

Sovereign Wealth Funds: National Security Risks in a Global Free Trade Environment

By
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The proliferation of sovereign wealth funds (SWFs) has resulted in an unstable political, legal, and regulatory environment for this form of foreign direct investment (FDI). This article explains SWF growth over the last half-century; discusses issues surrounding SWF “transparency” and host-country national security risk; reviews the legal and regulatory structures governing FDI in major national economies; examines proposed regulatory approaches to structure the FDI environment; and concludes with a discussion of SWF regulatory policy recommendations addressing corporate governance principles, national security restrictions on equity investment, and investment reciprocity, and suggests recommendations for executives considering engaging an SWF investment partner. © 2009 Wiley Periodicals, Inc.

Since the summer of 2007, sovereign wealth funds (SWFs) have received heightened international media attention and public policy scrutiny, as these government-owned funds have been involved in the purchase of minority equity positions in several world-class companies. Due to this increase in company-oriented equity investment by SWFs, there has been a growing concern among many Western governments that these government-owned investment funds could be used to advance a home-country geopolitical agenda contrary to the “national security” of the host country.¹ These na-

tional security concerns include inefficient allocation of firm resources (exacting a real cost on host economies), destabilization of financial markets (to the detriment of the host country), protection of SWF home-country industries at the expense of the host country’s industries, and the expropriation of technology (Markheim, 2008). Likewise, these national security concerns are problematic for executives who may have an interest in attracting SWF equity investment to their firms, as they could have a potential adverse impact on their own company’s sustainable competitive advantage in the global business

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environment. These potential national and firm security risks, and proposed SWF regulatory policy and executive management recommendations addressing these concerns, are the focus of this article.

As a result of the U.S. subprime mortgage “melt-down” (that began in August 2007), the financial sector has successfully sought and received investments from SWFs (Goodman & Story, 2008).² Since early 2007, SWFs have invested billions of dollars of much-needed capital into major American and foreign banks negatively impacted by the financial credit crisis. Many SWFs are attracted to investment opportunities that accept their money without them having to acquire too large an equity stake—an investment opportunity often found in the financial sector (“The New Rothschilds,” 2007).³ According to economic research firm Dealogic, SWFs are estimated to have invested \$37.9 billion in the U.S. financial sector (and over \$50 billion in all Western financial institutions) in 2007 (Rothnie, 2008). The U.S.-focused SWF investments represent 63% of total estimated SWF investment for 2007 (Rothnie, 2008).

Some examples of these SWF investments will illustrate this recent level of buying activity, both in the United States and abroad. In September 2007, the Bourse Dubai SWF purchased 19.9% of the Nasdaq stock market and Nasdaq’s 28% share of the London Stock Exchange (Cho, 2008). In December 2007, the China Investment Corporation (or CIC, formed in September 2007) agreed to purchase 9.9% of Morgan Stanley, the investment banking firm, for \$5 billion, and in February 2008, CIC’s representatives signed a \$4 billion agreement with J.C. Flowers & Company, a private equity fund, to invest funds in U.S. companies (Badian & Harrington, 2008; Chen, 2008). In January 2008, Merrill Lynch sold a special class of stock worth \$6.6 billion to sovereign wealth funds managed by the South Korean and Kuwaiti governments, while Citigroup announced the sale of 7.8% of its stock to a group of investors that includes the Singapore Investment Corporation (Cho, 2008). Through the first six months of 2008, SWFs played a significant role in stabilizing global credit markets by injecting more than \$80 billion in equity stakes in U.S.-based Merrill Lynch and Morgan Stanley, Swiss-based UBS AG, and U.K.-based Barclays PLC (Koh, 2008). Furthermore, in November 2008, Barclays PLC, in order to raise \$10.5 billion to comply with new capital requirements, sold 31% of its outstanding shares in convertible and preferred stock to SWFs in Abu Dhabi and Qatar (Livesey & Crowley, 2008).

In the second half of 2008, many SWFs, primarily from oil-rich nations whose domestic budgets require a

break-even price of \$50 per barrel of crude light oil (up from approximately \$20 per barrel in 2000–2002), are reassessing the importance of liquidity and uninspired “safe” assets and considering channeling increasing SWF investments into their domestic industries with the national goal of developing a sustainable economic and financial system (Waki, 2008).⁴ Other emerging SWF investment strategies being seriously considered in the recent era of worldwide recession and declining oil prices are “reciprocal investment” in infrastructure, energy, and technology and searching for strategic opportunities in emerging markets (“Krull Corporation President Says Leading Sovereign Wealth Funds,” 2008; Zawya, 2008).⁵ A recent example of this type of medium-term SWF investment strategy is the recent \$8 billion General Electric (GE) joint venture with Abu Dhabi’s SWF Mubadala, with Mubadala accessing GE’s expertise in Medicare and engineering, while exploiting growth opportunities in the Middle East and Africa (Zawya, 2008).⁶ Furthermore, to support an SWF investment strategy built upon equity ownership in physical infrastructure, the CB Richard Ellis Group, Inc. (CBRE), the world’s largest commercial real estate services firm, forecasts that SWFs are expected to become one of the most important investors in the world’s commercial property markets through 2015 (although more than half of all SWFs are believed to presently hold direct commercial real estate investments) (CB Richard Ellis, 2008). Anticipated expansion in this investment strategy will increase total SWF real estate holdings from 4% of their present portfolio to 7%, or approximately \$725 billion in net property investments over a seven-year time frame (based upon a Morgan Stanley estimated worldwide SWF asset growth to a valuation of approximately \$12 trillion by 2015 [Jen, 2007]) (CB Richard Ellis, 2008).⁷

While there is no consensus on a universal definition of what constitutes a “sovereign wealth fund,” one offered by the U.S. Department of the Treasury (and the working definition used in this article) defines SWFs as “government investment vehicles funded by foreign exchange assets and managed separately from official reserves” of government monetary authorities, with fund managers seeking higher financial returns (U.S. Department of the Treasury, 2007a).⁸ According to the International Monetary Fund (IMF; 2007), there are three primary types of SWFs: stabilization funds, savings and intergenerational funds, and reserve investment corporations. Stabilization funds are designed to smooth out a nation’s short-term budgetary or reserve developments due to adverse price fluctuations in natural resources

(oil and minerals), commodities, or foreign exchange operations (Kern, 2007). These funds tend to be more conservative in their investment strategy, focusing on fixed income rather than equity investments (Ziemba, 2007). Savings and intergenerational funds are designed to be a storehouse of wealth for future generations, spreading the financial returns from the nation's natural resources (in many cases) across generations in an equitable manner (Kern, 2007).

The IMF reports that, while the newer oil-based SWFs are predominantly focused on stabilization objectives, the increase in the price of oil in 2006 and 2007 has permitted these funds to have longer investment horizons and, thus, invest in a broader asset range, including bonds, real estate, private equity, hedge funds, and commodities (IMF, 2007). Reserve investment corporations are designed to reduce the opportunity cost of holding excess foreign reserves, or to invest their funds in private equity having higher financial return (IMF, 2007). These SWFs also tend to be the least transparent in their investment strategies. Because of a general lack of SWF "transparency" (i.e., disclosure of information about the funds' assets, liabilities, or underlying investment strategy),⁹ the governments of the United States, France, and Germany are considering financial regulatory responses to SWF behavior, while the Canadian government is considering a review of its foreign investment and ownership rules for its domestic corporations (Badian & Harrington, 2008; Markheim, 2008).

