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Possible Policy Responses to Sovereign Wealth Funds

While the previous chapter outlined five areas of concern about sovereign wealth funds, this chapter considers a range of policies that might be adopted or adapted to address these concerns. Most proposals fall under the heading of regulation by the recipient country either in a comprehensive or a limited form.

It is useful to consider, first, what regulation of SWFs would involve. In principle, regulation could be imposed in the jurisdiction receiving SWF investments, by the home country, or by both. In practice, the focus is on host-country regulation though funds are subject to the laws and regulations of their home countries. Since there are many jurisdictions receiving SWF investments, many with SWFs of their own, the almost inevitable result of uncoordinated national approaches would be an uneven pattern of regulation for SWFs.

Abstracting from SWFs per se, national financial regulatory regimes focus either on domestic financial institutions and their activities or on investment from outside the country, although there are overlaps. In its domestic focus, regulation aims to strike a balance between promoting the safety and soundness of the institutional providers of funds and financing and protecting the integrity of markets and the recipients of funds—the consumers of financial services. Moral hazard considerations are involved on both sides of the balance. In its external focus, regulation aims to protect the recipient country and, in some cases, its indigenous institutions.[1]

1. See Rose (2008) for a full treatment of this strand of the regulatory literature as it might be applied to SWFs.

From this framing of the general focus of financial regulation, it follows that bank-like regulation does not apply to SWFs except to the extent that the SWFs invest in banks and those investments are not otherwise covered by existing regulations. Setting bank-like regulation aside, and in light of the five basic concerns about SWFs discussed in the previous chapter, consideration can be given to four possible approaches to the regulation of SWFs: comprehensive regulation of all their activities, prohibitions of specific investments, limitations on investment activities, or reciprocal arrangements. My conclusion is that none of these approaches offers much promise in addressing the concerns about SWFs identified in chapter 3. That said, public policy needs to try to address the wide variety of concerns about SWFs, and so this chapter examines the aforementioned approaches to SWF regulation, while the next chapter will outline my preferred approach of establishing an international standard or best practices to promote SWF accountability and transparency.

Comprehensive Regulation

One approach to the regulation of SWFs would make no distinction between foreign and domestic investors and exploit the potential for using existing laws, rules, and regulations to influence, control, or guide all foreign government investments on a national treatment basis. The primary aim would be to address concerns about SWFs' contribution to market turmoil and uncertainty. Countries might examine their competition or regulatory disclosure policies in light of some of the issues that SWFs raise to ensure that those policies remain adequate to the task.[2] In the United States, this would mean looking beyond the on-off switch associated with the Committee on Foreign Investment in the United States (CFIUS) to rules and regulations, for example, of the SEC on share acquisitions, market integrity, corporate governance, and disclosure.[3] The Federal Reserve and other bank regulators, as well as other US regulatory and supervisory agencies, have mandates covering banking and finance as well as strategic sectors, such as energy, or market competition.[4]

2. Greene and Yeager (2008) examine this approach.

3. SWFs are subject to the requirement to disclose their intentions if they hold more than 5 percent of a registered class of securities and to disclose changes in their holdings if they hold more than 10 percent. They are required to disclose their portfolios to the SEC if they manage more than $100 million of SEC-registered securities. Some of these requirements can be avoided depending on how an SWF structures its US investment vehicle. See Linda Chatman Thomsen, "Sovereign Wealth Funds and Public Disclosure," testimony before the US-China Economic and Security Review Commission, February 7, 2008.

4. In 1988, the UK Monopoly and Mergers Commission, in the interest of fostering competition, required Kuwait's SWF to reduce its stake in British Petroleum from 20 percent to less than 10 percent.

National treatment is a concept of which economists are fond, precisely because it is nondiscriminatory in its effects. But there are many exceptions in practice. This reality is illustrated in the United States in the tax treatment of SWFs. A study by the Joint Committee on Taxation of the US Congress (2008) concluded that, with a few minor exceptions (most of which could be avoided through the use of well-designed investment vehicles), SWFs receive no more favorable treatment on their portfolio and nonportfolio investments in the United States than other foreign investors, which are in some respects treated better than domestic investors. (Oversimplifying only a bit, foreign direct investment is taxed like other forms of commercial activities, subject to the effects of tax treaties, and other investments essentially are untaxed.) Thus, the objections raised by critics such as Fleischer (2008, 2009) to the taxation of SWFs are essentially objections about the way the United States taxes foreign (primarily portfolio) investments. They have little to do with SWFs per se.

