

**SOVEREIGN WEALTH
FUNDS:
THE EVOLVING LEGAL
AND REGULATORY LANDSCAPE**

By

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INTRODUCTION

Few issues this year have captivated the attention of Wall Street and drawn the suspicion of Washington as have sovereign wealth funds.¹ Numbers provide an initial explanation. In 2007, sovereign wealth funds injected over \$25 billion into capital-starved American financial institutions. With an estimated \$2 to \$3 trillion in assets, sovereign wealth funds already have more assets under management than every hedge fund combined. One widely cited study projects that they will have as much as \$12 trillion by 2015.²

Sheer size, however, does not offer enough insight into why, from Congressional hearings to cocktail parties, sovereign wealth funds have only recently become the focus of such intense scrutiny and debate. The source and subject of these immense investments have triggered an enormous yearning by

¹ A sovereign wealth fund is generally understood to be an investment vehicle established and controlled by a government entity with funds separate from official reserves. *See, e.g.,* DEP'T OF THE TREASURY REPORT TO CONGRESS ON INTERNATIONAL ECONOMIC AND EXCHANGE RATE POLICIES (2007), *available at* http://www.treas.gov/offices/international-affairs/economic-exchange-rates/pdf/2007_FXReport.pdf.

² Stephen Jen, *Currencies: How Big Could Sovereign Wealth Funds Be by 2015?*, MORGAN STANLEY RES., May 3, 2007, http://www.morganstanley.com/views/perspectives/files/sovereign_2.pdf.

policymakers, regulators, investors, and citizens to know more. Countries from Canada and Norway to Australia and New Zealand have sovereign wealth funds. Even Iceland is exploring establishing one of its own. The primary players, however, are funds from oil-rich countries in the Middle East and Asian countries experiencing growing surplus reserves. Their investments have been in everything from real estate to natural resources. If there is one area, though, where sovereign wealth funds have become particularly prominent and controversial it is in U.S. banking and financial institutions.

Of all the questions raised by sovereign wealth funds, the leading one is whether there are sinister motives lurking behind their investments. The fear is that these funds could be modern-day Trojan horses, with political, not economic or commercial, considerations being the basis for investment decisions and, in turn, jeopardizing national security.

For now, efforts to understand and influence the behavior of sovereign wealth funds have centered chiefly on multilateral initiatives of a purely voluntary nature — codes of conduct, best practices, principles of understanding, and the like. Such initiatives are an important step in learning more about sovereign wealth funds and in assessing how they should be appropriately examined, but there have also been important legal and regulatory developments that suggest our understanding of how the activities of these funds will be treated is still evolving.

This WORKING PAPER provides a brief overview of the economic and social history of these funds; reviews some of the multilateral efforts that are being taken to make their operations more transparent; explores the principal legal and regulatory structures in which their investments in U.S. banking and financial institutions can be scrutinized; and highlights some preliminary

questions that may be raised as two regulatory bodies in the United States grapple with how to review sovereign wealth fund investments.

I. THE EVOLUTION OF SOVEREIGN WEALTH FUNDS

To understand the genesis of sovereign wealth funds, one must begin by looking at the underlying economic conditions of their sovereign benefactors.

Sovereign wealth funds can be traced back as early as 1953 when the State of Kuwait established what was then called the Kuwait Investment Board.³ In the early 1950s, Kuwait experienced a surge in oil revenues and sought to plan for the day when its oil wells would run dry. Put simply, the idea was that proceeds in excess of what was needed for its government to function could be transferred into a separate “fund for the future” for investment in areas that were less volatile.⁴ The Kuwait Investment Board, which was entirely controlled by the Kuwaiti government, would then invest these surpluses accordingly. Although the term was not used until recently,⁵ what Kuwait had essentially done was create a sovereign wealth fund.

Kuwait’s efforts were soon followed by other nation states establishing funds of their own. Today, there are approximately 40 sovereign wealth funds, with nearly half of them having been formed since 2000. Generally, the

³ See Kuwait Investment Authority: Official Website, <http://www.kia.gov.kw/NR/exeres/73CF85E2-0C5A-4060-B94B-54E2D9EDA231.htm> (last visited Aug. 13, 2008).

⁴ *Id.*

⁵ MARTIN A. WEISS, CONG. RESEARCH SERV., SOVEREIGN WEALTH FUNDS: BACKGROUND AND POLICY ISSUES FOR CONGRESS 5 n.18 (2008) (noting that the first use of the term was in 2005).

development of these funds has followed two tracks: funds based on surpluses from commodity exports and funds based on current account surpluses.

The first track has been referred to as “commodity-based” funds because they are funded by gains in state-owned commodities, most notably oil, or taxes on private activities in commodity exports.⁶ Based on holdings, the vast majority of assets held under management by sovereign wealth funds fall along this track, with the Persian Gulf-based funds being some of the more prominent examples.⁷ As with Kuwait, the operative purpose of these funds is two-fold: stabilization and savings. For example, in terms of stabilization, the Persian Gulf funds are designed to stabilize government spending should the price of oil, and corresponding tax revenues, plummet, as was the case in the early and mid-1980s.⁸ In terms of savings, a good example is Norway’s “government pension” fund, which has aimed to distribute the country’s oil gains across generations and ensure the sustainability of certain social welfare expenditures.

The second track of sovereign wealth funds, or “non-commodity” funds, are based on current account surpluses, typically from excess foreign exchange

⁶ Robert M. Kimmitt, *Public Footprints in Private Markets*, FOREIGN AFF., Jan.-Feb. 2008, at 120.

⁷ See Jen, *supra* note 2.

⁸ See, e.g., JOSHUA AIZENMAN & REUVEN GLICK, SOVEREIGN WEALTH FUNDS: STUMBLING BLOCKS OR STEPPING STONES TO FINANCIAL GLOBALIZATION?, FRBSF ECON. LETTER (FED. RES. BANK OF SAN FRANCISCO), Dec. 14, 2007, available at <http://www.frbsf.org/publications/economics/letter/2007/el2007-38.pdf>; see also Kimmitt, *supra* note 6. An example outside the oil context would be Chile’s main sovereign wealth fund, the Copper Stabilization Fund, which was founded in 1985 and later replaced in 2006 by the Economic and Social Stabilization Fund. See Chloe Hayward, *Sovereign Wealth Funds: Copper Lifts Chile’s Reserves*, EUROMONEY, Apr. 2008.

assets, with sovereign wealth funds being a “by-product” of such surpluses.⁹ The most active sovereign wealth funds along this second track have hailed from China — the China Investment Corporation (“CIC”) — and Singapore — the Government of Singapore Investment Corporation (“GIC”).

Regardless of which “track” a sovereign wealth fund is on, and the reality is that there is often a “mixture of motivations” at play,¹⁰ a common theme within the literature is that sovereign wealth funds have been rather predictable investors. That is, until recently. Their long-standing appetite for conservative U.S. Treasury securities has waned as the U.S. dollar’s value has declined relative to competitor currencies. The result has been a shift — in both interest and activity — to more aggressive, long-term investments across a wider range of asset classes, such as real estate and investments with, and in, private equity firms.¹¹ Not surprisingly, as a credit crunch has gripped the American economy and threatened the stability of many U.S. banking and financial institutions hit hard by the subprime mortgage crisis, sovereign wealth funds have found themselves in a new chapter of what had previously been a rather quiet history.

II. VERY SIZABLE INVESTMENTS IN FINANCIAL INSTITUTIONS

In the latter half of 2007, investments by sovereign wealth funds in some of the nation’s most preeminent banking institutions could not have gone

⁹ AIZENMAN & GLICK, *supra* note 8, at 1; *see also* Kimmitt, *supra* note 6, at 121.

¹⁰ EDWIN M. TRUMAN, PETERSON INST. FOR INT’L ECON., SOVEREIGN WEALTH FUNDS: THE NEED FOR GREATER TRANSPARENCY AND ACCOUNTABILITY 4 (2007).