Following this general introduction to SWFs, the author will place SWFs in an historical context by explaining the economic growth of SWFs over the last half-century. In the next section, the author discusses issues surrounding SWF "transparency" questions and strategic asset risk (political-, economic-, and defense-related) for host countries, resulting from the change in the investment strategy of many SWFs. The author then turns to discussing the existing legal and regulatory structure governing foreign direct investment (FDI) in major national economies, and examines the regulatory approaches being considered by multilateral organizations and national governments to effectively structure the investment environment for SWFs. The author concludes the article with a discussion of SWF regulatory policy recommendations, focusing on the dual objectives of meeting legitimate political-, economic-, and defense-related issues, while ensuring the future "free" flow of this specific form of FDI into host-country markets, and offering executive management recommendations to follow when a company is considering engaging in an SWF investment strategy.

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The Economic History of Sovereign Wealth Funds

The concept of SWFs began in the early 1950s (although the formal term *sovereign wealth fund* did not appear until the dawning of the twenty-first century) when the Kuwait Investment Board (in 1965, replaced by the Kuwait Investment Authority) was established in 1953 by the government of Kuwait and charged with the responsibility for holding and investing surplus oil revenue in foreign assets, thus reducing the country's nearly singular reliance on finite oil reserves (Kern, 2007). Kuwait was followed in 1956 by the British colonial administration in the Gilbert Islands (that in 1979 became the independent Republic of Kiribati) establishing the Revenue Equalisation Fund, an SWF charged with holding royalties accumulated from phosphate mining in trust and its managers with making overseas financial investment decisions (Kern, 2007). With the exception of the New Mexico State Investment Office Trust Funds (USA), established in 1958, growth in SWFs remained dormant throughout the 1960s and early 1970s.

In the mid-1970s, the first wave of SWFs appeared (largely, but not exclusively, as a result of the OPEC oil "shock" beginning in 1973), with the establishment of Singapore's Temasek Holdings and Papua New Guinea's Mineral Resources Stabilization Fund, both in 1974, and the Abu Dhabi Investment Authority and Canada's Alberta Heritage Fund, among others, in 1976 (Kern, 2007). This

SWF initial growth wave continued into the mid-1980s, culminating in Norway's Government Petroleum Fund's establishment in 1986 (Kern, 2007). By 1990, SWFs held approximately \$500 billion in their investment funds (Lachman, 2008). The second wave of SWFs began at the end of the 1990s, starting with the Hong Kong Monetary Authority Investment in 1998 Portfolio and Venezuela's Investment Fund for Macroeconomic Stabilization in 1998, and has continued unabated into the first decade of the twenty-first century (Kern, 2007). From 2000, the number of SWFs identified has more than doubled, from 20 to 43 such government-owned investment funds (Johnson, 2007; Sovereign Wealth Fund Institute, 2008c).¹⁰ Since 2005, there has been an acceleration in SWF creation, with 12 SWFs established, including the above mentioned CIC, ranked by initial investment reserve (\$200 billion) among the world's top ten largest SWFs (Kern, 2007; Kimmitt, 2008; Sovereign Wealth Fund Institute, 2008c).

As of October 2008, the Sovereign Wealth Fund Institute (2008b), a nonprofit, nonpartisan research organization located in Roseville, California, estimates that the combined SWFs of all countries is \$3.927 trillion, with 63.9% (\$2.509 trillion) oil- and gas-related and 36.1% (\$1.418 trillion) in other commodities.¹¹ The Sovereign Wealth Fund Institute (2008b) estimates that the world's top ten largest SWFs (see Table 1) account for \$3.239.4 trillion in assets, or 82.5% of the world's SWF assets. International Financial Services, London, has estimated that total SWFs grew by 18% in 2007 (Monaghan, 2008). Why the rapid increase in the growth in the actual number and dollar value of SWFs? Since 2005, the primary driving forces have been the increase in commodity prices, especially oil, and the high volume of foreign

exchange reserves, a result of trade surpluses (Badian & Harrington, 2008). Previously, SWF managers chose conservative investments, such as foreign government securities, but then sought a higher return (and accepted higher risk) in their investment capital choices (Badian & Harrington, 2008). According to International Financial Services, London, and investment firm Morgan Stanley, SWFs are forecasted to grow to \$10 trillion by 2015 (Jen & Andreopoulos, 2008; Monaghan, 2008).

In June 2008, the Monitor Group, a Cambridge, Massachusetts-based business consulting and research firm, released an empirical study of 17 SWFs involved with 785 deals (most transactions originating in the Middle East and Asia) worth \$251 billion between 2000 and 2008 (Miracky et al., 2008). The study results suggest that the SWFs are driven primarily by financial objectives,¹² and that the Middle East and East Asian SWFs are not active in any ways that threaten the economic or national security of the nations in which they invest.¹³ Furthermore, SWFs do take majority equity interests in more than half of publicly acknowledged SWF transactions, but the overwhelming majority of these transactions have taken place in their domestic and emerging markets, and not Organisation for Economic Co-operation and Development (OECD) countries. Finally, the Monitor Group study results show that SWFs had been building progressively increased financial risk into their financial portfolios, investing in less conservative asset classes and slowly emerging markets.

Transparency Issues and Strategic Asset Risk

Many Western countries have raised national security policy concerns about recent SWF investment activities,

