The *Politics* of Sovereign Wealth

Global financial markets enter a new era.

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Sovereign wealth funds and government-owned companies have been receiving increased attention in the media due to a number of significant recent acquisitions. With trillions of dollars of cash at their disposal, these entities are also receiving increased attention from regulators, both in the United States and abroad. While it is too early to predict what the future regulatory landscape might look like, sovereign wealth funds and government-owned enterprises should not wait to find out. They need to closely monitor developments in both the United States and elsewhere, particularly Europe, and become involved in the discussions.

While state-owned sovereign wealth funds have existed at least since the 1950s, their total size worldwide has increased dramatically over the past ten to fifteen years. Today these funds control an estimated $2.5 trillion, more than all of the world's hedge funds combined. By some estimates, total assets in sovereign wealth funds could reach $12 trillion by 2015.[1] Their growth is being fueled by high commodity prices, particularly for oil, and high levels of foreign exchange reserves resulting from trade surpluses. Whereas in the past many sovereigns invested their currency reserves in conservative investments such as U.S. government securities, they now seek greater returns and are willing to invest in riskier assets to achieve them. At the same time, government-controlled enterprises are playing an increasingly important role in capital markets, driven by the semi-privatization of government enterprises in areas such as banking, oil and gas, infrastructure, transportation, and real estate. Eight of the twenty largest publicly traded companies worldwide are majority state-owned.[2]

The United States, France, and Germany are each considering regulating sovereign wealth funds, while Canada is launching a review of its foreign-investment and

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ownership rules. France and Germany have called for a joint European response. At a meeting of finance ministers and central bank chiefs in October, the G7 called for greater transparency of sovereign wealth funds, but stopped short of proposing reforms to limit their activities. While some nations demanded a tougher approach, currently there does not appear to be a consensus view because these funds also contribute to world economic growth and, in some cases, market stability. However, following strong pressure from the United States and France, the G7 called on the International Monetary Fund, the World Bank, and the Organization for Economic Cooperation and Development to draft a new code of conduct for sovereign wealth funds, which is expected to include provisions on institutional structure, risk management, transparency, and accountability. While it may be possible to get some agreement on best practices through these efforts, it is not certain that an unenforceable code of corporate conduct will forestall future regulation.

Some commentators suggest making the activities of sovereigns an issue in global trade, subject to negotiation between countries that have funds and countries where the funds invest. Violations of the accord could be enforced by prohibitions on future investment. Jeffrey Garten, professor of international trade at Yale University, argues that the United States and the European Union must coordinate their policies; otherwise, investment funds could play one country against another. But trade negotiations could be difficult. Investor countries could bring up divisive issues, such as whether private hedge funds should also be bound by the provisions of any deal that requires disclosure by funds of financial information.

Alternatively, individual countries or regions could pass their own regulations. There is a danger, as Christopher Cox, chairman of the U.S. Securities and Exchange Commission, has warned, that the rise of sovereign wealth funds could provoke a new round of protectionism, in which various national governments erect barriers to foreign investment in what they consider to be strategic sectors of their economies, and in which the lines between restrictions on foreign government ownership and foreign private ownership are blurred.[3] In late November 2007, Joaquín Almunia, EU Commissioner for Economic and Monetary Affairs, said that the European Commission would be discussing sovereign wealth funds in December with a view to issuing a paper, adding that the discussions would focus on three areas: transparency, reciprocity, and governance. This may eventually lead to regulation, in the form of a binding EU directive.

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IS INCREASED U.S. REGULATION OF SOVEREIGNS ON THE WAY?

Several U.S. developments suggest that the United States could unilaterally regulate sovereign wealth funds and government-controlled enterprises. Although foreign government investments in the United States have not been the focus of significant attention in the U.S. presidential debates, national security and economic issues are fair game for discussion—with unpredictable results in an election year.

The increasing role that sovereigns play in U.S. capital markets is gaining the attention of Congress. The Senate Banking, Housing, and Urban Affairs Committee held a hearing in November on sovereign wealth fund acquisitions and other foreign government investments in the United States, focusing on economic and national security implications. Senator Richard Shelby (R-AL), ranking member of the Committee, is concerned that sovereign wealth funds could buy up most U.S. industries, and believes that the United States needs to know a lot more about the intentions and objectives of these funds. Several participants at the hearing were concerned that sovereign wealth funds could invest based on non-market prin-

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ciples and have too much influence on policy, even merely owning a significant minority interest.