¹¹ *See, e.g.*, Laura Badian & Gregory Harrington, *The Politics of Sovereign Wealth*, THE INT’L ECON., Winter 2008, at 52; Patrick Jenkins, *Moscow to Shift Wealth Fund’s Investment Focus*, FIN. TIMES, Apr. 28, 2008, at 3.

unnoticed: the Abu Dhabi Investment Authority's ("ADIA") 4.9% stake in Citigroup for \$7.5 billion, the CIC's 9.9% stake in Morgan Stanley for \$5 billion, and Singapore's 9.46% stake in Merrill Lynch through its investment arm, Temasek Holdings, for \$4.4 billion.¹² Outside of traditional financial institutions, the influence of sovereign wealth funds has also extended to the realm of private equity, with notable investments being CIC's 9.3% stake in The Blackstone Group L.P. for \$3 billion and the Abu Dhabi-based Mubadala Development Company's 7.5% stake in The Carlyle Group for \$1.35 billion. These investments represented a marked departure from sovereign wealth funds' traditional focus. As a result, they are experiencing newfound scrutiny and, fairly or not, being characterized by many as either the saviors of Wall Street or its invaders.¹³

III. CONTROVERSY AND CRITICISM: SOVEREIGN WEALTH FUNDS GO TO WASHINGTON

Concerns over the nature and extent of certain foreign transactions in the United States are nothing new. One need only look back a few years ago to

¹² Since these investments in Citigroup and Merrill Lynch were announced in 2007, there have been further investments in these entities by sovereign wealth funds. For example, Singapore's Temasek Holdings recently exercised an option it had to purchase an additional \$600 million in common shares of Merrill Lynch. *See Temasek Buys More of Merrill Lynch*, WALL ST. J., Apr. 16, 2008, at C2.

In the interest of precision, Singapore's Temasek Holdings is, unlike the Government of Singapore Investment Corporation, not the product of excess foreign exchange assets and, despite its activities often being treated within the context of sovereign wealth funds, Temasek Holdings declared earlier this year that it is not a sovereign wealth fund because it must continuously sell assets to raise capital for new investments and does not require government approvals for investment decisions. This self-classification, however, is subject to some debate.

¹³ *See, e.g., CBS News: China's Sovereign Wealth Fund Causing Concern in US* (CBS television broadcast Apr. 6, 2008) (transcript on file with authors); *The Invasion of the Sovereign-Wealth Funds*, ECONOMIST, Jan. 19, 2008, at 11.

the political backlash that resulted from Dubai Ports World's attempt to takeover several major U.S. port leases in 2006 and, a year earlier, China National Offshore Oil Corporation's ("CNOOC") efforts to acquire Unocal, one of the largest oil and natural gas production companies in the United States.¹⁴ Nearly two decades earlier, the outcry was over prestige buys by the Japanese, notably "trophy" assets like Rockefeller Center and Columbia Pictures.

Today, sovereign wealth funds' prominence comes at a time when the United States is experiencing its latest cyclical unease with foreign investment. Of course, given that such investments are made by entities formed and controlled entirely by sovereign governments, their investments — and, correspondingly, the concerns they raise — are qualitatively different from investments that had caused alarm in the past. Anxiety over sovereign wealth funds generally centers on the investment "personality" of a fund and its managers, with the specific fear that politics, not profit, may drive certain investments. More specifically, concerns include sovereign wealth funds eventually becoming active on corporate boards to support certain management or corporate decisions deemed favorable for the sovereign's "national champion" industries or businesses,¹⁵ or whether they may have informational advantages over other market participants.¹⁶

¹⁴ See generally JAMES KYNGE, CHINA SHAKES THE WORLD: A TITAN'S RISE AND TROUBLED FUTURE, AND THE CHALLENGE FOR AMERICA 140–44 (2006). Dubai Ports World and CNOOC are not sovereign wealth funds, but it is notable that sovereign wealth funds were never meaningfully discussed during the public controversy surrounding the national security implications of these two potential transactions.

¹⁵ A cogent illustration was offered by former Treasury Secretary Lawrence H. Summers at the World Economic Forum's annual meeting in Davos earlier this year. Mr. Summers noted that sovereign wealth funds could play an influential role merely by being long-term, non-voting shareholders intent on keeping poor management firmly in place, or as Mr. Summers put it, they would be the equivalent of "1-800-ENTRENCH." Mr. Summers summarized what could be the logic of some sovereign wealth funds: "Perhaps we want

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At least for now, there has been a paucity of evidence to substantiate claims that ulterior political motives are behind their activities.¹⁷ Still,

the airline to fly to our country, perhaps we want the bank to do extensive business, suppose we want suppliers in our country to be sourced, perhaps we want some disablement of a competitor for our country's national champion?" See Daniel Gross, *SWF Seeks Loving American Man*, SLATE, Jan. 24, 2008, <http://www.slate.com/id/2182746/index.html>; see also *Pentagon Surveying Use of Foreign Sovereign Wealth, Private Equity Funds*, INSIDE THE PENTAGON, Jan. 12, 2008 (referencing several Pentagon-sponsored studies currently examining foreign investment activity in the U.S. defense sector and researching if certain investments were made to further national interests).

¹⁶ This concern was most recently expressed by Ethiopis Tafara, director of the U.S. Securities and Exchange Commission's ("SEC") Office of International Affairs, during testimony before a subcommittee of the U.S. House Committee on Financial Services on March 5, 2008. *Foreign Government Investment in the U.S. Economy and Financial Sector: Hearing Before the Subcomm. on Domestic and Int'l Monetary Pol'y, Trade and Tech. and the Subcomm. on Capital Markets, Insurance, and Gov't Sponsored Enterprises of the H. Fin. Servs. Comm.*, 110th Cong. (2008) [hereinafter *Foreign Government Investment Hearing*] (statement of Ethiopis Tafara, Director, Office of International Affairs, Securities and Exchange Commission). The SEC's chairman, Christopher Cox, has also noted the potential for conflicts of interest arising from the inherent tension within sovereign wealth funds — with the sponsoring government acting as both the regulator and the regulated — and how these concerns could materialize in the context of certain material information a sovereign wealth fund obtained from its government's own national security and intelligence services. See Christopher Cox, Chairman, Sec. and Exch. Comm'n, Keynote Address at the John F. Kennedy School of Government and Robert R. Glauber Lecture: The Role of Government in Markets (Oct. 24, 2007) (transcript on file with authors); see also *SEC International Affairs Staffer Says Even With Rules, SWF Conflicts a Concern*, 40 SEC. REG. & LAW REP. 791 (May 19, 2008).

¹⁷ See, e.g., Interview by Gideon Rose, Managing Editor, Foreign Affairs, with Robert M. Kimmitt, Deputy Treasury Sec'y, U.S. Dep't of the Treasury (Jan. 28, 2008), available at http://www.cfr.org/publication/15359/sovereign_wealth_funds_and_the_world_economy_rush_transcript_federal_news_service.html (stating that there is no evidence that sovereign wealth funds have invested "for other than commercial purposes"); MONETARY AND CAPITAL MKTS. DEP'T AND POLICY DEV. AND REVIEW DEP'T, INT'L MONETARY FUND, SOVEREIGN WEALTH FUNDS — A WORK AGENDA 10 (2008) ("There is no clear evidence that SWF investments have been motivated by narrow political objectives."); but see *Asset-Backed Insecurity: Sovereign-Wealth Funds*, ECONOMIST, Jan. 19, 2008 (detailing one example of where a Norwegian fund was thought to have acted politically by selling short securities in several Icelandic banks despite an agreement by both countries against financial destabilization).

sovereign wealth funds are increasingly the subject of study by Congress¹⁸ and, interestingly, there are no clear partisan lines on which they are being viewed.¹⁹ Senators Christopher Dodd, chairman of the Senate Banking Committee, and Evan Bayh have expressed frustrations with perceived efforts by sovereign wealth funds to avoid the radar of regulators, as has the Committee's ranking member, Senator Richard Shelby, who, more dramatically, said his fear was that "we're going to be owned — controlled — by sovereign wealth funds."²⁰ Overall, however, the reaction by Congress to the rise of sovereign wealth funds has been relatively measured, at least compared to the political storm surrounding the CNOOC and Dubai Ports World transactions.