TABLE 1 Top Ten Largest Sovereign Wealth Funds

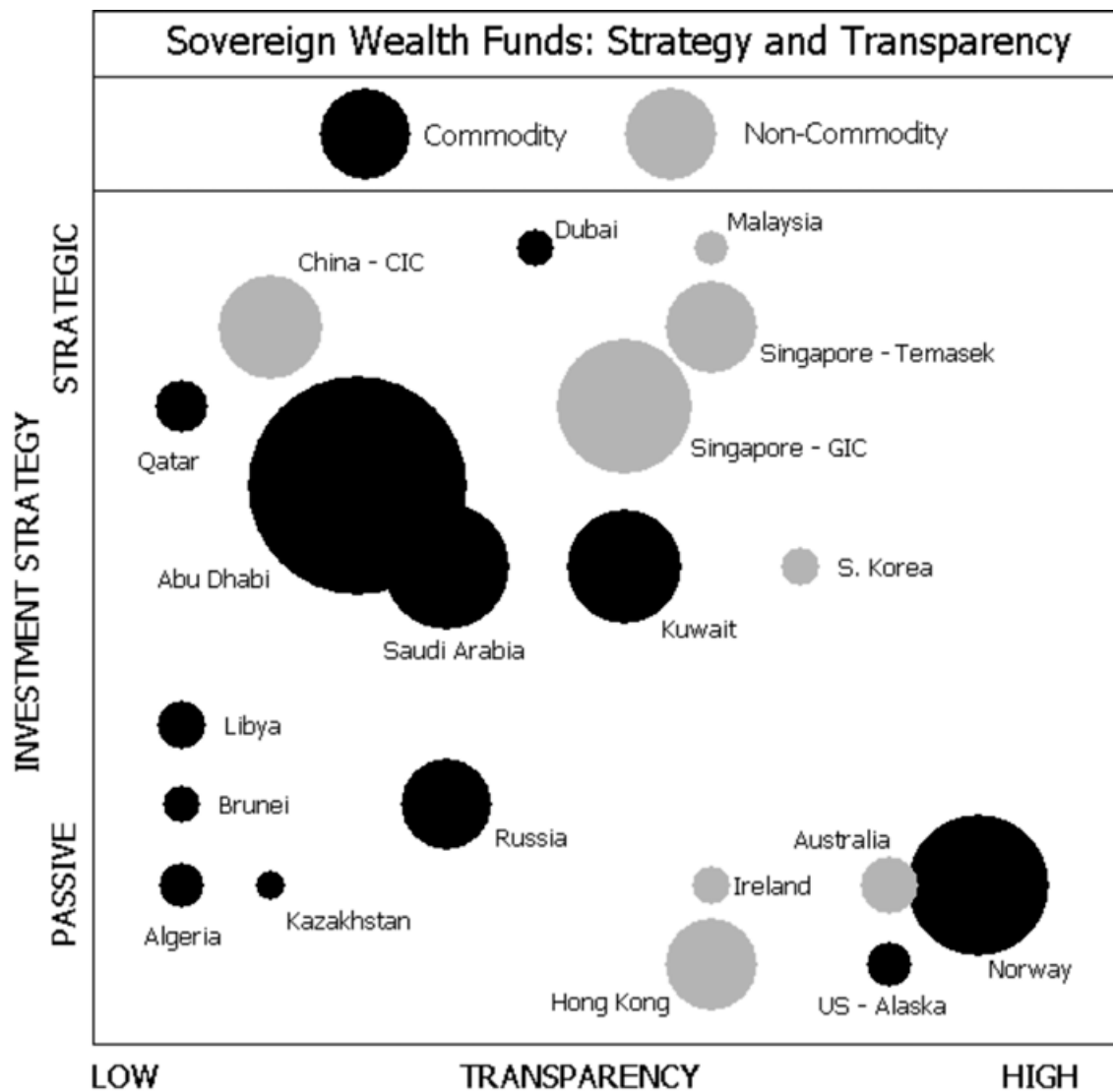
Country	Fund Name	Assets(\$ Billions)	Fund Inception	Origin
UAE-Abu Dhabi	Abu Dhabi Investment Authority	\$875.0	1976	Oil
Norway	Government Pension Fund—Global	\$396.5	1990	Oil
Saudi Arabia	SAMA Foreign Holdings	\$365.2	n/a	Noncommodity
Singapore	Government of Singapore Investment Corporation	\$330.0	1981	Noncommodity
People's Republic of China	SAFE Investment Company	\$311.6		Oil
Kuwait	Kuwait Investment Authority	\$264.4	1953	Oil
People's Republic of China	China Investment Corporation	\$200.0	2007	Noncommodity
China-Hong Kong	Hong Kong Monetary Authority Investment Portfolio	\$173.0	1998	Noncommodity
Russia	National Welfare Fund (includes Oil Fund)	\$189.7	2008	Oil
Singapore	Temasek Holdings	\$134.0	1974	Noncommodity

Source: Sovereign Wealth Fund Institute (2008b).

that no doubt has much to do with the fact that these host-country government-owned investment funds are emanating from authoritarian regimes in the Middle East and the People’s Republic of China, areas of the world that reflect political instability or have exhibited unfriendly policies toward Western interests. These national security concerns¹⁴ are focused in two distinct, but inter-related, areas: the first, a perceived lack by Western host countries of transparency of developing-country SWF operations and corporate governance structures, and the second, the potential for a rival nation employing SWF capital to acquire strategic corporate assets,¹⁵ especially in the financial, energy, information technology, telecom-

munications, and transportation sectors of the economy, and use them as a geopolitical “weapons” against a host country (that also leads back to the issue of transparency of SWF investment motives). The Sovereign Wealth Fund Institute (2008a), a California-based financial research firm, measures worldwide SWF transparency and investment strategy using the Linaburg-Maduell Index, developed by Sovereign Wealth Fund Institute founders Carl Linaburg and Michael Maduell, utilizing a scale of 1 (lowest transparency) to 10 (highest transparency).¹⁶ According to the Sovereign Wealth Fund Institute (2008a) (see Figure 1), SWFs for Kuwait (6),¹⁷ Abu Dhabi (3–5), and the People’s Republic of China (2) all fail to meet

FIGURE 1 Sovereign Wealth Funds: Strategy and Transparency



Source: Sovereign Wealth Fund Institute

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the recommended minimum transparency rating of 8. Three countries at the opposite end of the transparency and investment strategy spectrum are Australia, Norway, and the United States (Alaska), that all have high levels of information disclosure and accountability and exhibit a “conventional” or “passive” investment strategy (Lyons, 2007; Sovereign Wealth Fund, 2008a; Truman, 2007).¹⁸

Unlike privately owned, publicly regulated investment and pension funds, SWFs are under no financial regulatory obligation to provide operating information to shareholders or government agencies (Kern, 2007). In fact, unlike private hedge funds, SWFs are not necessarily driven by a need to generate a profit (“The Invasion of the Sovereign Wealth Funds,” 2008).¹⁹ Furthermore, there are no transnational regulations on SWF disclosure requirements concerning investment strategies or current holdings (Weiss, 2008). Why should this be of concern to Western policymakers? A lack of SWF transparency masks SWF investment activity and can obscure governance and risk-management problems within the funds (Weiss, 2008). This less-than-ideal transparency situation makes it difficult to assess systematic risk, determine if SWFs are acquiring strategic assets for nationalistic objectives (Summers, 2007), and audit the governance of the funds, therefore exacerbating problems of mismanagement or corruption (e.g., illegal insider trading) by fund managers (Chatman Thomsen, 2008). In countries lacking a foundation of good corporate governance, SWF failures due to poor management—if concentrated within certain industry sectors—could destabilize national or global markets (Weiss, 2008).

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While the goal of an SWF is to ostensibly create long-term, monetary value for a country’s financial reserves, the fact is that a government-owned investment fund may be motivated by strategic, noncommercial considerations in its investment decision-making calculus. Lyons (2007) and Luft (2008) argue that this form of “state capitalism” can be used to secure sensitive strategic assets in the infrastructure industries (e.g., telecommunications, media, energy, seaports, and financial services) and, in lieu of a direct military attack, undertake decisions contrary to the safety and security of the United States or other Western countries. Another concern is that a foreign government could use an SWF to acquire proprietary knowledge about how companies operate abroad, and then use this sensitive knowledge to enhance the national competitiveness of their rival state-managed firms (Teslik, 2008). There is also the potential for SWFs from a region, such as the Middle East or Asia, to collaborate (as shareholders) to oust the chief executive officer of a U.S. corporation (Teslik, 2008). This begs the question: Is this collaborative behavior for business reasons (“to institute effective business policies”) or political gain (“zero-sum game policies”) (Aizenman & Glick, 2007)? Financial market stability is another sensitive national competitiveness issue. Since SWFs are often of significant monetary size, concentrated, and nontransparent, actual or perceived shifts in fund asset allocation can cause adverse market volatility (Dohner, 2008). Lastly, while defense-related industries are usually considered not eligible for SWF investment, other forms of sensitive “dual-use” (civilian and military) technologies could fall into the possession of potential adversaries (Markheim, 2008). These SWF issues are of legitimate concern to Western policymakers, and their governments are contemplating public policy palliatives.