National treatment aside, the regulation of SWFs could be approached in a manner similar to other forms of regulation of foreign investment. Presumably the aim would be to address concerns about countries using their SWFs to pursue national political or economic objectives. The approach might yield some benefits in limiting market turmoil and uncertainty, but the result could be to exacerbate conflicts between countries—the fifth column.

One challenge in this type of comprehensive approach is that it would have to be broadly applied internationally, for example via agreement or treaty, so as not to disadvantage those countries within the regime vis-à-vis those outside it. Another challenge would derive from the somewhat amorphous nature of SWFs. If a country or group of countries tried to apply formal regulation to a preferred definition of such funds, the countries with the funds would either avoid the countries entirely or morph their funds into forms that did not fall under the definition (e.g., in the form of de facto investment accounts as part of their reserve holdings). A case can be made for a comprehensive approach to government-controlled foreign investments starting with foreign exchange reserves and ending with investments by government-controlled entities, but that approach would suffer from two challenges.[5] First, in the current environment of antiglobalization such a regime either might be so restrictive as to be counterproductive or might fail to attract sufficient support for ratification. Second, to the extent that the regime prohibited certain types of investments, it would be necessary either to force a large amount of disinvestment or to grandfather that investment—and either treatment would be problematic politically, economically, and financially. Neverthe-

5. I proposed such a broad approach in Truman (2007). Mattoo and Subramanian (2008) have suggested involving the World Trade Organization in the establishment of a standard for SWFs. See chapter 7.

less, a broad, comprehensive approach to government-controlled investments is an appropriate long-term goal.

Such a comprehensive regime for SWFs might apply only to controlling investments and not to "passive investments" as that term is used in the regulations issued by the US Department of the Treasury (2008b) for the CFIUS. However, no bright line is established by those regulations to distinguish controlling from passive investments.

The CFIUS regime was established formally under section 721 of the Defense Production Act of 1950 through the Exon-Florio amendment in the Omnibus Trade and Competitiveness Act of 1988, and most recently was further strengthened and codified by the Foreign Investment and National Security Act (FINSA) of 2007.[6] It applies to all foreign investments in the United States, establishes procedures for the review of such investments, and gives the president power to disapprove of such investments when they involve control and are deemed to threaten to impair US national security (Graham and Krugman 1995, Graham and Marchick 2006). This special regime distinguishes between domestic and foreign investors and applies in principle to both government and nongovernment investments, but only where control is involved. What is meant by national security is not defined in the legislation, but the US Treasury has issued guidance concerning the types of transactions that have presented general national security considerations. Critics of the US regime who tend to favor a form of negative-list approach (Demarolle 2008, 27), as discussed below, argue that the regime provides the US authorities with extremely broad latitude to determine whether a planned foreign investment should be subjected or not to the CFIUS procedure. Supporters argue that the real world is neither black nor white.

One can imagine a tighter regime applying to all foreign investments in a country or to all foreign government investments, controlling and noncontrolling. It has been suggested that each dollar of foreign-government-owned investment in the United States—direct investment of any size, purchases of stock, purchase of bonds, US treasury securities—on a case-by-case basis should be subjected to a range of tests including the current state of US relations with the home country of the entity or person making the investment and whether the country offers reciprocal treatment.[7]

Such a regime would be technically impossible to implement without dramatic changes in today's globalized financial system that would transform the system as we know it. The regime in effect would require the reimposition of comprehensive exchange and capital controls that have been largely dismantled, except in a few developing countries, since the end of World War II. At the extreme, funds of any type could not flow

6. The CFIUS as an informal interagency committee was established in 1975.

7. See the testimony of Gal Luft and the exchanges on pages 64–65 in US House of Representatives Committee on Foreign Relations (2008).

unless their flow received prior approval, presumably after their origins were traced. Given the ambiguity in many countries between governments and the private sector, a tight regime of foreign investment control would have to drop that distinction. Moreover, the introduction of an overtly political test into the approval process, at least in the United States, fails to recognize that the warmth of US relations with a country changes from decade to decade, if not month to month, raising again the grandfathering issue.

