

Sovereign Wealth Funds *Risks, Rewards, Regulations and the Emerging Cross-Border Paradigm*

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FOR THE PAST THREE DECADES, significant institutional and individual investment capital traditionally held on deposit in financial institutions or in direct equity investments has been increasingly redirected to private equity funds and hedge funds established to provide pooled investment opportunities otherwise unavailable to such investors. One consequence of this shift in investment capital flow is the creation of a new class of owners of corporate America, investment professionals by nature, who bring entrepreneurial spirit and financial expertise but not always industry-specific training and knowledge.

A parallel development in that time frame has been massive capital outflows from the United States and other industrialized economies to commodity-exporting economies, principally oil-producing states. One consequence of the accumulation of international reserves has been the development of government-owned or controlled investment vehicles that mirror private equity and hedge funds in many respects, particularly with regard to the diversity of their investment portfolios. Commonly referred to now as sovereign wealth funds or SWFs ("SWFs"), these investment vehicles have risen from relatively recent obscurity to center stage in international finance, with a number of attendant legitimate concerns and some potentially thorny misconceptions.

SWFs have been participants in international finance for longer than is often recognized. For example, the Kuwait Investment Authority was formed in 1960, while that country was still part of the shrinking British Empire. The Abu Dhabi Investment Authority ("ADIA"), which closed on an acquisition of 4.9% of Citigroup in November 2007 and is thought to be the largest SWF with assets worth an estimated \$900 billion, has been in place since 1976. Similarly, Singapore's Government Investment Corporation has been operational since 1981. Clearly, however, the net worth and global impact of SWFs has escalated in the last few years due in large part to the increased demand for and cost of petroleum. Currently it is believed that SWFs hold approximately \$3.2 trillion of assets and projections estimate that they will hold \$10 trillion by 2010.¹

This article examines the implications of the increasing prominence of SWFs. First, we examine the bases of sovereign wealth investment, some of the significant concerns that have been expressed by the US and Western European governments and some of the risks and benefits of this phenomenon. Next, we consider the existing legal and regulatory regimes and their efficacy for protecting the economic and national security concerns raised by SWF investments. Finally, we consider the merits of some of the current proposals in the public arena that are intended to

¹ One may argue that this rise in SWF wealth is attributable in substantial part to the failure of the U.S. to develop a rational and coherent long-term energy policy, but that subject will need to be addressed another time.

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allay some of the fears and anxiety generated by cross-border SWF activities.

SWF Goals And Interests

We start with consideration of the “whys” of SWF investment. The record of many oil-rich states in applying their capital surpluses to enhance domestic infrastructure and quality of life for their citizens is uneven at best.

Of course, the return on domestic application of international reserves has limits and leaves the state vulnerable to market fluctuations in the value of its single commodity source of wealth. Diversification through acquisition of international assets that provide multiple revenue sources provides some security for the future. Many oil-producing states are traditionally inward-looking and have shied away, in the past, from

substantial transnational investment in order to better preserve their insularity. The mere magnitude of the wealth recently accumulated; however, has led many oil-producing states to seek a larger role in international capital flows and a voice in maintaining the stability of the international financial system that allows those states to diversify their asset and revenue bases. In recent months, that voice has expressed itself in the form of minority investments in some of the leading financial institutions and private equity and hedge funds in America and Europe, including Citigroup, Merrill Lynch, UBS, Barclays, HSBC, Blackstone, Carlyle and Och-Ziff Capital Management, among others.

One concern of the US and other industrialized societies is that SWFs may have an investment agenda that differs from private entities. One senses a non-specific anxiety that permeates discussion of this subject in the US, reflecting a fear that national assets may be taken over by foreign buyers whose ownership and interests are

not well understood and whose intentions may extend beyond a satisfactory commercial return. Yet, the record of SWFs shows little, if any, evidence of efforts to destabilize or reconfigure the current international financial system or exert undue influence over US corporations or financial institutions in which investments are made. For example, the investment by ADIA in Citigroup came at a time when Citigroup critically needed a capital infusion to bolster its balance sheet and the terms of the investment, in the form of non-voting mandatorily-convertible preferred stock, would not indicate an intent on the part of ADIA to seek a control position in Citigroup. In light of the weakness of the US dollar as the global reserve currency and the self-inflicted troubles brought on by the recent credit crunch and debt crisis, the investment in Citigroup takes on a certain “White Knight” patina. One could reasonably conclude that competition for this investment opportunity was considerably less acute than in many of the seller-driven auctions that were popular prior to the current credit market turmoil.