¹⁸ Several committees, including the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs (the "Senate Banking Committee") and the Senate Finance Committee, have held hearings or are otherwise actively investigating issues relating to sovereign wealth funds. For example, the bipartisan leadership of the Senate Finance Committee has charged the Joint Committee on Taxation to investigate tax policy and law as applied to sovereign wealth funds and, specifically, to research whether certain passive income by such funds would be exempt from taxation under the Internal Revenue Code. *See Sens. Baucus, Grassley Seek Analysis of U.S. Taxation of Sovereign Wealth Funds*, 11 MERGERS & ACQUISITIONS LAW REP. 198 (Mar. 17, 2008).

¹⁹ *See Ron Orol, Foreign Affairs: Will Security Concerns Stop Sovereign Wealth Funds From Investing in U.S. Financial Institutions?*, THE DEAL, Jan. 28, 2008 (noting that the debate over sovereign wealth funds have made for "strange bedfellows" and discussing how even SEC Chairman Christopher Cox, a Republican and strong proponent of free markets, has voiced concerns over sovereign wealth funds' transparency and their role as "both referee and player" in capital markets).

Legislative interest in the activities of sovereign wealth funds has not been limited to the federal level. Earlier this year, the California State Assembly proposed legislation to restrict the state's top pension funds, California Public Employees' Retirement System and the California State Teachers' Retirement System, from investing in private equity firms that are owned, in whole or in part, by sovereign wealth funds. *See A.B. 1967*, 2008 Assemb., Reg. Sess. (Cal. 2008).

²⁰ *See Bill McConnell, Tighter Scrutiny of Sovereign Stakes*, THE DEAL, Apr. 24, 2008.

Although there are differences of opinion in what to make of sovereign wealth funds, by the time representatives of two sovereign wealth funds appeared before Congress for the first time on March 5, 2008, one theme emerged as a starting point: transparency.

IV. THE MANTRA OF TRANSPARENCY

A coordinated call for greater transparency has been made by several international bodies, including the International Monetary Fund (the “IMF”), the G-8, the World Bank, and the Organisation for Economic Co-operation and Development (the “OECD”). Domestically, the U.S. Treasury Department (the “Treasury Department”) appears to have taken the lead by tapping the IMF with the responsibility of establishing a set of voluntary guidelines and best practices on fund governance and transparency.²¹ To that end, in early May 2008, the IMF established the International Working Group of Sovereign Wealth Funds (“IWG”), which includes 25 member countries, most of which either have sovereign wealth funds or are recipients of their investments, as well as representatives from the OECD and the European Commission. The IWG is expected to present a draft set of guidelines by October 2008.

One model set of guidelines that the IWG may find instructive is a blueprint by Edwin Truman, a former Treasury Department and Federal

²¹ In March 2008, the Treasury Department was also successful in obtaining an agreement with Singapore (with respect to GIC) and Abu Dhabi (with respect to ADIA), both countries with active sovereign wealth funds. The agreement with the United States, albeit a non-binding one, sets forth a series of policy principles for countries with sovereign wealth funds (*e.g.*, a commitment to commercially-driven investments, enhanced disclosure of investment objectives) and also provides for a set of principles for countries receiving such investments (*e.g.*, a commitment not to discriminate among investors, more clearly articulated foreign investment rules). See Press Release, U.S. Dep’t of the Treasury, Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi (Mar. 20, 2008) (on file with authors).

Reserve Board official, who recommends that several themes be addressed by sovereign wealth funds, including: (i) the structure of a fund (e.g., its objectives, tax treatment, relationship with sovereign sponsor, and separation from the country's international reserves), (ii) its governance (e.g., its management and internal controls), (iii) accountability and transparency (e.g., its holdings, asset composition and rates of returns, strategy and time horizon for investments, and any audit activities and reporting actions), and (iv) investment behavior (e.g., its practice of adjusting its portfolio or consulting with recipient countries on certain investment and currency-related decisions).²² Of all sovereign wealth funds, Norway's pension fund may be the fund that most closely addresses the recommendations of this blueprint.

²² See TRUMAN, *supra* note 10, at 7–8. See also *Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007) (statement of Edwin M. Truman, Senior Fellow, Peterson Institute for International Economics), available at http://banking.senate.gov/public/files/111407_Truman.pdf.

Importantly, Mr. Truman argues that such an approach is meant not only to reduce the “mysteries and misunderstandings” of sovereign wealth funds rampant within recipient countries, like the United States, but also to address concerns voiced by citizen, investor, and regulatory constituencies back home. See *id.*; see also *Foreign Government Investment Hearing*, *supra* note 16 (statement of Martin Skancke, Director General, Asset Management Department, Norwegian Ministry of Finance) (“[T]ransparency provides a disciplinary effect on the fund management”); Heidi Crebo-Rediker & Douglas Rediker, *Watching Sovereign Wealth*, WALL ST. J. EUROPE, Feb. 28, 2008, at 11 (positing that Russia's recent launch of its National Wealth Fund was characterized by more transparency and greater disclosures “in part to insulate fund managers from allegations of theft or other improper conduct should an investment go sour in the future”); *An Embarrassment of Riches: China's Foreign Reserves are Growing at a Staggering Rate*, ECONOMIST, June 10, 2008, http://www.economist.com/agenda/displaystory.cfm?story_id=11526752 (last visited Aug. 13, 2008) (noting that the “CIC's head-line grabbing but so far loss-making investments in [Blackstone and Morgan Stanley] have drawn a flood of criticism in China” and that “[i]t has not escaped people's notice that most key positions at the CIC are filled by political appointees, not investment professionals”).

Norway has been widely cited as a model of transparency because it files financial reports every quarter, publishes information on its corporate governance structure, provides disclosure of every asset held by the fund in a given year, and assists the Norwegian Ministry of Finance in publishing an annual report to the Norwegian Parliament detailing, among other things, investment strategy and information on investment returns.²³ Even Norway, arguably the “golden child” of transparency, recognizes, however, that transparency is a vague concept and that granularity is needed to make the dialogue not only a meaningful one but one that will provide greater certainty to sovereign wealth funds that they will not be placed at a competitive disadvantage relative to domestic investors.²⁴ In other words, the transparency dialogue runs both ways: it is about exacting disclosures from funds as well as providing funds with specific guidance and definitional clarity as to how their activities would be reviewed under a recipient country’s jurisdiction.²⁵

It is not surprising, then, that the call for greater transparency, although an important one, is likely just the beginning of a larger, more complicated

²³ See Norges Bank Investment Management, Government Pension Fund Framework, http://www.norges-bank.no/Pages/Article_41394.aspx (last visited Aug. 13, 2008); see also *Foreign Government Investment Hearing*, *supra* note 16 (statement of Martin Skancke, Director General, Asset Management Department, Norwegian Ministry of Finance).

²⁴ See *Foreign Government Investment Hearing*, *supra* note 16 (statement of Martin Skancke, Director General, Asset Management Department, Norwegian Ministry of Finance) (“Claims for increased transparency have to be balanced against legitimate interests of investors. Whilst the Norwegian Fund is characterized by a high degree of transparency, there are certain aspects in the management of the Fund that, based on pure business considerations, are not made public.”).