In the U.S. (where the majority of SWF investment has recently taken place), largely as a result of the public furor over the People’s Republic of China’s government-owned enterprise’s (CNOOC) attempt to acquire the U.S. oil firm Unocal in 2005, and the United Arab Emirates’ Dubai Ports World aborted attempt to acquire several major U.S. seaports in 2006, the U.S. Congress passed the Foreign Investment Security Act of 2007 (FINSAs), that went into effect on October 24, 2007. At its core, FINSAs enhances the scope of authority of the U.S. government’s Committee on Foreign Investment in the United States (CFIUS), an oversight agency of the U.S. Department of the Treasury (Markheim, 2008).²⁰ Under CFIUS, foreign direct investments (FDIs)²¹ that raise national security concerns are voluntarily subject to a formal review process, and if found necessary, the

committee can recommend to the President blockage of foreign government investments that are deemed to have potentially adverse national security implications (Markheim, 2008). Due to the recent enhancement of its scope of review authority, CFIUS now has added critical infrastructure (e.g., energy assets) and foreign government-controlled transactions as factors for review, as well as greater transparency to its review process (Markheim, 2008).²² While the federal regulations issued by the U.S. Department of the Treasury (2008b) to implement FINSA do not specifically address SWFs, they do help clarify the concept of foreign control as it relates to private equity ownership interest, passive investment, and the difference between “control” and “influence,” all factors for the CFIUS board or president to consider with a proposed or present SWF equity investment.²³ Also, U.S. Senator Richard Shelby (R-Alabama), ranking minority member of the U.S. Senate Banking, Housing, and Urban Affairs Committee, concerned about the intentions and objectives of SWFs, has formally requested a study be undertaken by the Government Accountability Office (US GAO, an agency of the U.S. Congress) to ensure that SWFs are “effectively monitored” (Badian & Harrington, 2008).²⁴

Financial Regulatory Policy

One major reaction to SWF behavior is the potential for national governments to institute protectionist poli-

cies against this form of FDI, what Kimmit (2008) calls “counter-productive barriers to investments.” Of course, such protectionist policies are construed by many as reactionary to the global free flow of FDI—a hallmark of the twenty-first-century international economy. With certain exceptions for national security considerations, the United States is traditionally considered one of the most receptive world economies to FDI. As recently as May 2007, President George W. Bush reaffirmed the U.S. commitment to open economies, that thrive through reciprocal investment and trade (Dohner, 2008). In general, the European Union has reiterated its commitment to open markets and SWF investment as well, with the caveat that there is reciprocity in market openness to European FDI (Kern, 2007). Russia, a growing market economy (although not a member of the European Union) and that, incidentally, operates a \$32.7 billion SWF (funded by oil revenue), takes a relatively strong protectionist stance on FDI compared to its contemporaries in Western Europe (Kern, 2007; White, Davis, & Walker, 2008).

Many countries have enacted laws and instituted public policies that regulate FDI—generally, with an underlying regulatory focus on national security concerns. In a recent study undertaken by the US GAO (2008) to assess the laws and policies regulating FDI in ten countries (see Table 2), and comparing them to the U.S. legal and regulatory regime, the US GAO found substantial similarity among the countries surveyed to the U.S. CFIUS investment review process enacted under the Exon-Florio Amendment.

TABLE 2 Laws and Regulations Addressing Review of Foreign Direct Investment

Country	Laws and Regulations	Reasons for Review or Restrictions
Canada	Investment Canada Act (1985)	To ensure net benefit to Canada (no national security review)
People's Republic of China	2006 Regulations for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors, Catalog for the Guidance of Foreign Investment Industries	National economic security, protection of critical industries. Purchase of famous trademarks or traditional Chinese brands
France	Law 2004-1343, Decree 2005-1739	Public order, public safety, national defense
Germany	2004 Amendment to 1961 Foreign Trade and Payments Act	Ensure essential security interests, prevent disturbance of peaceful international coexistence or foreign relations
India	Foreign Exchange Management Act (1999)	National security and domestic cultural and economic concerns
Japan	1991 Amendment to the Foreign Exchange and Foreign Trade Act of 1949	National security, public order, public safety, or the economy
The Netherlands	Financial Supervision Act of 2006	Competition, financial market oversight (no national security review)
Russia	1999 Federal Law on Foreign Investments	Protection of foundations of the constitutional order, national defense and state security, antimonopoly
United Arab Emirates	Agencies Law of 1981; Companies Law of 1984	Economic and demographic concerns (no national security review)
United Kingdom	Enterprise Act of 2002	Public interest, control of classified and sensitive technology
United States	Exon-Florio Amendment to the Defense Production Act of 1950, as amended	National security

Source: US GAO (2008).

Eight [of the ten] countries use a formal review process—usually conducted by a government economic body—to review a transaction. Generally, national security is a primary factor or one of several factors considered in evaluating transactions. While the concepts of national security vary from country to country, all countries share concerns about a core set of national security issues. These include, for example, the defense industrial base, and more recently, investment in the energy sector and investment by state-owned enterprises and sovereign wealth funds.

However, each of the 10 countries has its own concept of national security that influences which particular investments may be restricted. As a result of the differing concepts, restrictions range from requiring *approval of investments in a narrowly defined defense sector* to *broad restrictions on the basis of economic security and cultural policy* (emphasis added). (US GAO, 2008, p. 3)

Beyond the nearly universal acceptance of the narrow view of national security (i.e., “defense-related”), Canada, Japan, and the People’s Republic of China explicitly indicate cultural nationalism or economic reasons as a basis for a review of FDI, while India specifies FDI restrictions pertaining to specific industry sectors (e.g., retail and atomic energy are strictly prohibited), and the United Arab Emirates include FDI restrictions (i.e., on equity ownership) ensuring their citizens’ involvement in its economy (US GAO, 2008). How often have these laws and regulations resulted in FDI being blocked or rejected? According to Kern’s (2007) study of five major countries’ economies (all included in the US GAO study), the evidence shows that Germany, Japan, and the United Kingdom have never invoked these laws and regulations, while one case has been blocked in the United States and nine cases have been rejected in France (between 1992 and 1994 for “public order” reasons).²⁵ This situation may be changing, as six of the countries studied by the U.S. Government Accountability Office (2008, p. 19) found government officials expressing specific concerns about foreign state-owned enterprises or SWFs. Regarding SWFs, these government officials’ concerns were “that they may be guided by political objectives rather than profit maximization or that their financial decisions may be motivated by support for certain ‘national champion’ companies.”