Arising out of the recurring current account deficits of oil-importing nations and the related long-term trade imbalances between petroleum importers and exporters, the SWFs can be seen in many respects as the latest manifestation of the capital surpluses of those commodity producers being put to work. Some years ago, those Eurodollars held as international reserves formed the financial underpinning for the international sovereign and private debt markets that fueled the explosion in international syndicated debt of many Latin American countries and other emerging markets in the 1970s and 1980s.²

Benefits Associated With Investments by SWFs

There are a number of benefits associated with SWFs. This section of the paper identifies some of the more important benefits.

Investment by SWFs, as a component of all foreign direct investment in the US, fuels US prosperity by creating jobs, strengthening the economy and increasing productivity. The statistics on foreign direct investment in the US illuminate the benefits that the US has reaped by providing foreign investors with a stable and welcoming market in which to invest. The United States is the largest recipient of foreign direct investment in the world. In 2006, foreign direct investment contributed \$175.4 billion dollars to

The \$69 billion that SWFs have invested in US financial institutions has played a key role in stabilizing the strained American financial system.

² We leave it to the reader to consider whether U.S. national sovereignty and well-being are placed at greater risk by significant, but still occasional acquisitions or minority investments by SWFs or by the failure of U.S. policymakers to address the country’s dependency on Japanese and Chinese purchases of U.S. Treasuries.

the US economy. Foreign companies employ over five million US workers and, on average, the compensation paid to those employees is 36% higher than that paid to employees at private sector companies in the remainder of the US economy. In addition, foreign companies purchase 80% of their inputs, such as raw materials, semi-finished and finished goods from US companies, indirectly supporting an additional 4.6 million jobs held by US workers. In 2006, foreign companies reinvested \$64.5 billion back into the US economy, over half of their US income. Foreign companies also account for 15% of US spending on research and development and approximately 19% of all US exports. While the specific contribution to these tangible benefits by SWFs has been fairly modest, we should be mindful of the potential for much greater future contributions by SWFs given projections on growth and capital, together with the risk that developing protectionist policies, even if targeted specifically at SWFs, could likely impact adversely all foreign investment in the US.

Secondly, SWF investment in the United States creates a situation whereby foreign governments take a stake in the economic prospects of the United States. Applying traditional commercial norms, success for the SWF is defined by the increase in value of their investments. Foreign governments that investment into the US share an economic interest with the shareholders, managers and employees of the American companies into which they invest. Arguably, this serves to align the interests of the foreign governments investing more closely with those of the United States.

Next, SWF investment into the United States introduces foreign businesses to the American business model. To the extent that this introduction to the American business model results in the incorporation of some of this learning into foreign businesses, there is the potential to benefit American businesses. American multinational companies rely on the ability to efficiently transfer information and knowledge. With increasing exposure to the American business model by foreign investors, the greater harmonization of business practices that follows from this exposure could reduce costly barriers for the expansion of American businesses abroad. Conversely, harmonization reduces barriers to further foreign investment into the United States.

Additionally, SWF investment into the United States enables foreign investors to infuse capital constructively into American companies and financial institutions at times of market turmoil, a time when American investors are perhaps less

prepared or equipped to assume the financial risks. At a time when American investors find themselves with reduced portfolio values and lower risk appetites, a foreign investor, backed by commodity-driven capital surpluses, could be better positioned to act quickly and opportunistically to gain an equity stake in a prestigious US business that might otherwise be unavailable, and also to provide capital when other sources are unable or unwilling to invest. Specifically, this benefit has recently been noted in the American financial services industry. The approximately \$69 billion that SWFs have invested in US financial institutions over the last 11 months has played a key role in stabilizing and recapitalizing the strained American financial system. Citigroup, Merrill Lynch and Morgan Stanley, for example, appear to have benefited substantially from the recent investments by SWFs based in countries such as China, Japan, Kuwait, Singapore and South Korea.

Finally, SWFs are widely perceived to be long-term investors that are motivated to participate in the long-term value creation of the businesses into which they invest. The investment patterns of SWFs are fairly consistent in displaying a preference for illiquid, minority positions in major commercial and industrial companies and financial institutions. One does not often find in the terms of an SWF investment the alternative exit strategies, such as puts and registration rights, that are often a component of the investment terms for a private investor. At least for the moment, recipients of SWF investments may derive comfort from the fact that such investments typically have a very long-term horizon and thereby contribute to a more stable capital base.

Risks Associated With Investments by SWFs

Investment by SWFs into the United States does raise legitimate concerns. We focus on three potential major risks associated with SWF investment.