A comprehensive approach to the regulation of SWFs does not appear to be in the cards and, in any case, would only address one or two of the concerns about them—the potential pursuit of national political or economic power objectives and, perhaps indirectly, concerns about market turmoil and uncertainty.

Prohibition of Specific Investments

For some observers, a more promising approach than a comprehensive regulatory regime applying to foreign investments, or to foreign investments by governmental entities such as SWFs, is to establish a list of sectors in which SWFs, or foreign government entities more generally, are not allowed to invest—that is, a negative list of sectors in which such holdings would not be permitted.[8] This would be a more targeted approach to addressing concerns about the political objectives of SWF investments. Such a de facto "safe harbor" approach roughly corresponds to the current regime for foreign investment in many OECD countries today, including France and also Russia, but it could be expanded and codified.[9] Marchick and Slaughter (2008) argue in the case of foreign investment in general that countries should avoid sector-based lists for determining investment reviews or only use them as a second-best alternative. Against the possible benefit to foreign investors of increased certainty in treatment, they stress the practical problems involved in sensibly creating and applying these lists.

An open invitation to countries to rule out investments by SWFs in certain sectors, however, almost certainly would produce a very long list of prohibited sectors in many countries, in particular if the use of lists ruled

8. Advocates include the editorial page of the *Financial Times* (October 22, 2007) and George Kleinfeld, "Foreign State Funds Should Be Offered Shelter," *Financial Times*, November 28, 2007. Kleinfeld, a Washington lawyer, was admirably motivated to lower the cost to SWFs investing in the United States by offering a safe harbor for SWF investments in other sectors.

9. Some OECD countries, such as France, follow a modified version of the negative-list approach; foreign investments in the 11 sectors on the French list are subjected to prior authorization from the minister for the economy. Another modification is for the host government to own, or to acquire defensively, golden shares in the relevant firms in strategic industries, which would allow the government to control key decisions of the firm regardless of the other investors.

out the possibility of any form of investment review. If the lists did not rule out reviews, then the utility of the lists would be reduced. Moreover, there could be knock-on effects in other countries considering their own investment regimes, which would tend to either create a crazy quilt of de facto regulation or be used by local interests to expand national lists. For the United States at least, where foreign investment rivals foreign trade for lack of public support and understanding, such an approach would be problematic (see chapter 3). Graham and Marchick (2006, 148–49) reported that in 2003 the US Department of Homeland Security identified 12 sectors that it considered critical infrastructure: agriculture and food, water, public health, emergency services, the defense industry, telecommunications, energy, transportation, banking and finance, chemicals, postal services and shipping, and information technology. They note that those industries in 2002 accounted for 24.4 percent of US nonfarm civilian workers. One can imagine that a list of prohibited sectors to SWF investments could be much longer. The FINSA requires CFIUS to consider and report on the implication of foreign investments in critical infrastructure and technologies, but the application of those tests is substantially narrower than an outright prohibition and is limited by the standard that the investment must threaten to impair US national security.

Leaving aside the special features of the US economic and political environment, to be broadly applicable the negative-list approach would have to define what is meant by investment. Would the restriction be on any investment (bonds as well as stocks) of any size regardless of whether control would be involved?

An alternative is a positive-list approach to certain investors. At a conference on foreign investment at Columbia University in October 2008, Manfred Schekulin, director of export and investment policy at the Austrian Ministry of Economics and Labor, thoughtfully mused about a concept of knowing your foreign investor: say "yes" to an investment if the host authorities know and are comfortable with the investor, but perhaps "no" to an investment if the host authorities do not know or are uncomfortable with the investor. This concept is an extension of ideas such as knowing your customer and applying suitability criteria to senior management in financial institutions. However, the nondiscriminatory application of such a concept would be difficult to ensure if it rests on judgments that necessarily would be subjective and might well be biased. For example, we trust those we know and went to school with more than those we do not know or with whom we have had no common experiences.