Multilateral public policy responses to SWFs (and similarly, to government-owned enterprises) have focused on the development of voluntary codes of corporate governance. In October 2007, the G-7 finance ministers and central bank governors recommended (after pressure was applied by the United States and France) that the Inter-

national Monetary Fund, the World Bank, and the Organisation for Economic Co-operation and Development (OECD) identify “best practices” for SWFs in the areas of institutional structure, risk management, regulatory transparency, and accountability of the implementing authorities (Badian & Harrington, 2008; U.S. Department of the Treasury, 2007b). Also in October 2007, the IMF’s International Monetary and Financial Committee called on the Fund to engage with representatives of key SWFs, central banks, and finance ministries to assist in developing a voluntary set of best practices for SWF management (IMF, 2008a). After accepting this challenge, the IMF has since coordinated its activities with the OECD, the European Commission, and the World Bank (IMF, 2008a).

On February 27, 2008, the Commission of the European Communities released its principles for a voluntary code of SWF corporate governance that touts commercial goals, rather than strategic considerations, in investment strategies (Commission of the European Communities, 2008). These principles support an open investment environment, multilateral cooperation on the development of a common framework for SWF investment, use of existing legal instruments, respect of European Community obligations and international commitments, and regulatory proportionality and transparency (Commission of the European Communities, 2008).²⁶ European Trade Commissioner Peter Mandelson said that if SWFs refuse to abide by a voluntary code of corporate governance, “pressure may grow for laws obliging them, at the least, to disclose their investments” (“EU to Consider Sovereign Wealth Fund,” 2008).

On March 20, 2008, representatives of the U.S. Department of the Treasury, the governments of Singapore and Abu Dhabi, and their respective SWFs, GIC and ADIA, agreed on five basic corporate governance policy principles for SWFs, in addition to four basic policy principles for host countries receiving SWF investment, in support of the processes under way by the OECD and IMF to develop voluntary best practices for SWFs (U.S. Department of the Treasury, 2008a). The policy principles for SWF corporate governance include: investment decisions should be based solely on commercial grounds, rather than geopolitical goals; there should be greater information disclosure regarding purpose, investment objectives, institutional arrangements, and financial information; strong governance structures, internal controls, and operational and risk management systems should be in place; SWFs and the private sector should compete fairly; and SWFs should comply with host-country regulatory and disclosure requirements (U.S. Department of the Treasury, 2008a). The significance of GIC (Singapore) and ADIA (Abu Dhabi) participation is that both SWFs were ranked near the bottom in the Peter-

son Institute for International Economics “scorecard” on best corporate governance practices—GIC third from the bottom and AIDA last (Barkley, 2008).

On May 1, 2008, the IMF sponsored and established a 25-member International Working Group (IWG) of Sovereign Wealth Funds and charged it with developing voluntary principles based on economic and financial risk and return-related criteria for SWFs by October 2008 (IMF, 2008b).²⁷ This voluntary code draws on the existing body of principles and practices, including the IMF’s *Guidelines for Foreign Exchange Reserve Management* (2001); the OECD’s *Guidelines for Corporate Governance of State Owned Enterprises* (2007), that have applicability to both SWFs and state-owned enterprises, and the Commission of the European Communities’ *A Common European Approach to Sovereign Wealth Funds* (2008). On October 11, 2008, the IWG of Sovereign Wealth Funds presented the result of their efforts, the “Santiago Principles,” to the IMF’s International Monetary and Financial Committee in Washington, D.C. (International Working Group of Sovereign Wealth Funds, 2008a). The Santiago Principles consist of 24 generally accepted principles and practices that properly reflect SWFs’ investment practices and objectives (International Working Group of Sovereign Wealth Funds, 2008b).²⁸ The Santiago Principles cover three key areas: (1) legal framework, objectives, and coordination with macroeconomic policies; (2) institutional framework and governance structure; and (3) investment and risk management framework.²⁹

The guiding purpose of the Santiago Principles is to:

1. Have in place a transparent and sound governance structure that provides for adequate operational controls, risk management, and accountability;
2. Ensure compliance with applicable regulatory and disclosure requirements in the countries in which SWFs invest;
3. Ensure SWFs invest on the basis of economic and financial risk and return-related considerations; and
4. Help maintain a stable global financial system and free flow of capital and investment.

In June 2008, the OECD adopted a declaration welcoming investments by SWFs, and recommitted its membership to governing principles of investment openness and nondiscrimination (Mandelson, 2008; Organisation for Economic Co-operation and Development, 2008b).³⁰ This OECD declaration was soon followed in September 2008 with an agreement among its members to base their investment policies on two existing investment instruments calling for fair treatment of investors: the first, the OECD

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Code of Liberalisation of Capital Movements (that covers both long-term and short-term capital movements), adopted in 1961, and the second, the OECD Declaration on International Investment and Multinational Enterprises, issued in 1976 and revised in 2000 (Organisation for Economic Co-operation and Development, 2008c).³¹ Nevertheless, the OECD recognizes the right of member countries to take appropriate actions to protect their national security when an SWF raises concerns as to whether its objectives are commercial or driven by political, defense, or foreign policy considerations (Organisation for Economic Co-operation and Development, 2008c).

While there have been recent efforts to develop voluntary codes of corporate governance addressing SWF investment, there are also legal and regulatory efforts under way among several nations that will affect FDI decisions by state-owned enterprises and SWFs. In Europe, the German government is actively redrafting an update to its investment law that will establish a formal review process allowing the nation’s executive branch to block SWFs or other large, state-sponsored investment agency company acquisitions deemed of “strategic relevance” (Biberovic, 2008; Walker, 2008). The Italian government of Prime Minister Silvio Berlusconi has established a “national interests committee”

to develop regulations applicable to controlling the behavior of SWFs (Bennhold, 2008). The Italian government is opposed to SWFs owning more than 5% of equity in Italian companies (Bennhold, 2008). French President Nicolas Sarkozy has expressed strong misgivings about the lack of reciprocity with the SWF host countries themselves, demanding that there be investment “reciprocity before we open Europe’s barriers” (“Sarkozy Attacks Wealth Funds,” 2008). While supportive of a voluntary code of corporate governance, the French government has raised the possibility of creating a list of “strategic sectors” of industry potentially immune to foreign control (DLA Piper, 2008).³² In November 2008, the French government announced the creation of a \$29 billion Strategic Investment Fund to prevent the takeover of strategic French companies by foreign companies as well as to assist French companies to cope with the negative economic effects of the worldwide credit freeze (Caisse des Despoits, 2008; Chassany, 2008).³³ In North America, the Canadian government launched a review of its Investment Canada Act, and in December 2007, it issued guidelines clarifying the Investment Canada Act as it pertains to foreign state-owned enterprises (DLA Piper, 2008).³⁴ Furthermore, since national security is not the focus of the guidelines, the Canadian government is currently considering a national security test as part of its foreign investment review process (DLA Piper, 2008).