²⁵ *Id.*; see also *Kimmitt Warns Sovereign Wealth Funds to Stay Focused on Making Money Only*, BANKING DAILY (BNA), Mar. 18, 2008 (highlighting the view of one Persian Gulf sovereign wealth fund that demands for greater transparency are a “two-way street” and that it is “equally important that countries receiving SWF investments define terms such as strategic interest, strategic sectors and national security interests”).

dialogue on how investments by sovereign wealth funds will be reviewed by recipient countries. The delicate dance between wanting greater assurance that their activities are limited to commercial purposes and “doing no harm” to discourage them from providing critical liquidity is likely to continue. At best, it will help set the tone from which American policymakers will proceed in reviewing existing regulatory frameworks to monitor, review, and assess investments by sovereign wealth funds. At worst, an unsuccessful effort to thoughtfully flesh out and add depth to a basic understanding among sovereign wealth funds to limit their investments to commercial aims could intensify suspicion and lead to disproportionate responses from Washington.

V. SCRUTINIZING INVESTMENTS IN U.S. BANKING AND FINANCIAL INSTITUTIONS: TWO FRONTS EXAMINED

Transparency is only one side of the ongoing debate. The other side is whether there are adequate legal and regulatory structures in place to monitor and scrutinize certain investments by sovereign wealth funds.

It is axiomatic that every transaction, and any related evaluation, is fact-specific. In this vein, investments by sovereign wealth funds are no different. Depending on the nature of the investment, a range of legal and regulatory powers may be implicated in at least two broad respects: (i) *notification or reporting requirements* for contemplated or completed transactions involving foreign investors and (ii) *specific restrictions*, many of which are sector-based, that limit a foreign investor’s ownership or control of certain assets (or impose remedial measures for certain completed transactions).

An investment by a sovereign wealth fund may already trigger certain notice requirements. For example, if such a fund were to acquire more than 5%

of a publicly-held company's common stock, disclosures would have to be made on Form 13D, although lighter disclosures would be required in a Form 13G filing if a fund, acting more passively, acquired between 5% and 20% of non-voting securities.²⁶ Similarly, certain acquisitions in privately-held companies, which of course are not swept up by SEC disclosure, would fall under the radar of the U.S. Commerce Department's Bureau of Economic Analysis ("BEA"). A sovereign wealth fund would have to file Form BE-13 with the BEA if it acquired a 10% or greater voting interest in a U.S. company, even if the fund were to indirectly acquire the company by acquiring its foreign parent.²⁷ Lastly, no merger or acquisition transaction by a sovereign wealth fund could close without appropriate notification to the Federal Trade Commission under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 if the size of the deal or the size of the parties involved exceeded certain dollar thresholds.²⁸

Investments by sovereign wealth funds, however, are subject to more than reporting requirements. The vast American investment terrain has an array of sector-specific restrictions and regulations that apply to sovereign wealth funds. In the communications sector, for example, a sovereign wealth fund, as a government-controlled entity, could not acquire any broadcast or common carrier license as a matter of law.²⁹ Moreover, it could not directly acquire more than 20% of a U.S. company holding such licenses and, if acquiring more than 25% of such a company through indirect means, then the fund would still have to obtain approval from the Federal Communications

²⁶ See 17 C.F.R. § 240.13d-1 (2008).

²⁷ See 15 C.F.R. § 806.15(j)(3) (2008).

²⁸ See 15 U.S.C. § 18a (2006).

²⁹ 47 U.S.C. § 310(b) (2006).

Commission.³⁰ Likewise, a sovereign wealth fund could not quietly escape the eye of the U.S. Department of Defense if it were to invest in any U.S. company, such as a consulting firm with sensitive government contracts, holding certain kinds of security clearances.

As with other sectors, investments by sovereign wealth funds in U.S. banking and financial institutions face extensive regulatory review. Two regulatory fronts — the Board of Governors of the Federal Reserve System (the “Federal Reserve”) and the Committee on Foreign Investment in the United States (“CFIUS”) — are of particular importance.

A. Formal Review Under U.S. Banking Laws

A distinguishing feature of the high profile investments by sovereign wealth funds over the past year is that their stakes in U.S. financial institutions have all been under 10% of voting equity, or in the case of Citigroup, ADIA’s investment came in at 4.9%. Such investment levels have less to do with coincidence and more to do with design.

U.S. banking laws provide the Federal Reserve with authority to review and approve certain investments in banks and bank holding companies. Principally, two laws establish statutory thresholds that trigger the Federal Reserve’s powers: the Bank Holding Company Act of 1956 (the “BHC Act”)³¹ and the Change in Bank Control Act of 1978 (the “CBCA”).³²

³⁰ *Id.* § 310(b)(3)-(4).

³¹ Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (1956) (codified as amended at 12 U.S.C. §§ 1841-1844, 1846-1849).

³² 12 U.S.C. § 1817(j) (2006).

Under the BHC Act, a company's contemplated investment in a U.S. bank would trigger Federal Reserve review if it were determined that the company has the ability to effect control over the bank, with control being found in three circumstances: (i) direct or indirect ownership or control of 25% or more of any class of voting securities; (ii) the ability to elect a majority of the company's directors; or (iii) if the Federal Reserve determines that the investor-company nonetheless has a "controlling influence" over a bank's management or policies.³³

For investments falling under the control trigger of 25%, as most do, the operative inquiry typically turns on whether there is "controlling influence." There is a statutory presumption that no controlling influence exists if a company owns or controls less than 5% of voting securities of a given bank or bank holding company.³⁴ For stakes between 5% and 25%, the Federal Reserve has considerable latitude to examine "all the circumstances" of a particular transaction, including the investor's relationships with and intent to influence management, the total equity investment, certain business relationships and interlocks, and the ability to elect directors. As a matter of practice, the Federal Reserve does not generally find a controlling influence where an investor holds less than 10% of an institution's voting shares. Most acquisitions in the range of 10% and 25% of an institution's voting shares, however, are subject to the rebuttable presumption that the investor has a controlling influence over the institution.³⁵

³³ See *id.* § 1841(a)(2); 12 C.F.R. § 225.2(e).

³⁴ See 12 U.S.C. § 1841(a)(3).

³⁵ Such a presumption can be overcome through execution of "passivity commitments" in which an investor demonstrates its intent to be only a passive investor.

A chief reason for structuring transactions to fall outside the BHC Act's thresholds is not simply to steer clear of the Federal Reserve's orbit of review but to avoid the exacting supervision and regulatory requirements designed to protect the "safety and soundness" of the institution. Even if, however, a transaction was structured in such a way as to avoid the investor being deemed to have control over a particular institution, another statute might still provide banking regulators with a means of review.

The CBCA is related to the BHC Act in the sense that it was enacted to respond to investments by individuals not implicated by the "company" definition of the BHC Act and its related threshold requirements. The practical significance, however, is that the CBCA may effectively sweep up transactions by companies not triggering review under the BHC Act. Under the CBCA, notice is required if a person, as defined broadly by the statute, seeks to acquire control of any insured depository institution.

Although the CBCA defines control as an investor's power to direct an institution's management or policies or to vote 25% or more of any class of voting securities,³⁶ in practice similar to the BHC Act, persons (including companies) seeking to acquire the power to vote 10% or more of voting stock have been presumed to have acquired control. This presumption includes those factual scenarios where several investors acquiring small stakes are acting in concert to obtain control of an institution, with the effect being that these small, individual stakes are aggregated for the purpose of determining whether the CBCA's notification requirement has been triggered.³⁷

³⁶ See 12 U.S.C. § 1817(j)(8)(B) (2006).