In addition, it is reasonable to ask why host countries should single out SWFs as a group with respect to the sectors in which they can invest or where they come from while other forms of government investments via state-owned or state-controlled entities would be permitted. Moreover, if the restrictions were broad in terms of the type of investment entity and tight in terms of the scale of the investment, what would be done about the substantial existing international investments by government entities? Grandfathering creates its own competitive distortions.

Finally, under this approach of limiting the sectors in which SWFs could invest, there would be the issue of indirect investments via special-purpose vehicles registered in some Caribbean location or merely via investing in hedge funds, private equity firms, or other types of investment vehicles.

Thus, prohibitions of investments by SWFs in specific sectors would offer limited benefits in addressing the possible national political or economic power motivations of such investments and would be problematic in terms of practicality and effectiveness even in terms of achieving this limited objective.

Limitations on Investment Activities

Short of outright prohibitions on investments by SWFs in some sectors, consideration might be given to imposing limitations on the activities of SWF investors. This approach might be motivated by concerns about the potential for market disruption associated with SWF activities as well as about the exercise of political or economic power. For example, SWFs (individually or as a class) might be (1) limited in the size of their stakes in domestic financial or nonfinancial corporations; (2) prohibited from appointing members to the boards of the corporations; (3) limited to holding nonvoting shares (or prohibited from voting their shares); or (4) required to channel their investments through intermediaries.[10] Indeed, a number of SWFs have voluntarily adopted, or have been persuaded to adopt, these types of limitations in some of their higher-profile investments. However, voluntary restraint is different from unilateral, across-the-board limits.

These types of limitations might appear on their surface to be attractive alternatives to outright prohibitions. However, on closer examination they

10. The *Financial Times* in its October 22, 2007 editorial advocated the first proposal. In August 2007 in the *Financial Times* Jeffrey Garten called for a limit of 20 percent on stakes without direct consultation between the home and host governments ("We Need New Rules for Sovereign Funds," *Financial Times*, August 8, 2007). In the context of an SWF code of conduct, Hildebrand (2007) also endorsed this approach, writing that an "SWF code of conduct will have to set the limit for individual stakes at a level significantly below the typical threshold of a controlling minority, let alone an absolute majority." Recall from chapter 3 that a number of SWFs already limit their stakes, but recall also that other SWFs do not. Gilson and Milhaupt (2008) advocated the third proposal; they argue that transforming voting into nonvoting shares when they are held by an SWF would separate the economic profit motive from the strategic or political motive. Buiter (2007) made a similar proposal directed at "the risk of political extortion by a foreign state-owned investor," in effect addressing the conflict-of-interest concern identified in chapter 3. In July 2007 in the *Financial Times,* Summers (2007a) advocated the use of intermediaries, as did Stuart Eizenstat and Alan Larson in the *Wall Street Journal* later that year ("The Sovereign Wealth Explosion," November 1, 2007, A19).

are subject to many of the same technical implementation issues as more draconian approaches.

First, it is not at all clear that one can separate the motives of shareholders neatly into the economic and the strategic as suggested by Gilson and Milhaupt (2008). Moreover, large shareholders have many other means of influencing the management of the companies in which they invest aside from voting their shares. It is a foolish management of a corporation that does not at least listen to an important shareholder even if that shareholder holds less than, say, 5 percent of the shares of the corporation.

Second, disenfranchising shareholders is inconsistent with most notions of shareholder democracy and its associated benefits in terms of economic efficiency. Moreover, if a country is going to disenfranchise SWFs as voting shareholders, is it going to treat domestic governmental entities, such as pension SWFs, the same way? Whether it does so or not, the country can expect that other countries almost certainly would retaliate. That retaliation would be against a broader definition of SWFs, including government pension funds. In the US case, state and local government pension funds held more than $400 billion in foreign assets at the end of 2009. Even if retaliation against US SWFs were a politically acceptable cost in the United States, it would be a high price to pay in terms of reduced opportunities for diversification.