Discussion and Recommendations

The worldwide controversy surrounding SWFs has created an unstable political, legal, and regulatory environ-

The worldwide controversy surrounding SWFs has created an unstable political, legal, and regulatory environment concerning this form of FDI.

ment concerning this form of FDI. For financial service firms, recent SWF equity investment has been a stabilizing source of capital for those facing the harsh financial consequences of the subprime mortgage meltdown of late 2007 (Cho, 2008). Nevertheless, the recent proliferation of new SWFs, primarily established by authoritarian regimes of Middle Eastern nations (flush with revenue from oil sales) and the People’s Republic of China (cash rich from consumer products sales), has initiated public policy introspection over national security concerns within many Western countries, the target market of the majority of recent SWF equity purchases. The fact that many Western countries also operate SWFs makes this issue relevant for them as well. In a global economy ostensibly committed to the free flow of trade and investment, the resolution of this controversy is important to the continued maintenance of the “openness” of this international economic system. To assist in maintaining a stable environment for the free flow of investment capital, there are three policy areas that must be resolved: (1) clarity in SWF corporate governance practices; (2) an understanding of the scope of the definition of “national security”; and (3) the issue of reciprocity in investment opportunities.

As mentioned earlier, the IMF has taken a leadership role in facilitating efforts by the IWG of Sovereign Wealth Funds to create a voluntary code of 24 generally accepted principles and practices—the Santiago Principles—for improving SWF corporate governance. This IMF-supported process has had the benefit of involving not only the countries operating the largest SWFs, but also recent corporate governance principles agreed upon by the United States, Singapore, and Abu Dhabi, the OECD, and the Commission of the European Communities—all sharing marked similarities in substantive recommendations. The Santiago Principles will provide an international “baseline” of responsible SWF managerial practices. For it to be of practical value, however, each government accepting SWF investment will need to specify that the Santiago Principles are expected to be adhered to and that its transparency provisions will allow for periodic accountability/audit or certification by the host country. Wilson (2003) recognizes that voluntary self-regulation can be based on a form of inspection and certification of compliance with established standards or business practices. To that end, the IMF may itself consider implementing a program of “fourth-party” certification (i.e., international regulation is undertaken by a governing body; Wilson, 2003, p. 148) of SWFs who meet the requirements of the voluntary Santiago Principles, modeling itself loosely on the certification process of the United Nations’ Global Compact, but with a higher level of compliance account-

ability than is required by the Global Compact program. If established, a Standing Committee of Sovereign Wealth Funds (within the IMF) can be empowered to manage this Santiago Principles SWF certification process. For executives (and boards of directors) of firms who have SWF shareholders, or who are attempting to attract this type of equity investor, having an SWF investor who has received this voluntary Santiago Principles certification will help assuage the concerns of other firm stakeholders, including shareholders, employees, and national governments, and make it easier for SWF managers to execute an effective investment strategy. Insistence on mandatory SWF Santiago Principles certification (or other unbiased evidence of adherence) should be a requirement for negotiations by any executive or board of directors.

The scope of what can be defined as “national security” ranges from a narrow description of the defense sector to a broader view incorporating economic security and cultural policy. A broader interpretation of national security offers the potential for “protectionist” policies, although it is justifiable for economic security to be considered in a reasonable definition of the national security interest. Sovereign states exercise their legal rights to establish the scope of such restrictions on FDI, including government-financed SWFs and government-owned enterprises. The argument for restrictions on SWF equity (voting) ownership involves the dedication of such capital investments to an investment strategy focusing on passive commercial success over time. This is where transparency in SWF operations is crucial: Is there a track record of passive commercial vs. geopolitical motivations behind such government-owned investments?

Since SWFs are extensions of national governments, it would be naïve to believe that countries that are geopolitical rivals would not be tempted to exercise their power to affect a rival’s economic stability given their opportunities through control of voting equity stock in a major firm.³⁵ For example, a top foreign policy advisor to then-President Vladimir Putin, Sergei Prikhodko, announced in late 2006 that Russia might raise its equity ownership by VTB, a state-controlled bank, in the European Aeronautic Defence & Space Company, which owns Airbus, from 5% to over 25%, enough to block any major policy decisions (White et al., 2008). Recently, however, the Russian Finance Minister Alexei Kudrin indicated that Russia’s National Wealth Fund would follow the Norwegian SWF model and limit firm equity holdings to less than 5% ownership and not seek a management role (White et al., 2008). Both the Russian and German governments are considering legislation to restrict foreign investment in strategic sectors of their economies. In Russia, there may

be no more than 10% equity ownership through FDI in oil, gas, gold, and copper enterprises (US GAO, 2008); in Germany, no more than 25% voting equity ownership in firms having “strategic relevance” to the “public order” or “national security” (Biberovic, 2008).

There is evidence that controlling ownership interest in a company can be generally acquired with 20% of direct and indirect voting equity ownership control (LaPorta, Lopez-de-Silanes, & Shleifer, 1999, p. 477). One recommendation to address this contentious issue is to incorporate a conservative limit of no more than 10% of any combination of SWF or government-owned enterprise equity ownership control in any designated, non-defense, strategic-sector firm.³⁶ This limitation on equity ownership will preserve a continued flow of SWF/FDI for passive commercial investment, while reasonably precluding management control of the firm (and the threat of geopolitical investment agenda) by the SWF, government-owned enterprise, or some collaboration. Such an ownership threshold can be included in bilateral negotiations between a prospective firm’s management/board and the SWF management team/board (that, again, should reduce stakeholder concerns about the SWF’s ability to influence the management of the firm) or incorporated into the FDI laws and regulations of the host country. Furthermore, SWF managers contemplating equity acquisitions in the United States should assess the potential security implications of their investments early in the due diligence process and, if appropriate, schedule pre-filing meetings with CFIUS staff.

The issue of reciprocity in FDI has again resurfaced, this time focusing on SWF investment. By definition, reciprocity requires that free trade also be fair trade between countries (i.e., access to the same capital investment opportunities). Because of the right of sovereign nations to restrict SWFs or government-owned enterprises from investing in certain firms or industries considered to have a national security sensitivity, the fact is that there will be not be free or fair flow of invested capital by SWFs (or of FDI) between many countries. One approach to managing this situation is to have countries operate with an SWF/FDI policy that is both multilateral and bilateral. A multilateral policy toward SWF investment establishes the host country’s general position on reciprocity of FDI; the bilateral policy on SWF investment is negotiated between the host investment country and the SWF investor country through treaty agreement. The reciprocity rules are established between the two countries employing the most restrictive limitations on FDI (and SWF investment) found in both countries’ laws and regulations. This treaty agreement will allow for a “fair,” if not fully “free,” ex-

change in FDI between the two countries, and perhaps incentivize both countries to periodically reappraise the efficacy of FDI limitations established in law and regulation—a national economic policy that should be aggressively lobbied for by national business associations encouraging free *and* fair trade.