³⁷ Recently, during a hearing on sovereign wealth funds before the Senate Banking Committee on April 24, 2008, Senator Dodd expressed frustration that regulators were

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B. Inter-Agency Review Under CFIUS

Central to any discussion of whether there are adequate regulatory means of scrutinizing the investments of sovereign wealth funds is the CFIUS process. CFIUS is an inter-agency panel chaired by the Secretary of the Treasury and comprising about a dozen representatives from the Departments of State, Defense, Homeland Security, Energy, as well as other bodies, such as the Council of Economic Advisors and the National Security Council. Its powers are formidable. It can review a wide array of transactions that would result in foreign “control” of a U.S. company and, based on national security grounds, recommend that the President suspend or prohibit a transaction, or even require divestiture if already completed.³⁸ Although not an example of a sovereign wealth fund investment, the recent implosion of the \$2.2 billion buyout of 3Com Corp. by Bain Capital LLC and Huawei Technologies Co. Ltd., a minority partner in the buyout group with close business ties to Chinese military and intelligence agencies, is but one example of how CFIUS-related concerns can complicate, and even kill, a transaction.³⁹

being “gamed” when funds kept their investments right under certain numeric thresholds. He questioned the ability of regulators to capture the intent of several sovereign wealth funds investing, for example, in Citigroup if, individually, each held less than 5% but, collectively, they owned more than 10% of the banking behemoth. The CBCA’s “aggregation” principle would address this if a determination could be made that the funds in Senator Dodd’s scenario were acting together to effectuate control.

³⁸ Although there is no “statute of limitations” on reviews by CFIUS, post-hoc review of a transaction is generally only permitted where a party submitted false or misleading information, or omitted material information, in the review process or intentionally and materially breached a mitigation agreement. This so-called “evergreen” provision of CFIUS has removed the “safe harbor” from post-transaction unwinding or divestiture that successful foreign acquirers who made voluntary filings for CFIUS review enjoyed prior to the enactment of the Foreign Investment and National Security Act of 2007.

³⁹ Given the perceived relationship between Huawei Technologies and Chinese military officials, the specific fear was that certain sensitive encryption technologies of one of

The historical roots of CFIUS extend to an executive order of the President in 1975, which established the CFIUS body to monitor foreign investments and assist the Executive Branch in assessing significant developments in foreign investments.⁴⁰ CFIUS is largely viewed, though, as an outgrowth of the Exxon-Florio amendment (“Exxon-Florio”) to the Defense Production Act of 1950,⁴¹ which gives the President sole authority to decide, based on credible evidence, whether a transaction resulting in foreign control of a U.S. company would threaten national security in such a manner that is not adequately addressed by other federal laws. In 1988, shortly after passage of Exxon-Florio, and pursuant to Executive Order 12,661, the President delegated to CFIUS his investigative authority.⁴²

Today’s incarnation of CFIUS, however, comes from the Foreign Investment and National Security Act of 2007 (“FINSAs”), which formally codified existing regulatory practices under Exxon-Florio and gave CFIUS a basis in statute.⁴³ A legislative product of the outcry over the Dubai Ports

3Com’s business units, TippingPoint Technologies Inc., would eventually come into the hands of the Chinese government. See Bill McConnell, *Bain Ends 3Com Deal*, THE DEAL, Mar. 20, 2008.

⁴⁰ See Exec. Order No. 11,858, 40 Fed. Reg. 20,263 (May 7, 1975). Executive Order 11,858 has been subsequently amended, most recently by Executive Order 13,456 on January 23, 2008, to implement certain provisions of the Foreign Investment and National Security Act of 2007.

⁴¹ Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 5021, 102 Stat. 1425 (codified as amended at 50 U.S.C. app. §§ 2158-2170 (2006)) (amending Defense Production Act of 1950 § 721, 50 U.S.C. app. §§ 2158-2160). The Exxon-Florio provision is found at Section 721 of the Defense Production Act of 1950, as amended. Reviews under CFIUS are sometimes referred to as “Section 721 reviews.”

⁴² See Exec. Order No. 12,661, 54 Fed. Reg. 779 (Dec. 27, 1988).

⁴³ Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (effective Oct. 24, 2007).

World and CNOOC transactions, FINSA reflects the heightened scrutiny to which foreign investments are now subject.

In brief, FINSA sets forth an initial 30-day review process, commenced at the election of the parties to the transaction or any member agency of CFIUS. The purpose of this “review” is to evaluate whether a transaction that results in foreign control also involves a threat to “national security.” An additional 45-day “investigation” would be presumptively required where: (i) the initial review concluded that a transaction could threaten the nation’s security; (ii) the transaction would result in a foreign government (or an entity controlled by or acting on behalf of a foreign government) taking control of a U.S. business; or (iii) the transaction would result in the change in control of “critical infrastructure” to a foreign person. A factual predicate for any review or investigation, however, is that the transaction result in foreign control.⁴⁴ Generally, passive foreign investments falling below a 10% stake have not been transactions covered by CFIUS.⁴⁵

The very sizable investments by sovereign wealth funds in U.S. financial and banking institutions of late have brought renewed attention to the CFIUS process. Critics and skeptics of sovereign wealth funds have questioned whether the CFIUS process has practical application to sovereign wealth funds, a question fueled undoubtedly from the perception of funds “gaming” the

⁴⁴ The concept of control is intertwined with the “jurisdiction” of CFIUS. Any CFIUS review or investigation is predicated on the subject transaction resulting in a change to foreign control. This emphasis reflects a Congressional intent to limit the resources and attention of the Executive Branch to those transactions posing the greatest threat to national security, as well as to “do no harm” to the attractiveness of the United States to foreign investment.

⁴⁵ While the *sine qua non* of non-control under FINSA is an investment being below 10%, as explained below, the mere fact that a foreign stake falls under 10% does not result in “immunity” from CFIUS.

system by structuring their investments below 10%.⁴⁶ On the other hand, many sovereign wealth funds have expressed frustration with the murky definitional contours of terms like “national security” and “critical infrastructure” and have argued that clarity and coherency are needed for greater predictability and less politicization in the CFIUS process.

For sovereign wealth funds, a robust debate centers on whether their minority stakes in Wall Street firms represent controlling interests and also if U.S. banking and financial institutions qualify as “critical infrastructure” of the United States for purposes of national security reviews and investigations under CFIUS. There are no easy answers, and both FINSA and proposed regulations issued in late April 2008 by the Treasury Department illustrate that the understanding of how investments by these controversial vehicles are to be appropriately scrutinized is an evolving one.⁴⁷ Three themes are of particular note.

First, the proposed regulations under FINSA provide a much-needed step toward clarity on the threshold concept of control. They address forthrightly the false perception that a safe harbor exists for any investments falling under 10% of voting equity and reinforce the importance of looking to more qualitative, “functional” aspects of control to determine whether an investment is solely passive. Under the proposed regulations, control is about the power “to determine, direct, or decide important matters” affecting a U.S.

⁴⁶ See generally *supra* note 37 and accompanying text.

⁴⁷ The proposed regulations would amend the Treasury Department’s existing Exxon-Florio regulations at 31 C.F.R. Part 800. A public comment period on the proposed regulations ended in early June 2008, with final regulations expected to be promulgated later this year.

business,⁴⁸ either affirmatively (*e.g.*, causing approval of major decisions, appointing directors, setting policy and budgets) or negatively (*e.g.*, vetoing or stalling major decisions, blocking directors). Thus, even if a foreign acquisition is for a relatively small equity stake, say 8% or 9%, a transaction can still merit CFIUS review in certain circumstances. Where, however, the foreign acquirer has 10% or less of voting equity *and* holds its interest “solely for the purpose of investment,” the transaction is not of the type covered by CFIUS.⁴⁹ The significance for sovereign wealth funds is that their growing political salience has likely pushed the Treasury Department to make even clearer that CFIUS looks “beyond the numbers” and that investments need to be carefully structured to avoid a threshold finding that they are for anything other than a good return.

