds* at 16 (cited in note 23) ("Most SWF respondents note that they are not allowed to borrow or use leverage.").

⁶² In fact, Koch states: "As a privately held company, Koch Industries does not release its financial statements or other financial data. . . . Koch does provide information to Moody's Investors Service and Standard and Poor's, who rate Koch Industries, LLC's long-term credit." Georgia Pacific Corp, *Schedule 14D-9C, Exhibit 99.3 2* (Nov 14, 2005), online at <http://www.secinfo.com/d14D5a.z6sW9.b.htm#1stPage> (visited Jan 11, 2009). The statement goes on to report overall gains for Koch that dwarf those of S&P companies. See *id.* No one can look to the data to either interpret or verify the claims. But this hardly matters. The authors would both prefer having stock in Koch Industries to receiving information about it.

ry principle covers all risks.⁶³ And for better or worse, the tempering effect of such disclosure should not be underestimated.

These existing disclosure obligations make it likely that strategic investing by SWFs will be detected by the American public, and thus operate to decrease the likelihood of such behavior. SWFs are highly diversified and have a keen interest in ensuring continued open access to Western markets. If the American public caught wind that they had used their influence as a shareholder in a domestic company to advance their nation's geopolitical goals, the backlash it would trigger would place the fund's entire portfolio at risk. One response could be a subtle politicization of the CFIUS review process. Another could be specific trade sanctions against the offending nation. And the possibility that political forces will urge more comprehensive regulation of all SWFs will lead all SWFs to place quiet pressures on the others. Thus, in those cases where an SWF is actually in a position to influence firm behavior, existing incentives make it very unlikely that it would act strategically.⁶⁴

That SWFs are sensitive to public perceptions in host countries concerning their motivations is borne out by the evidence. After the purchase of a telecommunications company in Thailand by Temasek Holdings led to a backlash among Thai citizens, the fund announced that going forward it will avoid investing in "iconic" companies, will partner with local investors, and will opt for a minority stake if investing in a company from a sensitive industry.⁶⁵ Moreover, SWFs often agree to limitations on the exercise of their rights as shareholders, even in the absence of a CFIUS-mandated mitigation agreement. In connection with its \$7.5 billion investment in Citigroup, for example, ADIA agreed that it will not own more than a 4.9 percent 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 board of directors."⁶⁶ And after Dubai Ports World's (DPW) acquisition of Peninsular and Oriental Steam Navigation Company (P&O) was met with public outcry in the United States, DPW agreed to sell P&O's US ports operations to an American company.⁶⁷

⁶³ See Part I.B.

⁶⁴ See Rose, 87 NC L Rev at 120 (cited in note 9) (observing that SWFs "operate under unique scrutiny" and that the suspicion surrounding them "will likely cause [them] to act hyper-cautiously").

⁶⁵ *Temasek to Avoid Politically Sensitive Investments* (Reuters Nov 23, 2007), online at <http://in.reuters.com/article/idINSIN215220071123> (visited Jan 11, 2009).

⁶⁶ *Citi to Sell \$7.5 Billion Equity Units to Abu Dhabi Group* (Reuters Nov 26, 2007), online at <http://www.reuters.com/article/idUSWEN270620071127> (visited Jan 11, 2009).

⁶⁷ See Jonathan Weisman and Bradley Graham, *Dubai Firm to Sell U.S. Port Operations: Move to End Three-week Dispute Comes after GOP Lawmakers, Defying Bush, Vowed to Kill*

Sensitivity to Western concerns about SWFs is presumably the reason why the funds have (albeit reluctantly) agreed to participate in the promulgation of SWF “best practices” with recipient countries. It likely also explains their essentially spotless track record as purely commercially driven investors. The contrast with the likes of CalPERS—which with about \$259 billion in assets has the clout of an SWF, yet none of its inhibitions—is too evident to require further elaboration.⁶⁸

Three features thus dominate the political landscape facing SWFs. First, SWFs have natural incentives to avoid strategic investing. Second, SWFs lack any track record of such behavior. Third, the United States has multiple responses available to it if SWFs change their behavior; it might, for example, interpret the definition of “control” in the FINSA regulations more expansively than it has in the past. In the end, then, we do not see why additional prophylactic regulations are necessary to protect our capitalist system from the rise of the “new mercantilism.” If anything, a bit of deregulation may be in order. Ultimately, therefore, we suspect that something else is at play—perhaps old-fashioned protectionism or, more generously, residual concern about the possible national security threats posed by foreign sovereign investment in the United States. Many of the largest SWFs, after all, hail from countries that do not share our democratic traditions, and some are from countries that have had uneasy relations with the United States in the past. While the CFIUS review process appears sufficiently robust to protect against the most obvious national security threats, it may be thought that anything that reduces the flow of SWF investments into the United States would necessarily make us safer. As we argue below, this type of thinking is exactly wrong.⁶⁹

C. Collateral Consequences

One common mistake in dealing with international trade policy is to assume that there is now in place any effective insulation of international politics from the issues of international trade. On this score, the critics of SWFs investment in the United States are correct to point out the connection, but wrong to insist that the safer path lies in

Deal, Wash Post A1 (Mar 10, 2006) (reporting that DPW was forced to sell when the president's veto threat proved ineffective and Congress was set to revoke the sale).