First, much of the concern centers on the potential for SWFs to behave in a way that presents a risk to national security. For example, a foreign government that acquires a significant position in a US business through its SWF may have the ability to obtain access to sensitive information or

The United States already has in place a number of legal and regulatory mechanisms that reduce the risks posed by SWFs.

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technologies through that investment. In addition, there exists the possibility that an SWF in a control position may manipulate production or availability of scarce goods or resources for the benefit of its home market.

Secondly, SWF investment arguably presents a greater risk for unfair competition relative to private investment. SWFs have the ability to raise additional capital from the government that owns

Foreign ownership or control of nuclear power facilities is prohibited by the Atomic Energy Act.

the fund, quite possibly at below market rates and on more beneficial terms than those available to private investors. Greater access to investment capital could more easily lead to establishing a controlling position in a particular industry on a global basis, even though the US aspects

of the business will be subject to a review of the competitive impact of the acquisition by the Federal Trade Commission or Department of Justice.

Lastly, foreign governments could channel investment through their SWFs in non-commercially driven ways or in an effort to secure a greater advantage for a competitive business in its home market. Just by way of hypothetical example, the inherent conflict of interest present in the acquisition by an oil-producing state of a controlling position in a leading alternative energy producer could stifle development in that alternative energy sector. We should emphasize that we are not aware of any such efforts; however, that type of concern does overhang the mixed receptiveness to SWF investment that one observes in the current US market.

US Regulatory Oversight of SWF Investment

The United States already has in place a number of legal and regulatory mechanisms that reduce the risks posed by SWF ownership of US assets, to such an extent that the net incremental value of layering on further regulatory schemes targeted specifically at SWF investment would appear to be highly problematic. In the follow-

ing segment, we review briefly some of the key components in the array of legal and regulatory review of, and restrictions on, foreign ownership now in effect to safeguard critical national assets.

As a starting point, the US government simply refuses to do business or permit its citizens to do business with certain pariah states and persons. The Office of Foreign Asset Controls, part of the Treasury Department, maintains a list of prohibited governments, entities and persons for US investment or trade. Needless to say, a SWF owned or controlled by one of these governments, entities and persons would be blocked entirely from acquiring a US business or assets.

Foreign acquisitions of US assets that may raise national security issues are regulated under the Exon-Florio provisions of the National Defense Production Act, as amended in 2007 by the Foreign Investment and National Security Act (“FINSA”). Under Exon-Florio, the President may modify or block any proposed or completed transaction that would give a foreign person “control” over a US business that threatens national security. Review of such potential transactions is conducted by the Committee on Foreign Investment in the United States (“CFIUS”), an interagency committee chaired by the Secretary of the Treasury and often led by the department or agency which asserts the greatest interest in the subject matter of the transaction. In the wake of the political firestorm that erupted following CFIUS’s approval of Dubai Ports World’s purchase of certain US port operations in 2006, Congress passed FINSA, making CFIUS reviews more rigorous for transactions in certain sensitive sectors and elevating the scrutiny of acquisitions where the investor is a foreign government-controlled entity such as a SWF.

The CFIUS review period can run up to 90 days. It commences with an initial 30 day review period for the committee, which can then determine whether or not to commence an investigation during a further 45 day period, which would then be followed by a 15 day period for the President to approve or block the transaction. The vast majority of the foreign investment transactions reviewed by CFIUS do not extend beyond the initial 30 day review period. One noteworthy change enacted by FINSA is the requirement that any acquisition by an acquiror controlled by or acting on behalf of a foreign government be subject to the further 45 day investigation.³

While filing for CFIUS review of a transaction

³ CFIUS must conduct a review if the proposed transaction could result in control of critical infrastructure or critical technology by an entity controlled by or acting on behalf of a foreign government, unless the Secretary of the Treasury and the head of the lead agency jointly determine that the transaction will not impair U.S. national security.

is voluntary, parties that do not file run the risk that their transaction will be investigated or even subject to a post-closing divestiture. However, CFIUS's approval of a transaction does not provide a safe harbor against a future divestment order by the President. Under FINSA, CFIUS may re-open an approved transaction and a follow-up review may be conducted if the approval was granted based upon a false, misleading or incomplete submission or the parties breach a mitigation agreement imposing conditions on the transaction or on the conduct of the parties following the closing.