Second, FINSA clarified that CFIUS’s emphasis on national security includes threats to “critical infrastructure,” defined as “systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security.”⁵⁰ The frustration for sovereign wealth funds is the relative lack of guidance as to what this means. For example, in the context of financial institutions, the question is whether investments in banks and other financial institutions present the same risks as those investments in areas that more easily evoke images of “infrastructure,” such as nuclear power, electricity, port

⁴⁸ Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 31 C.F.R. § 800.204 (2008).

⁴⁹ As the proposed regulations set forth, a foreign investment or acquisition that is made “solely for the purpose of investment” is one where the foreign person does not manifest the intent to exercise control and does not take actions that are inconsistent with passive ownership in general. *See id.* § 800.223.

⁵⁰ *See supra* note 43, Pub. L. No. 110-49, 121 Stat. 247.

operations, or water filtration plants. More than mere definitional curiosity is at stake; under FINSA, certain transactions that result in foreign control of any critical infrastructure are presumed to require a 45-day investigation, a presumption which, among other things, places foreign acquirers and sovereign wealth funds at a disadvantage relative to domestic bidders. The Treasury Department's proposed regulations offer no material alteration or elaboration to the current definition, possibly suggesting that regulatory flexibility in this area, at least for now, is the favored course.

Finally, FINSA creates a presumption of a 45-day investigation where a covered transaction would result in a change in control to a foreign government or to an entity controlled or acting on behalf of one. Because sovereign wealth funds, by definition, are controlled by foreign governments, additional scrutiny of acquisitions involving controlling stakes should be expected. Even if the likes of Citigroup or Merrill Lynch are not considered "critical infrastructure," it is likely that controlling investments by sovereign wealth funds in such banking and financial institutions would still be subject to a mandatory 45-day national security investigation. That is, unless the federal banking laws "trump" FINSA, a subject that is addressed below.

Overall, FINSA and the proposed regulations of the Treasury Department may very well prove to be a positive development for sovereign wealth funds in the long term. As explained, CFIUS has the capacity to subject their investments to substantial scrutiny. A better understanding of CFIUS's reach will hopefully allay the outsized fears that have been raised following some of the more high profile stakes announced in late 2007 and earlier this year.

VI. INTERPLAY BETWEEN THE FEDERAL RESERVE AND CFIUS: COOPERATION OR COLLISION

Behind much of the commentary and Congressional testimony to date are signs of potential tension between the Federal Reserve and CFIUS in the review of banking-related investments made by sovereign wealth funds. At least three issues arise that, until now, have been largely unexplored.

A. Sovereign Wealth Funds as “Companies”

An initial question is whether a sovereign wealth fund can be considered a “company” under the BHC Act, thereby triggering the jurisdiction of the Federal Reserve in addition to any review by CFIUS.

This precise question was addressed earlier this year in testimony by Scott G. Alvarez, the Federal Reserve’s General Counsel, before subcommittees of the House Committee on Financial Services. In the context of whether existing banking laws and regulations would capture a controlling stake in a U.S. bank or bank holding company by a sovereign wealth fund, the Federal Reserve highlighted what it viewed as a critical distinction between controlling investments made *by* sovereign governments and those made by corporate entities *controlled by* sovereign governments. Mr. Alvarez made plain that a sovereign wealth fund taking a controlling stake in an American bank or bank holding company would indeed be considered a “company” under the BHC Act and, therefore, subject to Federal Reserve review and approval. Conversely, if a foreign government acquired a controlling stake directly, then it would not be considered a company under the BHC Act.⁵¹

⁵¹ See *Foreign Government Investment Hearing*, *supra* note 16 (statement of Scott G. Alvarez, General Counsel, Board of Governors of the Federal Reserve System); see also *Mille Lacs Bancorp., Inc.*, 82 Fed. Res. Bull. 336, 337 n.8 (Apr. 1996) (stating that “foreign
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As the basis for this “long-standing interpretation,” Mr. Alvarez pointed to a 1988 determination by the Federal Reserve involving the Banca Commerciale Italiana (“BCI”), an Italian bank seeking to acquire a controlling interest in the Irving Bank Corporation (“Irving Bank”), a U.S. bank. BCI was controlled by an agency of the Italian government, the Istituto per la Ricostruzione Industriale (“IRI”), and the Federal Reserve determined that IRI was a bank holding company under the BHC Act and, therefore, subject to the regulatory reach of the Federal Reserve. The significance of the BCI decision extended beyond the fact that it frustrated, and ultimately proved fatal to, BCI’s acquisition of Irving Bank. The decision was in direct contrast to a 1982 decision of the Federal Reserve to approve BCI’s acquisition of the Long Island Trust Company without requiring IRI to submit a formal application under the BHC Act.⁵² Six years later, the Federal Reserve found that because IRI was structured as a corporate vehicle, it could not benefit from the exemption afforded to foreign governments.⁵³

Mr. Alvarez draws on the BCI case to support the view that sovereign wealth funds, as “government-owned corporations,” would indeed be treated as companies under the BHC Act and, therefore, subject to Federal Reserve

governments are not companies for purposes of the BHC Act” and that “if a company or similar organization that was controlled by a Native American tribe owned a U.S. bank, that organization would be, as in the case of a company controlled by a foreign government, a ‘company’ under the BHC Act”); PAULINE B. HELLER & MELANIE L. FEIN, FEDERAL BANK HOLDING COMPANY LAW § 2.03[9], at 2–16 (“Although the BHC Act does not exclude foreign governments from the definition of ‘company,’ the Board has stated that a foreign government or ‘government like institution’ does not fall within the definition.”).

⁵² See Banca Commerciale Italiana, 68 Fed. Res. Bull. 423 (July 1982).

⁵³ See, e.g., Mille Lacs Bancorp., Inc., *supra* note 51; HELLER & FEIN, *supra* note 51.

jurisdiction.⁵⁴ Notwithstanding the fact that the BCI case did not involve a sovereign wealth fund, or that the Federal Reserve has never formally reviewed such a fund, the practical effect of this approach is that form, not substance, becomes the driving focus. Interestingly, similar criticism was lodged at the Federal Reserve back in 1988 when it announced the BCI decision.⁵⁵

From a policy perspective, whether an entity is a non-corporate entity of a foreign government or a legal corporate vehicle controlled by a foreign government may very well be a distinction without a meaningful difference. Indeed, it may even be a fallacious one. Robert M. Kimmitt, Deputy Secretary of the Treasury Department, has provided an authoritative treatment of some of the policy questions raised by sovereign wealth funds in an article in *Foreign Affairs*, where he identifies three other forms of sovereign investment in

⁵⁴ See *Foreign Government Investment Hearing*, *supra* note 16 (statement of Scott G. Alvarez).

⁵⁵ One newspaper report filed shortly after the Federal Reserve's BCI decision was issued in 1988 is of instructive reference 20 years later:

. . . A number of lawyers said the [BCI] decision was particularly puzzling because of some of the logic used.

Although its statement on this subject is not entirely clear, the Fed's ruling appears to apply only to foreign banks that are owned by entities indirectly owned by a government, not those that are owned directly.

"We view this decision as a narrow one that does not seek to apply the [BHC Act] to foreign governments directly," said Lawrence R. Uhlick, executive director of the New York-based Institute of International Bankers. By that reasoning, if Istituto were to transfer its shares in Banca Commerciale to the Italian Government, it would not fall under the Fed's definition of a holding company.

Yet, if it were as easy as that to comply with the Fed's ruling, some lawyers suggested that the central bank had become unusually concerned with form instead of substance

Sarah Bartlett, *Italians Will Push Irving Bid*, N.Y. TIMES, Aug. 23, 1988, at D1.

addition to sovereign wealth funds: international reserves, public pension funds, and state-owned enterprises. Mr. Kimmitt views state-owned enterprises as “companies over which the state has significant control, through full, majority or significant minority ownership,” whereas sovereign wealth funds are “government investment vehicles funded by foreign exchange assets and managed separately from official reserves.”⁵⁶ But like their state-owned enterprise cousins, these “stand-alone investment funds” of foreign governments have no private investors and, at least at their genesis, the same sovereign sponsor. Their similarities certainly beg the question as to why they should be afforded such different treatment.