As previously mentioned, there is every indication that SWF equity investment will continue to grow in the upcoming decade. In the present global financial crisis, however, the value of SWFs in the Middle East have exacted significant losses primarily due to a nearly 71% decline in oil prices, from a monthly average of \$133.93 a barrel (of West Texas Intermediate Crude) for June 2008 to \$39.16 for February 2009. Most of these Middle Eastern SWFs have reportedly either stopped investing or have become increasingly risk-averse in purchasing foreign assets in recent months, and are using their SWFs to expand public-sector spending in the hopes of stimulating their own slumping, oil-based economies (Knowledge@Wharton, 2009; Setser & Ziemba, 2009). Moreover, Asian SWFs, including those of the People's Republic of China and Malaysia, are also taking a conservative view regarding investment opportunities during the first half of 2009, awaiting the global recession to work itself out (Booth, 2009; "Economic Crisis Hits Sovereign Wealth Funds," 2009). One example of the impact of the world economic recession on the value of an SWF is Singapore's Temasek Holdings, whose management reported a 31% drop in the value of its investment holdings (to \$81 billion) from March through November 2008 ("Economic Crisis Hits Sovereign Wealth Funds," 2009).

In an interview at the 2009 World Economic Forum held in Davos, Switzerland, Sameer al-Ansari, the CEO of Dubai International Capital, a \$13 billion SWF, said that "there (is) going to be a great opportunity in the next year or two to acquire assets at historically unprecedented levels" (Booth, 2009). However, Donald DeMarino, cochairman of the National U.S.-Arab Chamber of Commerce, cautions that "the inactivity of the funds during the [financial] meltdown" can be explained by "the treacherous political environment for them in the West" (Knowledge@Wharton, 2009). Remembering the Dubai Port World controversy in 2005, the National U.S.-Arab Chamber of Commerce's DeMarino believes that Middle Eastern SWF managers will be ever cognizant of Western concerns of "Arabs buying up assets too cheaply" (Knowledge@Wharton, 2009).

Nonetheless, over the long run, the Santiago Principles will provide some self-regulatory relief for SWF recipient nations, but even if generally adopted by most of the world's major SWF funds, these corporate gover-

nance guidelines may not be enough to counter national legislation and policies, such as those being considered in Italy (5% limitation on SWF equity ownership) and implemented in France (Strategic Investment Fund), that overcompensates for the potential threats from such government-owned investment funds. As Simon Johnson (2007, p. 57), former economic counselor and director of the IMF's Research Department, has argued, "[T]he real danger is that sovereign wealth funds (and other forms of government-backed vehicles) may encourage capital account protectionism, through which countries pick and choose who can invest in what." This would indeed be a "lose-lose" environment for both SWFs and recipient host countries, as they now appear to need each other more than ever in the most recent global recession.

Notes

1. For the purpose of this article, the term *national security* is defined to include domestic political and economic stability, as well as national competitiveness and defense-related issues.

2. The Monitor Group (2008), a Cambridge, Massachusetts-based business consulting and research firm, has recently found (as a result of a survey undertaken by the firm) that SWF investment in the financial sector has dropped significantly since the first quarter of 2008. The financial sector comprised \$143.4 billion of SWF deal value in the first quarter of 2008, compared to \$4 billion each in the second and third quarters of 2008.

3. Although in the United States, if a foreign SWF were to attempt to purchase 10% or more of equity ownership in the financial sector, it would likely trigger a congressional inquiry and potential political furor.

4. The Monitor Group (2008) found that 46% of reported SWF deals in the third quarter of 2008 were domestic transactions, the highest percentage since 2003. Some analysts argue that SWFs should avoid investing in domestic industries, as it could create inflationary pressure and lead to inefficiency due to a major public-sector involvement in private-sector management (Waki, 2008). In October 2008, the Russian government announced it will use one of its SWFs to fund 50% of the \$34.18 billion subordinate loans package designed to bolster its flagging banking system (Vorobyova, 2008).

5. The Monitor Group (2008) reports that 54% of second- and third-quarter 2008 SWF deals by value (\$23 billion out of \$42 billion) were in emerging markets, the highest share of total SWF deal value since 2005.

6. It is also reported that Germany's Siemens, a major GE competitor, is in similar negotiations with other SWFs (Zawya, 2008).

7. This SWF investment translates into SWFs owning up to 20% of global real estate by 2015 (Propertywire, 2008).

8. This definition is designed to differentiate SWFs initially funded by net foreign assets (through commodity exports or exchange-rate intervention) from, for example, ordinary domestic pension funds that are initially funded in domestic currency but that may then diversify internationally (U.S. Department of the Treasury, 2007a). Jen (2007), while essentially agreeing with the preceding U.S. Department of Treasury definition, argues that a definition of SWF should explicitly include that it: (1) be sovereign, (2) have high foreign currency exposure, (3) possess no explicit liabilities, (4) be characterized by high-risk tolerance, and (5) is focused on a long investment horizon.

9. There are other commentators, such as Gai and Shin (2003), who argue that, while transparency can be an effective instrument for limiting the moral hazard (and encouraging financial stability) of investors and national governments, care should be exercised regarding the types

of information provided to the marketplace. Gai and Shin (2003) posit that, while the disclosed information must be coherent and open, it must also be selective, as certain information may exacerbate a crisis situation a financial institution is confronting (e.g., if the New York Federal Reserve had required the management of hedge fund Long-Term Capital Management in September 1998 to publicly announce its trading positions as a precondition for facilitating the coordination of its creditors, this decision would have exposed its greatest vulnerabilities and served as a coordinating signal to exploit the weakened position of the distressed parties in the crisis).

10. Based on their interpretation of IMF data, between December 2001 and October 2007, global foreign exchange reserves from which SWFs are bankrolled nearly tripled from \$2.1 trillion to \$6.2 trillion, with more than 80% concentrated in the developing world (Griffith-Jones & Ocampo, 2008).

11. However, Stephen Jen, an economist at Morgan Stanley, London, estimates that the world's SWFs have declined between 18 and 25% in 2008 (due to a precipitous decline in oil prices resulting from a world-wide recession tamping down consumer demand), bringing the world's SWFs' total value down to between \$2.3 trillion and \$2.5 trillion (Reed, 2008).

12. In a recent econometric study of 53 SWF equity purchases from 1989 to 2008, Fotak, Bortolotti, and Megginson (2008) found that SWF investment may have a significant negative impact on corporate financial returns (i.e., the average abnormal buy-and-hold return is a negative 40.96%, as measured 480 trading days after the SWF investment occurs). The Global Institute estimated that as of July 2008, SWFs had collectively lost \$14 billion in equity assets from recent investments in the financial sector (Farrell, Lund, & Sadan, 2008).

13. The Monitor Group found that SWF investments in strategic sectors of the economy (e.g., transportation, defense, aerospace, and high technology) consisted of less than 1% of all equity purchases, and when expanding the strategic sectors to include energy and utilities, under 5% of all SWF acquisitions were for controlling interests in OECD markets (Miracky et al., 2008).

14. For example, in January 2006, Singapore's Temasek SWF purchased from the family of the then-Prime Minister of Thailand, Thaksin Shinawatra, a controlling stake in the Thai telecommunications Shin Corporation, that included control of space satellites used by the Thai military (Weiss, 2008). This financial transaction caused a political crisis in Thailand, resulting in the collapse of the Prime Minister's government (Weiss, 2008).

15. "Strategic assets" correlates with "critical infrastructure" defined by the U.S. Department of Homeland Security (2006, p. 7) as "the assets, systems, networks, and functions that provide vital services to the Nation" and that are largely owned and operated by the private sector.