Various legislation bars or restricts foreign direct investment in certain sectors considered particularly sensitive such as aviation, maritime, communications and energy. In order to register an aircraft for domestic air transport of passengers or freight, no more than 25 percent of the capital stock of the owner may be held by foreign investors. In addition, acquisition of control of a US air carrier is subject to the approval of the US Department of Transportation. Similarly, under maritime law, coastal and freshwater shipping in the US is restricted to vessels which are built and registered in the US and at least 75 percent owned by US citizens. The sale, lease, charter or transfer of any US-owned vessel to a non-US citizen requires the approval of the Secretary of Transportation.

Under the Federal Communications Act of 1934, foreign ownership of radio station licenses cannot exceed 20 percent and the Federal Communications Commission also has the authority to review mergers between telecommunications common carriers.

Foreign ownership or control of nuclear power facilities is prohibited by the Atomic Energy Act. In addition, licenses to own or operate hydroelectric power facilities on federally-controlled property are restricted to US persons. While a US person may be a corporation owned or control by foreign investors, applications for licenses by such corporations are more highly scrutinized.

Several of the recent high profile SWF investments have been in the financial services industry, which is subject to extensive regulation, and to rigorous review and disclosure in the case of investments that exceed certain thresholds or might constitute a change of control.

Foreign investments in US banks and bank holding companies are federally regulated by both the Bank Holding Company Act (BHC Act)

and the Change in Bank Control Act (CIBC Act).⁴

Under the BHC Act, any buyer must obtain approval from the Federal Reserve before making a direct investment in a US bank or bank holding company if the proposed investment will result in the buyer (1) owning or controlling 25 percent or more of any class of voting securities; (2) controlling the election of the Board of Directors; or (3) acquiring a controlling influence over the management or policies. It is presumed that investors who control less than five percent of the voting shares also lack the measure of control evaluated in the second and third parts of the test and are thereby exempt from the approval requirement. An investor meeting any one of the three triggers is considered a "bank holding company" and, in addition to the approval of the Federal Reserve, will be subject to continuing Federal Reserve supervision including examination, reporting, and capital requirements, as well as to the restrictions on the mixing of banking and commerce.

While the BHC Act excludes the review of investments in banks and bank holding companies by foreign governments, the Board of Governors of the Federal Reserve System has not extended this exclusion to companies controlled by foreign governments, thereby capturing investments by SWFs.

In addition, prior approval of the Federal Reserve is generally required under the CIBC Act if the investor will be acquiring 10 percent or more of any class of voting securities of a state member bank or bank holding company. With this lower threshold, some banking industry investments will trigger review under the CIBC Act, even if they do not trigger review under the BHC Act.

Investment by SWFs in US public companies is subject to the full panoply of initial and periodic reporting and disclosure required of other investors under the rules and regulations of the Securities and Exchange Commission (SEC), which will be well known to many readers and are too extensive to summarize here. We do note that investments (subject to limited exceptions) that equal or exceed five percent of an SEC

In a seminal event, the US government and officials from Abu Dhabi and Singapore agreed to a set of basic policy principles.

⁴ Investments in the financial services industry may also be subject to review and approval at the state level, by a state superintendent of banks, state insurance department or other state agency depending upon the nature of the target business.

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reporting company require extensive disclosures regarding the identity of the acquiror, its beneficial ownership, its source of funds and its investment intent.

Looking Towards a Multinational Policy on SWF Investment

While the merits and concerns of SWF investment require a more nuanced analysis than one often encounters in the public debate, it is a basic truism that SWFs are fundamentally different, or at least pose the risk of conducting themselves in a fundamentally different manner, than private investors in the cross-border M&A setting. That issue is mitigated, but not eliminated, by a review of historical patterns of SWF investment and a recognition of their stake in the international financial system. The underlying concern for a possible “hidden agenda” has led to an as yet nebulous groundswell of support for agreed standards of SWF investment, ranging from the well reasoned, but somewhat idealistic, to the patently xenophobic, which would appear to be clearly contrary to US economic interests.

We identify five principles that appear to form the core of the SWF investment standards under discussion among the US and other industrialized nations that are witnessing a surge in SWF investment. Those five principles include: Articulated investment objectives and strategy; good corporate governance; transparency; stability in investment behavior; and reciprocity. They do not all have equal merit, nor would all of them be acceptable to other governmental or private investors. We address each briefly in turn, although there is considerable overlap among some of them.

Publicly-stated investment objectives and strategy—It is difficult to see how adoption of this principle would lead to much more than a non-binding statement of banal generalities. It seems quite reasonable that every acquiror (as opposed to a seller, granting a non-compete, for example) would want to maintain as much flexibility as possible. Importantly, it seems likely that the value to the US seller or investee of the SWF investment company would be disproportionately diminished if inflexible investment goals are required.