Reliance on such a bright-line distinction — treating investments made by corporate entities established by foreign governments differently from those made by sovereign governments themselves — fails to recognize the practical reality that strong state connections can exist even in entities structured as corporate vehicles. Consider, for example, two Chinese investment bodies. One, CIC, is an entity structured as a corporate vehicle with apolitical investment aims. According to one study, however, it functions more as a state agency charged with managing investments from a portion of the country’s foreign exchange reserves, with its management ultimately reporting to the State Council of the People’s Republic of China, the chief administrative organ of the Chinese government.⁵⁷ The other body, China’s State Administration of Foreign Exchange (“SAFE”), which is chiefly responsible for managing the country’s vast foreign exchange reserves, is controlled by the Chinese

⁵⁶ See Kimmitt, *supra* note 6, at 120.

⁵⁷ See Brad W. Setser, *What’s in a Name?*, EMERGING MARKETS, May 29, 2008 (noting the “murky” relationship between the CIC and the Chinese government and positing that the CIC “looks more like a state agency”).

Government and operates directly under the auspices of the country's central bank. Under the Federal Reserve's BCI-based formulation, CIC would be considered a "company" under the BHC Act, but SAFE presumably would escape the Federal Reserve's jurisdiction because it is not structured as a separate corporate vehicle.

As sovereign wealth funds continue to grow both in number and size, it is possible that the Federal Reserve may eventually be presented with factual scenarios that will cause it to revisit its earlier formulation.

B. Dual Searches for "Control"

A second issue that may emerge from the potential tension between the Federal Reserve and CFIUS relates to the question of whether a particular transaction would result in control of a U.S. financial institution.

As discussed previously, whether a transaction would result in foreign control is a gateway inquiry for both the Federal Reserve and CFIUS. Under the BHC Act, the Federal Reserve may review a proposed foreign investment in a U.S. bank, even if such a stake would be under 10% of voting equity, by looking at other, less quantitative factors that would indicate a "controlling influence."⁵⁸ Likewise, CFIUS has the authority to review transactions falling below 10% of voting equity if the foreign acquirer would have the power "to determine, direct, or decide important matters" of the U.S. target company.⁵⁹

⁵⁸ See *supra* note 33.

⁵⁹ See *supra* note 48; see also *Cohen Ruminates on Recent Bank Deals*, CORP. CONTROL ALERT (April 2008) at 12 (noting the "dead wrong" perception that, under CFIUS regulations, a foreign investment in a U.S. company falling under 10% of total voting equity is deemed automatically to be a non-controlling one).

This raises the question whether it is possible for a foreign transaction involving a U.S. bank to be deemed controlling under one regime, but not the other. Such a factual scenario — and any related turf war — has yet to come before the Federal Reserve and CFIUS, but it is one that may be worth some consideration as the role of CFIUS evolves.

It is notable that the Federal Reserve, which of course predates CFIUS, has well-developed precedents of what constitutes control — and non-control — under the BHC Act. Although the Federal Reserve is not a member agency of CFIUS, it undeniably has a regulatory apparatus and expertise that CFIUS, which has not articulated why its expertise or standards should be favored, would be well-advised to defer on threshold questions of control. From letter rulings to more formal interpretative decisions, the Federal Reserve offers greater predictability and transparency than CFIUS, a body that also has not been immune from criticism of opaqueness.⁶⁰ Parallel inquiries by the Federal Reserve and CFIUS would also likely result in inefficiencies of resources as well as invite the potential for conflict between these bodies and confusion over any competing determinations of control.

Oversight by the Federal Reserve entails a host of restrictions on the ability of companies to exercise control over U.S. financial institutions in which they hold equity interests. At the very least, as one prominent international banking group has urged, “CFIUS should take the nature and extent of these existing regulatory restrictions into account in assessing whether a minority investment by an internationally headquartered bank is likely to confer

⁶⁰ See *Sovereign Funds Need Best Practices, Not New Legislation*, Treasury Official Says, 40 SEC. REG. & LAW REP. 235 (Feb. 18, 2008).

‘control’ over a U.S. business.”⁶¹ Indeed, such an approach would still take advantage of the Federal Reserve’s considerable expertise and address the efficiency- and conflict-related concerns that would be implicated by two bodies making control determinations.

C. Banks as Critical Infrastructure and a Role for the Federal Reserve

Finally, there are issues arising from whether an acquisition resulting in foreign control of a U.S. financial institution would involve “critical infrastructure” of the United States and, relatedly, whether any corresponding national security concerns are more appropriately reviewed by one body over another.

The term “critical infrastructure” is not one of insignificance. Under FINSA, CFIUS has the authority to review investments that would result in foreign control of critical infrastructure. What exactly “critical infrastructure” means is of fluid interpretation — something that certainly has engendered criticism — and the definition provided under FINSA may offer more questions than answers. The main issue, however, is whether banks and other financial institutions fall within this term and, if so, what role the Federal Reserve should have along with CFIUS.

Ironically, recent actions taken by the Federal Reserve may have opened the door to persuasive arguments that U.S. banking institutions do indeed constitute “critical infrastructure” and, therefore, CFIUS, and not the Federal

⁶¹ Letter from Lawrence R. Uhlick, Chief Executive Officer, Inst. of Int’l Bankers, to Nova Daly, Deputy Assistant Sec’y, U.S. Dep’t of the Treasury (June 9, 2008) (on file with authors), at 6 (internal citation omitted).

Reserve, has the greater prerogative in any regulatory review process aimed at scrutinizing foreign investments.

In mid-March 2008, faced with the collapse of Bear Stearns, one of the largest global investment banks and brokerage firms in the world, the Federal Reserve feared a “chaotic unwinding of positions,” “systemic damage to the financial system,” and a full-fledged “crisis.”⁶² What followed were unprecedented actions by the Federal Reserve: opening the Discount Window for the first time to investment banks and committing to lend \$30 billion to a limited liability company of JPMorgan Chase & Co. to purchase \$30 billion of mortgage-backed securities from Bear Stearns.⁶³ During their first week with access to the Discount Window, investment banks borrowed \$37 billion from the Federal Reserve. For these actions, the Federal Reserve used a 1932

⁶² See *Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 110th Cong. (2008)* (statement of Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System); *id.* (statement of Timothy F. Geithner, President and CEO, Federal Reserve Bank of New York).

The minutes of a meeting of the Federal Reserve’s Board of Governors on March 14, 2008 illustrate both the sense of urgency that guided the Federal Reserve’s actions and its view that it had no other choice than to come to Bear Stearns’ rescue:

[G]iven the fragile condition of the financial markets at the time, the prominent position of Bear Stearns in those markets, and the expected contagion that would result from the immediate failure of Bear Stearns, the best alternative available was to provide temporary emergency financing to Bear Stearns through an arrangement with JPMorgan Chase & Co.

Minutes of the Board of Governors of the Federal Reserve System (Washington, D.C., March 14, 2008).

⁶³ The Federal Reserve’s recourse on \$29 billion of the \$30 billion is to the mortgage-backed securities.

“emergency” statute — found at Section 13(3) of the Federal Reserve Act⁶⁴ — under which it had lent a total of \$1.5 *million* to businesses during the Great Depression. Not since the Great Depression, however, has the Federal Reserve invoked this provision.

The Federal Reserve’s actions were nothing short of extraordinary, leading even one of its former chairmen, Paul A. Volcker, to characterize them as “at the very edge of [the Federal Reserve’s] lawful and implied powers.”⁶⁵ According to Mr. Volcker, the “plain implication” is that in “time of stress” it is possible for investment banks to be “deemed of systemic importance.”⁶⁶ Following in the wake of the Federal Reserve’s actions, the Treasury Department, on March 31, 2008, issued a 218-page “Blueprint for a Modernized Financial Regulatory Structure.” Significantly, the Blueprint noted the “essential role” of U.S. financial institutions in the economy.