Lowery (2008) endorsed a more sensible approach: either an SWF should choose voluntarily not to vote its shares or it should disclose how it votes, as is now done voluntarily by some UK institutional investors and is required by the SEC for US mutual funds.[11] The objective of the SEC rule for mutual funds is to address concerns about conflicts of interest and, as noted earlier, similar concerns arise with respect to SWFs. It is an open question whether SWFs would face a formal SEC compliance requirement in this area. Keller (2009) proposes legislation to impose a compliance procedure that would involve a presidential determination with respect to accepting a process agreed upon by the SEC and the SWF. Formally singling out SWFs by unilaterally imposing such a requirement would likely be perceived as protectionist by their home countries.[12]

As for the required use of intermediaries (Summers 2007a, Keller 2009, Cox 2007a), this would be a difficult requirement to enforce.[13] Moreover,

11. A similar approach was under consideration in the European Union prior to the 2007–09 global financial crisis (Mezzacapo 2009), and the crisis has intensified pressures to move in this direction for hedge funds, private equity firms, and, by extension, SWFs.

12. As discussed in chapter 6, the Santiago Principles call for the SWFs voluntarily to disclose publicly their approach to voting their shares of publicly listed companies.

13. Keller (2009) suggests that in the interests of minimizing costs, the requirement be associated with an ownership threshold, which would add an additional level of complexity and the potential for being viewed as protectionist, in particular if the United States applied the requirement unilaterally.

unless there were complete transparency about the nature of the contractual arrangements, and those contracts ensured arm's-length investment decisions without advance direction or limitations (and vice versa), most of the same concerns about SWF investments would remain. Additional concerns would be created because of the potential use of offshore intermediaries and entities such as hedge funds and private equity funds. Finally, since governments have investment vehicles other than SWFs, ranging from their reserves to their government-owned or -controlled banks and nonfinancial corporations, little would be accomplished by forcing investments into other channels.

A variation on this proposal is one made by Aizenman and Glick (2007) to encourage SWFs to invest in well-diversified index instruments. They note the advantages to the funds of this investment strategy, suggesting that large funds are rarely likely to beat the market as a whole, in particular the global market. On the other hand, there is a large difference between encouragement and a requirement that SWFs invest only in this manner. A requirement would not only be discriminatory to the SWFs, but would increase the probability of regulatory arbitrage, given that some countries already invest a portion of their foreign exchange reserves in equities.

My conclusion is that the approach of establishing limitations on SWFs in their investment activities in order to protect the integrity of markets, or to limit the pursuit of political or economic power objectives, offers limited benefits and would be difficult to apply.

Reciprocal Arrangements

A final possible policy response to SWFs is to insist on reciprocal treatment. A country or group of countries might require countries with SWFs to grant reciprocal treatment to investments from the countries in which the SWF wants to invest, including, but presumably not limited to, investments by SWFs of the host country. In terms of concerns about SWFs, the threat of financial protectionism against SWFs would be turned around to promote protectionism.

The Commission of the European Communities (2008) linked its own openness to foreign investment and the principles of its internal market with respect to SWFs and other foreign investors to its efforts to open third-country markets to EU investors—implicit use of leverage by example. Gerard Lyons (2007) has advocated a more aggressive pursuit of a level playing field with countries whose SWFs, for example, want to invest in Western financial institutions, but he would stop short of erecting barriers to SWF investments if those efforts failed. The commission, no doubt, was responding to sentiments previously expressed by European leaders such as Luxembourg Prime Minister and Euro Group President

Jean-Claude Juncker when he said, "Countries that protect their own markets cannot expect to be allowed to make unimpeded investments in Europe."[14] Jeffrey Garten argued that reciprocity should be required for all countries with SWFs that want to invest in the United States or Europe.[15] If the funding of the SWF involved monopolistic pricing practices—such as petroleum or other policy distortions such as exchange rate policy—Garten would use approval of SWF investments as leverage over those policies. Garten's argument illustrates the fact that the nature of any formal reciprocity requirement would have to be specified. Would the reciprocal treatment be for the SWFs of the countries receiving SWF investments from other countries, or would it involve a broader reciprocity for all investments from the open host country into another country whose SWF was investing in the country in question? The former would be consistent with normal reciprocity agreements, but that does not seem to be the motivation of most advocates. They want the home country to be open to investment from the host country whether by a government-owned or -controlled entity such as an SWF or by a private investor.