⁶⁸ For further elaboration, see Steil, *California's Sovereign Wealth Fund*, Wall St J at A14 (cited in note 56).

⁶⁹ Of course, if specific weaknesses in the CFIUS review process were identified and determined by national security experts to present credible threats to the United States, further reforms would be warranted. But, for the reasons discussed below, we do not believe that generalized concerns about the implications of SWF investment on national security justify the broad regulatory responses currently under discussion.

keeping these funds from investing in the American market. As should be evident, we think that the opposite result is likely to prove true.

Consider by way of comparison the constant willingness to keep out foreign steel or textiles for overtly protectionist reasons. These maneuvers are clearly easier to deal with than SWFs, because no foreign goods entering the United States pose the national security risks that might arise with the transfer of sensitive information to SWFs, which are in turn responsible to political bodies. But these decisions on tariffs and entry restrictions also generate their share of unwelcome and delicate political issues. It is extremely difficult to ask nations to support us on a variety of international military or security issues if we make it impossible for them to sell their goods in the United States. Why should the Pakistanis align themselves with the United States in the fight against al Qaeda if the United States blocks entry of their goods?

The simple point is that economic interaction gives foreign nations a stake in our domestic welfare, which in turn increases the likelihood that they will support us in other ventures. Wholly apart therefore from the economic gains from trade, open borders offer enormous political advantages. We are certainly not the first to make this point. Baron de Montesquieu observed the same in the eighteenth century: "Peace is the natural effect of trade. Two nations who traffic with each other become reciprocally dependent; for if one has an interest in buying, the other has an interest in selling; and thus their union is founded on their mutual necessities."⁷⁰ Empirical studies substantiate the notion that free trade enhances cooperation, and diminishes conflict, between trading countries. Solomon Polacheck and Carlos Seiglie observe that "the overwhelming evidence indicates that trade reduces conflict."⁷¹

The same logic applies to foreign direct investment (FDI), including foreign investments by SWFs. When SWFs invest in the United States, their nation's welfare becomes more intimately tied to ours.⁷²

⁷⁰ Baron de Montesquieu, 1 *The Spirit of the Laws* 316 (Hafner 1949) (Thomas Nugent, trans).

⁷¹ See Solomon W. Polachek and Carlos Seiglie, *Trade, Peace and Democracy: An Analysis of Dyadic Dispute* *62 (Institute for the Study of Labor Discussion Paper No 2170, June 2006), online at <http://papers.ssrn.com/abstract=915360> (visited Jan 11, 2009) (surveying conflict-trade literature). Compare Stergios Skaperdas and Constantinos Syropoulos, *Guns, Butter, and Openness: On the Relationship between Security and Trade*, 91 *Am Econ Rev* 353, 357 (May 2001) ("Trade and economic interdependence can help resolve conflict, but it is naïve and scientifically inappropriate to think they are sufficient by themselves to do so."); Kenneth N. Waltz, *Theory of International Politics* 158 (McGraw-Hill 1979) (arguing that the close interdependence of European nations before World War I refutes the idea that trade leads to peace).

⁷² Polachek and Seiglie, *Trade, Peace and Democracy* at 52–55 (cited in note 71) (discussing studies examining FDI's impact on international relations, including one suggesting that "the

Their investments in our economy make them hostage (in the nicest of senses) to our domestic welfare. The new level of dependency means that they suffer direct losses proportionate to their investment when they take steps that compromise the position of the United States. The common-sense observation that “[i]t’s bad for the bottom line to shoot your customers or your suppliers”⁷³ extends to investments. Thus, analysts scoffed when Venezuelan President Hugo Chavez threatened to stop selling oil to the United States due to legal wrangling between Venezuela and Exxon in early 2008; that threat was incredible because any embargo would harm Citgo Petroleum Corp, a US company owned by a unit of Venezuela’s state-owned oil company, Petróleos de Venezuela.⁷⁴ On this point, moreover, turnabout is fair play. The decision to let American businesses invest in foreign economies creates the reverse dependence, creating at home a built-in constituency to resist our not inconsiderable protectionist impulses.

The virtues of the diversification of sovereign risk are substantial. The greater the number of nations in which SWFs invest, the more beholden they become financially to an open and peaceful world economy. We bore the fruits of this integration when SWFs from the developing world stepped in to help Western financial institutions in the wake of the subprime mortgage crisis, and SWFs’ recent turn toward commercial real estate may help spur a recovery in the secondary market for real estate debt.⁷⁵ Moreover, by scattering sovereign assets around the globe, where they can be attached in appropriate circumstances by domestic authorities, SWFs make a credible commitment to the rule of law.⁷⁶ These are powerful forces that should be encouraged, not disparaged.