Good Corporate Governance—It would seem preferable that the guidelines for these principles emanate out of the existing legal and regulatory regime as it applies to both the acquiror and the

US target business. For example, we do not need a separate set of fair labor practices to govern how employees are treated at SWF owned enterprises.

Transparency—This principle overlaps with each of the others, is the most difficult to articulate as a free-standing principle, yet seems to be the nub of much of the concern. Simply put, the idea that we want to know who we are dealing with, given the sheer magnitude of SWF investment, is widely seen to be a very legitimate concern. Also the notion that we can judge the suitability of an investor by the company that he or she keeps (that is, their other foreign investments) comes into play. In order to elevate the overall comfort level, avoid conjecture and reduce the likelihood of unwanted indirect alliances with other SWF investees, we do advocate a policy of disclosure as to ultimate control persons and other material holdings in the SWF portfolio.

Stability in investment behavior—The notion that a SWF investing in a particular enterprise should commit to hold the investment for a minimum period seems pointless and unworkable. The terms of the initial investment (which might include conditions, holding periods or mandatory divestitures imposed as part of a regulatory approval process), and subsequent market forces, are likely to be the more effective means for implementing a stability of investment principle.

Reciprocity—A policy promoting an open foreign investment climate in the SWF home market would likely be of considerable value to the US, and has an appealing sense of basic fairness about it. We should be mindful that first Britain then America, in the 19th and 20th centuries, respectively, led the transnational charge into foreign markets. It is rooted deep in our economic system and, in our view, a reasonable policy position to pursue with the commodity-producing states in particular.

In a seminal event seeking to memorialize a mutual understanding regarding SWF investments, the US government and officials from Abu Dhabi and Singapore agreed on March 20th to a set of basic policy principles (the “March 20th Accords”). Interestingly, the stated principles are bilateral; setting forth guidelines governing both the SWFs and the countries in which they invest. The agreed code of conduct for the SWFs follows closely the principles identified above. In summary, the parties agreed that SWFs should (i) make investment decisions based solely on commercial grounds and that this policy should be publicly stated; (ii) provide greater disclosure in areas such as purpose, investment objec-

tives, institutional arrangements and financial information; (iii) put in place strong corporate governance, including internal control and risk management systems; (iv) compete fairly; and (v) respect and comply with local laws. With respect to principles for the countries receiving SWF investment, the parties agreed that those countries should (i) prevent creating protectionist barriers to SWF investment; (ii) ensure a predictable investment framework by clearly articulating the laws and regulations regulating foreign investment; (iii) avoid discrimination among investors; and (iv) not seek to steer or direct SWF investment and try to ensure that restrictions on SWF investment grounded in national security concerns are proportional to genuine national security risks raised by the transaction.

This announcement followed a letter sent on March 17th by Abu Dhabi to certain Western officials, including US Treasury Secretary Henry Paulson, outlining the investment guidelines of its governmental investment organizations. In addition to articulating the principles outlined above, Abu Dhabi emphasized that their SWFs are professionally managed, primarily by outside firms, and that they have been making responsible, long-term investments in the US and Europe for more than 30 years. While the letter did not propose principles for recipient countries, Abu Dhabi encouraged recipient countries to keep the process for scrutinizing in-bound investments "clear, fair and timely."

It is noteworthy, that both of these announcements came prior to the International Monetary Fund's (IMF) executive board meeting on March 21st regarding its ongoing study of SWF investment and effort to create a voluntary code of best practices to guide SWF investment and while the US Treasury is actively drafting implementing regulations for FINSIA.

Conclusion

An important question that remains is how

the US will implement, evaluate and enforce those principles it has agreed in the March 20th Accords, and may agree in the future with other SWF states. The March 20th Accords offer a promising framework for both further bilateral and multilateral agreements with other SWF states and the anticipated IMF best practices policy statement for SWF investment. The path forward; however, will not necessarily be one without potholes. For example, China has publicly conveyed contradictory positions on the necessity or desirability of a code of conduct. As for the US, we would caution against a unilateralist approach, which is too likely to be counterproductive and perceived as adversarial at a time when SWF investment may provide some critical capital for the US economy. We believe the best interests of the US lie in leading the discussion and then coalescing around a global consensus, to the extent achievable, on principles to govern SWF investment, while relying on the existing safeguards provided by our existing, extensive legal and regulatory regimes. Fortunately, as indicated by the March 20th Accords and the continuing dialogue between the US and the World Bank and IMF regarding the establishment of a code of best practices, the US government appears receptive to this approach and willing to be pro-active in advancing mutual agreement.

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