The media is also paying increased attention to the investing power of the sovereigns, which could be a precursor to future regulation. China has received most of the attention, with criticism often tied to U.S. and EU concerns over its rising trade surplus. Meanwhile, there is increasing concern over the investment power of Russia and Middle Eastern countries. Although there was some testimony at the recent Banking Committee hearing that funds can be distinguished from each other, there is no assurance that future regulation of sovereign wealth funds and government-owned enterprises would be country-specific. The top five sovereign wealth funds account for about 70 percent of total assets; more than twenty countries have these funds, and half a dozen more have expressed an interest in establishing one.[4] Thus regulation could apply to all sovereign wealth funds and foreign government-owned companies. In addition, while sovereign wealth funds vary greatly in size, transparency, risk profile, and investment strategy, it is not clear that future regulation will take these differences into account.

A major area of U.S. regulatory concern relates to national security. Countries, including the United States, typically prohibit foreign countries from owning a controlling interest in industries seen as vital to national defense or that would otherwise hurt their ability to defend citizens from terrorist attacks. Under the U.S. Foreign Investment and National Security Act of 2007, which became effective October 24, 2007, a forty-five-day investigation by the Committee on Foreign Investment in the United States is now mandatory in any case in which a transaction will result in foreign government control over a U.S. entity, unless both the U.S. Secretary of the Treasury and the agency selected to head up the CFIUS review of the transaction find the transaction will not impair U.S. national security. However, some commentators have expressed concern that acquisitions of U.S. companies by the sovereigns involving large dollar amounts will not necessarily be subject to U.S. government review because the purchasers will not end up in "control" of the U.S. company. In response to the proposed acquisition by China Investment Corporation of an eventual 9.9 percent equity stake in U.S. investment bank Morgan Stanley for $5 billion, announced on December 19, 2007, Senator Christopher Dodd (D-CT) suggested that a CFIUS review of the transaction may be "warranted." The following day, President George Bush said that he was not troubled by the recent investments by sovereign wealth funds in U.S. financial institutions.

Moreover, although the U.S. Department of the Treasury has acknowledged the importance of foreign direct investment to the United States, such sentiments could easily give way to protectionist fears. While SEC Chairman Christopher Cox has warned about protectionism, he has indicated that the SEC will closely monitor sovereign wealth funds and government-controlled enterprises, and that there should be

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no special breaks for governments. In prepared testimony before the U.S. Senate Banking Committee in July, Cox indicated that the combination of the growing governmental (and potentially political) influence over capital market flows that sovereign wealth funds portend, together with the funds' lack of transparency, presents challenges to a regulatory system premised on free markets, the free flow of information, and investor incentives based on profit and loss. Then, in October, in a speech[5] at Harvard University, Cox laid out several arguments for greater regulation of sovereign wealth funds and government owned companies. Cox raised the following concerns:

■ Regulation and enforcement activities may not be as rigorous for sovereigns as for private-sector competitors. Will the high level of cooperation that the SEC knows from experience is required in international cases be forthcoming if the foreign government or an entity it controls is itself under suspicion?

■ When government is both the regulator and the regulated, the opportunity for political corruption increases. Cox observed that 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.

■ Governments have an unfair information advantage, which could lead to insider trading and a collapse of U.S. markets. Unlike private investors and businesses, governments have at their disposal vast amounts of covert information collected through their national intelligence services. Cox stated that, unchecked, this would be the ultimate insider trading tool. If U.S. retail customers come to believe that they are at an information disadvantage, confidence in U.S. capital markets could collapse, and along with it, the market itself. If the powers of government are no longer used solely to police the securities markets at arm's length, but rather are used to ensure the success of the government's own commercial or investment activities, then not only retail customers but every private institutional investor could be put at a serious disadvantage.

■ There is a lack of transparency. In many industrialized countries today, the ability of journalists and citizens to inquire into government affairs, or to criticize the conduct of government, is severely limited. In Cox's view, when it comes to transparency, the track record of most sovereign wealth funds does not inspire confidence.

■ Investments may be politically motivated, leading to market inefficiencies. Government-controlled companies and investment funds may not always direct their affairs in furtherance of investment returns. If such funds use business resources in the pursuit of

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Staking Claims

In March 2007, China said it would shift an estimated $200 billion of its $1,200 billion currency reserves into riskier assets. In June 2007, it took a $3 billion stake in Blackstone Group LP, a New York private equity firm. In July 2007, the China Development Bank bought a 3.1 percent stake in Barclays in connection with its bid for ABN Amro. On October 25, 2007, Industrial and Commercial Bank of China announced a $5.5 billion investment in Standard Bank Group Ltd., which would give it a 20 percent stake in Africa's largest bank. On November 2, 2007, CITIC Securities, China's largest listed securities company, announced that its board had approved an alliance with U.S. investment bank Bear Stearns that would give the companies cross-ownership in each other. On December 19, 2007, Morgan Stanley announced that China Investment Corporation would acquire a 9.9 percent equity participation for $5 billion. The next day, various news services reported that Merrill Lynch was in advanced talks with Temasek Holdings, a Singapore state-owned investment company, with respect to a $5 billion investment.