16. The Linaburg-Maduell Transparency Index is based on ten principles depicting SWF transparency to the public. These ten principles, each carrying a weight of "one point," are (Sovereign Wealth Fund Institute, 2008c):

- Fund provides history, including reason for creation, origin of wealth, and government ownership structure.
- Fund provides up-to-date independently audited annual reports.
- Fund provides ownership percentage of company holdings, and geographic location of holdings.
- Fund provides total portfolio market value, returns, and management compensation.
- Fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines.
- Fund provides clear strategies and objectives.
- If applicable, the fund clearly identifies subsidiaries and contact information.
- If applicable, the fund identifies external managers.
- Fund manages its own Web site.
- Fund provides main office location, address, and contact information, such as telephone and fax.

17. It is against Kuwaiti law for the Kuwait Investment Authority to publicize its assets' worth (Portman, 2008).

18. A "conventional" or "passive" SWF investment strategy means not actively exercising corporate governance voting rights and seeking traditional investor returns (i.e., stock appreciation and dividend payments). In contrast, a "strategic" SWF investment strategy involves a potential noncommercial or political agenda by the investing country.

19. Singh (2008) notes this "double-standard" practiced by Western policymakers, as they tend to overlook similar, or greater, levels of secrecy and unaccountability presently practiced by hedge funds, private equity funds, and investment banks. However, unlike these privately held financial investment instruments, SWFs with political motives might accept financial losses if their governments believed their political gains would offset their economic losses (Rose, 2008).

20. The Exon-Florio Amendment, that established CFIUS, is found in the Omnibus Trade and Competitiveness Act of 1988 § 5021, Pub. L. No. 100-418, 102 Stat. 1107 (1988) (codified at 50 U.S.C. App. § 2170).

21. Foreign direct investment is defined "as the purchase of real assets abroad for the purpose of acquiring a lasting interest in an enterprise and exerting a degree of influence on that enterprise's operations" (US GAO, 2008, p. 5).

22. Under the final regulations issued by the U.S. Department of the Treasury, there are six new factors to be considered by CFIUS or the President of the United States (Bingham, 2008):

1. Whether the transaction has a security-related impact on "critical infrastructure," including major energy assets;
2. Whether the transaction has a security-related impact on "critical technologies";
3. Whether the transaction involves control by a foreign government;
4. A review of the current assessment of (i) the adherence of the subject country to non-proliferation control regime, including treaties and multilateral supply guidelines, (ii) the relationship of such country with the U.S., specifically on its record of cooperating with the U.S. in counter-terrorism, and (iii) the potential for transshipment or diversion of technologies with military applications, including an analysis of national export control laws and regulations;
5. The long-term projection of U.S. requirements for sources of energy and other critical resources and material; and
6. Such other factors as the President determines are appropriate.

23. Rose (2008) believes that the FINSA regulations broadly interpret "control" so as to diminish the sphere of shareholder "influence," including determining, directing, or deciding "important (company) matters" or where an SWF causes the appointment or dismissal of officers or senior managers.

24. The President's Working Group on Financial Markets has initiated a review of SWFs, and the U.S. Department of the Treasury recently established a working group that has initiated policy analyses and regular reporting to the U.S. Congress on SWF acquisition activity (Kimmitt, 2008).

25. It is important to note that pending FDI transactions may have been politically discouraged from proceeding through to the conclusion of a formal review process (that exists in nine of the 11 countries surveyed by the US GAO), resulting in companies voluntarily withdrawing from the investment opportunity before a formal decision is rendered.

26. The Commission's principles of good governance include (Commission of the European Communities, 2008, p. 10):

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

Transparency practices that could be considered would include (Commission of the European Communities, 2008, p. 11):

- annual disclosure of investment positions and asset allocation, in particular for investments for which there is majority ownership;
- exercise of ownership rights;
- disclosure of the use of leverage and of the currency composition;
- size and source of an entity's resources; and
- disclosure of the home-country regulation and oversight governing the SWF.

27. Jeffrey Garten, professor of international trade at Yale University, argues that it is crucial for the United States and the European Union to coordinate their policies on SWFs, or these government-owned investment funds could play countries against one another (Badian & Harrington, 2008).

28. See International Working Group of Sovereign Wealth Funds (2008b). The list of 24 generally accepted principles and practices can be found on pp. 7–9.

29. The IWG has announced the establishment of a Formation Committee to explore the creation of a Standing Group of Sovereign Wealth Funds, whose intended purpose is to keep the Santiago Principles under review and examine the implementation of this voluntary code by recipient countries, multilateral institutions, and the private sector (International Working Group of Sovereign Wealth Funds, 2008a).

30. The members of the OECD's Freedom of Investment, National Security, and Strategic Industries Project agreed to support three principles for national investment policy measures that address essential security interests: (1) transparency and predictability; (2) proportionality; and (3) accountability (Organisation for Economic Co-operation and Development, 2008a, p. 55).

31. These two investment instruments embody five principles, including commitments to nondiscrimination, transparency, progressive liberalization, and undertakings not to introduce new restrictions and not to insist on reciprocity as a condition of liberalization (Organisation for Economic Co-operation and Development, 2008b). Furthermore, these investment instruments also involve a process of "peer review" to monitor countries' observance of the five principles (Organisation for Economic Co-operation and Development, 2008b). For further clarification of OECD country policies toward SWFs, please see Organisation for Economic Co-operation and Development (2008b).

32. This would be in addition to the list of French industrial sectors designated for economic protection, which was drawn up by the French government in 2006 (Wruuk, 2008).

33. The Strategic Investment Fund (SIF), a public limited company, is to be managed by the Caisse des Depots et Consignations, a state-owned lender, who will invest for the long term in equity ownership of small and medium-sized companies and assist in stabilizing the capital of certain large French enterprises (Caisse des Depots, 2008). The French government is initially funding the SIF with 7 billion Euros of state-owned minority shares in Renault SA and Air France-KLM Group (Chassany, 2008).

34. These investment guidelines include (Walker, 2008):

- Define "state-owned enterprises" (SOEs) owned or controlled directly or indirectly by a foreign government (that may include sovereign wealth funds).
- Do not apply to all SOE investments but only those that result in an acquisition of control of a Canadian business and exceed certain monetary thresholds.
- Focus on the SOE's adherence to Canadian standards of corporate governance and its commercial orientation.
- Do not single out particular economic sectors or countries for special scrutiny.

35. In March and April 2008, Norton Rose LLP (2008) surveyed 113 respondents (composed of sovereign wealth funds and investors, private equity managers and funds, financial institutions, and corporate entities) on the topic of sovereign wealth funds. When asked to identify the most important criteria for SWEs, 35.5% of respondents said "the high-

est economic return," but 36.4% answered "potential strategic benefit/investment for relevant wealth fund jurisdiction."

36. In some cases, "pyramiding schemes," where there are a sequence of firms having control over the next one (thus, forming a control chain), allow for indirect voting rights potentially being combined with direct voting rights in the firm and effectively exceeding the 20% control threshold (LaPorta et al., 1999; Leechor, 1999). The recommended 10% direct equity ownership limit will mitigate the possibility for this type of control situation to occur.

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