If U.S. financial institutions are “critical infrastructure,” what, then, are we to make of the dynamic between the Federal Reserve and CFIUS? Is one body better equipped to review transactions or do the underlying goals of each body differ in such a way that both must proceed in reviewing a transaction involving foreign control of a U.S. bank or bank holding company?

Mr. Alvarez’ recent testimony reminds that the Federal Reserve already has a highly established review and supervisory process. In light of such

⁶⁴ Section 13(3) of the Federal Reserve Act authorizes a Federal Reserve Bank to make loans from the Discount Window to “individuals, partnerships and corporations” in “unusual and exigent circumstances.” *See* 12 U.S.C. § 343 (2006).

⁶⁵ Paul A. Volcker, Remarks at the 395th Meeting of The Economic Club of New York (Apr. 8, 2008) (transcript on file with authors).

⁶⁶ *Id.*

regulatory infrastructure, one may question whether CFIUS has a legitimate or practical role in the review of banking-related investments, but it would be extreme to say that no role for CFIUS exists and it is unlikely that Congress would adopt such a position.

While CFIUS is charged with scrutinizing controlling investments on national security grounds, the Federal Reserve has no similar mandate. Rather, the Federal Reserve's principal role is manifested chiefly through its examination of a foreign banking organization's financial condition, the record and strength of its management, and its standing and compliance with the laws of the home country.⁶⁷ Notably absent is any explicit statutory basis for the Federal Reserve to scrutinize investments primarily on national security grounds.

Still, it would also be an extreme position to conclude that the Federal Reserve should have no meaningful role in assessing the impact of certain transactions on the stability and security of the nation's financial system. Although the Federal Reserve's traditional standard of review under the BHC Act does not include national security considerations, the Federal Reserve does

⁶⁷ See Federal Reserve Board, Policy Statement on Supervision and Regulation of Foreign-Based Bank Holding Companies, 1 Fed. Res. Reg. Serv. 4-835 (Feb. 23, 1979) (acknowledging that the Federal Reserve Board's "supervisory responsibilities are for the safety and soundness of U.S. banking operations"); see also *Foreign Government Investment Hearing*, *supra* note 16 (statement of Scott G. Alvarez) (noting that the BHC Act looks to "competitive, supervisory, and financial and managerial factors," while the CBCA, similarly, looks to, among other things, "competitive and informational standards as well as whether the transaction would jeopardize the financial stability of the bank, prejudice the interests of the depositors of the bank, or result in an adverse effect on the Deposit Insurance Fund"); cf. Regulation Y (Factors Considered in Acting on Bank Acquisition Proposals), 12 C.F.R. § 225.13 (noting that the Federal Reserve may not approve any application made under the BHC Act if the transaction would, among other things, result in a monopoly or substantially lessen competition and stating that the Federal Reserve may also look to an applicant's financial condition, managerial resources, and ability to address the convenience and needs of the communities to be served).

have authority under the BHC Act, and Regulation Y issued by the Federal Reserve thereunder, to consider whether certain activities would “reasonably be expected to produce benefits to the public.”⁶⁸ This “benefits to the public” test looks to a non-exhaustive list of factors, which include greater convenience to the public, increased competition, and efficiency gains, as well as an evaluation of the would-be acquirer’s financial and managerial resources.⁶⁹ These benefits are to be considered in light of “possible adverse effects,” which include, but are not limited to, unsound banking practices and undue concentration of resources.⁷⁰ The BHC Act and Regulation Y could be read to provide a statutory basis for including national security concerns among the factors the Federal Reserve may consider in assessing certain proposed transactions.

Even if there is sufficient latitude for the Federal Reserve under its traditional standards to consider national security considerations in the context of its broader review of banking-related investments by sovereign wealth funds, it is possible that CFIUS and the Federal Reserve could examine national security concerns differently. To avoid the potential for an unfortunate and unproductive collision between these two bodies, policymakers should look for ways to foster cooperation and to take greater advantage of the obvious expertise-related advantages that the Federal Reserve and other regulatory bodies, including the SEC, possess.⁷¹ A sensible, workable approach would be

⁶⁸ Bank Holding Companies and Change in Bank Control, 12 C.F.R. § 225.5(a).

⁶⁹ *See id.* § 225.5(a)-(b).

⁷⁰ *See id.* § 225.5(a).

⁷¹ It is worth noting that, following the collapse of Bear Stearns, the Federal Reserve and the SEC have actively sought to build a closer relationship in their oversight of investment banks. These two regulatory bodies have recently executed a memorandum of understanding that details, among other things, how information and analysis will be

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for CFIUS “to give banking and securities regulators the primary role in assessing the impact of acquisitions of control on the stability of the financial system,” while employing its own resources only when there are “exceptional transactions” involving financial institutions that raise security concerns “beyond the systemic and institutional factors assessed by banking and securities regulators.”⁷²

Undoubtedly, both the Federal Reserve and CFIUS have important roles to play in the overall regulatory framework that is in place and, as evidenced by the active dialogue on sovereign wealth funds, it is a framework that has not yet been fully developed.

CONCLUSION

The rise of sovereign wealth funds is striking. Their sizable investments have wooed Wall Street, but have set off alarm bells in Washington and on Main Street. Much of the concern rests on their opaque profiles, as well as the perception that their investments have nefarious motives behind them. This WORKING PAPER has provided background on these increasingly prominent and controversial investment vehicles and has examined the primary legal and regulatory structures equipped to review their investments in U.S. banking and financial institutions, as well as the issues that the interplay of these structures may raise.

shared. See Memorandum of Understanding Between the U.S. Securities and Exchange Commission and the Board of Governors of the Federal Reserve System Regarding Coordination and Information Sharing in Areas of Common Regulatory and Supervisory Interest (July 7, 2008) (on file with authors), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080707a1.pdf>.

⁷² See Uhlick, *supra* note 61, at 8.

Although beyond the scope of this article, there is an important subtext to sovereign wealth funds that should at least be noted in closing. Sovereign wealth funds have come to the fore of American public policy and debate at precisely the moment in which the United States is experiencing an economic malaise that has shaken consumer confidence and, not least of all, the American psyche. A falling U.S. dollar and a surge in oil prices have accompanied the debut of sovereign wealth funds, and their initial reception, much like the high-profile investments by the Japanese in the 1980s,⁷³ has been one of considerable suspicion. Suspicion alone, however, does not advance our understanding of these increasingly influential investors.

Meaningful study and treatment of sovereign wealth funds can come only if policymakers recognize that these funds may not be problematic to American competitiveness and security but rather are symptomatic of larger, fundamental changes in the global economy — reflecting, as one political commentator has described, the “rise of the rest”⁷⁴ and the rapidly growing influence of the economies of countries like China, India, Russia, and Brazil — and our own failings of public policy that are evidenced by unsustainably high trade and budget deficits, low savings rates, and the lack of a national energy policy. Viewing sovereign wealth funds in such a context will aid the crafting of legal and regulatory responses that are proportionate to the risks that these funds pose and may lead policymakers to conclude that significant legislative energy is likely better spent on more systemic issues confronting our economy.

⁷³ ADIA’s acquisition of a majority stake in the iconic New York skyscraper, the Chrysler Building, in early July 2008 certainly brought to mind the move made by Japanese investors almost 20 years earlier to acquire a controlling stake in Rockefeller Center. *See, e.g.,* Landon Thomas Jr., *A Growing Trophy Case*, N.Y. TIMES, July 10, 2008, at C1.

⁷⁴ *See* FAREED ZAKARIA, THE POST-AMERICAN WORLD 2, 202–04 (2008).