Last year, many members of Congress expressed alarm when Dubai Ports World proposed acquiring U.S. port terminals, which attention ultimately scuttled the deal. In October 2007, Dubai International Capital agreed to purchase a $1.25 billion stake in Och Ziff Capital Management, representing 9.9 percent of the New York-based hedge fund. In September, Bourse Dubai acquired a 19.9 percent stake in the NASDAQ Stock Market and bought NASDAQ's 28 percent stake in the London Stock Exchange. In late November 2007, Dubai International Capital announced a major investment in Sony, followed the next day by an announcement by Citigroup that the Abu Dhabi Investment Authority would become its largest shareholder, acquiring a 4.9 percent stake.

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other government interests, what will be the effect on the pricing of assets and allocation of resources in the domestic economies of other nations?

Cox has indicated that the outcome of the analyses that are underway in a number of venues, including the President's Working Group on Capital Markets, as well as in the G7, the World Bank, and the International Monetary Fund, "may well be more generalized agreement about the kinds of strong fiduciary controls, disclosure requirements, professional and independent management, and checks and balances to prevent corruption that will help protect both investors and markets."

Cox painted two dramatically different scenarios that could be the outcome of these developments. One possibility is that U.S. markets will be less transparent, less responsive to outside law enforcement, and less able to wisely allocate scarce resources. Government-owned investments which lack transparency could contribute to market volatility stemming from uncertainty about the allocation of their assets. Alternatively, these developments may be a stabilizing and modernizing influence in global finance. The rise of sovereign wealth funds could be viewed as a better way for a nation's monetary authority to stand ready to meet its balance of payments needs, through better diversification into a broader range of asset classes and the attainment of higher returns. According to Chairman Cox, it is not self-evident which of these views is more accurate.

While policymakers study the issues, Cox indicated that the SEC will continue to treat both government-owned companies in U.S. public markets and sovereign wealth funds as it would any similarly situated private entity. It will also pursue "a cooperative and collaborative dialogue" with its regulatory counterparts in other nations, and "engage them regarding the best way to apply" its regulatory approaches.

It has been said that, like nature, regulators abhor a vacuum. But how much and what type of regulation the United States and other countries could attempt to impose on sovereigns is an open question. It is also a complex one, with broad effects on the global economy, which are being studied in the United States by the President's Working Group on Capital Markets, as well as by the G7, the International Monetary Fund, and the World Bank.

Having failed to get a firm regulatory grip on U.S. hedge funds, the SEC appears to be directing its focus toward sovereign wealth funds, which collectively control more assets than all of the world's hedge funds combined, as well as government-owned enterprises. In addition, the U.S. Congress is beginning to pay attention to the issue, and increased media coverage could increase pressure on legislators and regulators to "do something," not unlike the pressure in the 1970s and 1980s to limit investments in the United States by Middle Eastern countries and Japan. All of this could be a precursor to increased regulation. Measures could include new disclosure requirements and SEC oversight, as well as outright limits on foreign ownership or foreign shareholder voting rights in U.S. companies if Congress gets into the act. Regulation in Europe and other countries is also a possibility.

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Sovereign wealth funds and government-controlled enterprises that have a higher level of transparency and governance, and that are able to demonstrate that their investment decisions abroad are motivated by the rate of return on investments rather than a desire to increase foreign influence or forward a political agenda, will be in a better position to fend off protectionist regulation.

To date, media coverage and regulatory commentary have tended to focus on potential negative consequences of these investments, so sponsors of sovereign wealth funds and government controlled enterprises would be well-served to highlight their positive effects. Otherwise they may find themselves complaining afterwards, somewhat predictably, that they do not like any regulatory scheme that emerges. ◆

NOTES

1. Stephen Jen, "How Big Could Sovereign Wealth Funds Be by 2015?," Morgan Stanley Global Economic Forum (May 3, 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 (December 5, 2007).
3. Christopher Cox, "The Role of Government in Markets," keynote address, John F. Kennedy School of Government, Harvard University (October 24, 2007).
4. "The Rise of Sovereign Wealth Funds," *Finance and Development*, Vol. 44, No. 3 (September 2007).
5. Cox, "The Role of Government in Markets."