The same point can be made in a more ominous way. Suppose that the United States denies in significant fashion SWFs’ open participation in the American market. Those funds will have to go else-

United States, China, and Taiwan are drawn closer together because FDI flows between the countries instigate the necessity to maintain stability”).

⁷³ Donald J. Boudreaux, *Want World Peace? Support Free Trade*, Christian Sci Monitor 9 (Nov 20, 2006).

⁷⁴ See Gregory Meyer, *Chavez Threat, Cold Snap Lift Crude 2% to \$93.59*, Wall St J C5 (Feb 12, 2008) (reporting that Chavez’s threat was discredited by analysts, although it still managed to “spook the market”).

⁷⁵ CB Richard Ellis, *Sovereign Wealth Funds Expected to Invest \$725 Billion in Commercial Real Estate Globally by 2015* (Sept 24, 2008), online at <http://www.cbre.com/NR/rdonlyres/ED6B8EB8-DE38-4C9B-9C50-8776257094B2/0/PressReleaseSoverignWealthFundsfinal.pdf> (visited Jan 11, 2009).

⁷⁶ For a study on the effectiveness of freezing sovereign assets as an economic sanction, see Mahvash Alerassool, *Freezing Assets: The USA and the Most Effective Economic Sanction* 1–7 (St Martin’s 1993). See also Rose, 87 NC L Rev at 111 (cited in note 9) (observing that a “large investment by CIC in a major media company . . . would perhaps incentivize China to protect intellectual property rights more effectively”).

where. And when they do, we will not only lose the opportunity to strengthen peaceful ties with their nations; the set of loyalties and dependence will follow too, as other—potentially unfriendly—nations move into alignment with the SWFs that have invested in their domestic businesses. Perhaps the total amount of invested funds will be reduced because of the smaller opportunities. If so, that excess wealth may instead be used to fund military or political activities against our best interests.⁷⁷ Erecting barriers to SWF investment in the United States could also cause foreign nations to retaliate by restricting investment opportunities for US companies in their domestic markets, or by imposing trade sanctions on US goods. Moreover, if SWFs disinvest in the United States, their nations may become more likely to switch their reserve currency, which could negatively impact the dollar.⁷⁸

The political benefits of welcoming SWF investments in the United States, and the risks associated with *not* doing so, are in our estimation far greater than the counter-risks that have been articulated by critics of SWFs. Chairman Cox has warned, for example, that it could be practically difficult for the SEC ever to prosecute an SWF for insider trading.⁷⁹ Lawrence Summers has asked us to ponder

the day when a country joins some “coalition of the willing” and asks the US president to support a tax break for a company in which it has invested, ... [o]r 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.⁸⁰

Compared to the political and economic opportunity costs associated with discouraging SWFs from investing in the United States, these are relatively benign possibilities that, frankly, we are prepared to live with.

⁷⁷ See Samuel Gregg, *Sovereign Wealth Follies*, Acton Commentary (Acton Institute Feb 6, 2008), online at http://www.acton.org/commentary/429_sovereign_wealth_follies.php (visited Jan 11, 2009) (observing that increased SWF investments suggests “that many developing nations are turning away from squandering their wealth on vain monuments, petty wars, and highways that lead nowhere”).

⁷⁸ See *Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the U.S.: Assessing the Economic and National Security Implications*, Hearing before the Senate Committee on Banking, Housing, and Urban Affairs, 110th Cong, 1st Sess (Nov 14, 2007) (testimony of Gerald Lyons), online at http://banking.senate.gov/public/_files/111407_Lyons.pdf (visited Jan 11, 2009) (noting that “if Asian central banks were to switch reserves to match countries with whom they trade, they would need to offload \$1.39 trillion, or a quarter of the world’s reserves”).

⁷⁹ Cox, *The Rise of Sovereign Business* (cited in note 2).

⁸⁰ Summers, *Funds that Shake Capitalist Logic*, *Fin Times* at 11 (cited in note 1).

CONCLUSION

At least to date, SWFs have acted as model investors and have not sought to leverage their position to pursue political ends. That their track record is superior to many a domestic pension fund in this regard is not surprising: SWFs have strong natural incentives to avoid being perceived as strategic investors, so as to avoid a public backlash that could compromise their continued access to Western markets. In light of this, proposals for prophylactic regulations designed to save our capitalist system from a “new mercantilism” seem overly dramatic. In our view, it would be a mistake to discourage SWFs from investing in the United States by imposing on them any additional regulations at this time, even a self-policing but diplomatically coerced code of “best practices.” When SWFs buy a stake in a US company, they also buy a stake in our domestic welfare. That’s an investment we ought to welcome with open arms, not one to burden unnecessarily. Rather than devising counterproductive ways to regulate SWFs, American policymakers ought to focus on the domestic fiscal and energy policies that helped fuel their growth to begin with.