In general, reciprocity should be discouraged as a tool of international financial diplomacy where its use currently is not absent but is less common than in the trade area. International standards should be based on national treatment as much as possible. All potential host countries should welcome foreign investment; in general, inflows of foreign capital provide additional net saving to increase investment, which produces other economic benefits, though not entirely without the potential for subsequent macroeconomic problems and controversies. Given that the forms of investments by SWFs can be many and varied, and given that restrictions on foreign investments in many countries today are many and varied, it would be next to impossible to administer a broad program of country-by-country and category-by-category reciprocity for countries with SWFs.

On the other hand, countries with SWFs can make a strong case for a level playing field on international investment as well as other dimensions of international finance such as governance of the major international economic and financial institutions. For decades, the traditional industrial countries have preached doctrines of open markets and receptivity to capital flows, particularly in the form of foreign direct investment. Given the substantial recent, and likely ongoing, transfer of relative wealth from industrial countries to emerging-market economies, even if this process slows from the pace of 2002–07, the shoe now is on the other foot on openness, with the important qualification that many of the new breed of foreign investors are governments. Hypocrisy in international

14. Reported in *Handelsblatt*, October 19, 2007.

15. Jeffrey Garten, "We Need New Rules for Sovereign Funds," *Financial Times*, August 8, 2007.

finance is no more attractive than in other areas of human and sovereign interaction.

Establishment of a standard of reciprocity as the quid pro quo for SWF investment may be an attractive political response to public opinion. This is the argument made by Demarolle (2008) in the French and European context. He rejects a special regime for SWF investments, but favors a dialogue with countries with SWFs founded on the principle of reciprocity. The dialogue would help open doors to investments by companies in host countries to SWF investments in the home countries of the SWFs, such as China and Russia, and thereby break down what Demarolle sees as an unsatisfactory asymmetry. Demarolle's aim is to make progress. He argues that the principle of reciprocity does not necessarily mean identical treatment.

However, establishment of a reciprocity standard for SWF investment would do little to address the concerns about SWFs summarized in chapter 3. In fact, few of the remedies outlined in this chapter promise much on that score.

To summarize, most of the proposed policies regarding SWFs are intended to deal with the concern in countries receiving SWF investments about the pursuit of political and economic power objectives by the countries with the funds: comprehensive regulation, prohibitions on specific SWF investments, or limitations of various types on the form or conditions of investment. In general, these mechanisms of comprehensive regulation would be costly and ineffective. Some of them could prove to be deleterious to the host country as well as to the global financial system. One exception might be comprehensive approaches that are applied on a national treatment basis, but in those cases issues arise regarding the cost of additional regulation.

It could be argued that some of the proposed limits on SWF investments, such as the size of stakes and voting rights, would limit the potential for market turmoil and uncertainty associated with the activities of SWFs. But that is a stretch. Moreover, by potentially driving the funds into less transparent channels of investment, they also might be counterproductive in terms of this concern. The issue of regulatory arbitrage is common to most approaches to SWF regulation in part because of the difficulty in precisely defining these pools of official capital.

A formal or informal reciprocity requirement on countries with SWFs is difficult to square with any of the concerns SWFs raise. It is better viewed as fanning the flames of financial protectionism. If the result were tit-for-tat escalation, the consequences for financial markets and their turbulence would be magnified beyond the mere denial of a few billion dollars of capital inflows.

Along the same lines, unless carefully negotiated and established in a multinational context, including a number of countries that are both home and host to SWFs, the approaches summarized in this chapter would tend to increase conflicts of interest rather than reduce them, with the possible technical exception of an outright prohibition.

Finally, none of the approaches discussed in this chapter bear directly on the issue of mismanagement of investments by the home country. Where they are at all relevant, such as regarding limitations on such investments, one could argue that they tend to exacerbate the underlying issues by discouraging the home country from investing using normal commercial structures.

Nevertheless, SWFs are here to stay, and they raise a wide variety of concerns. Public policy has an obligation to try to address these concerns. Starting in 2007, I argued that the best combined approach to SWFs was via the establishment of an international standard or set of best practices to promote SWF accountability and transparency. The next chapter outlines my preferred approach.