

2008

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### Recommended Citation

Justin O'Brien, *Barriers to Entry: Foreign Direct Investment and the Regulation of Sovereign Wealth Funds*, 42 INT'L L. 1231 (2008)  
<https://scholar.smu.edu/til/vol42/iss4/3>

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# Barriers to Entry: Foreign Direct Investment and the Regulation of Sovereign Wealth Funds

JUSTIN O'BRIEN\*

## Abstract

*Direct and indirect investment by Sovereign Wealth Funds in the financial services sector globally has increased exponentially since the credit crunch began last July. The investment has been accompanied by increasingly shrill rhetoric within recipient countries. This concern encompasses the governance and operational management structures adopted by diverse funds and the impact on individual corporations. More problematically, it also centers on alleged wider geo-political and economic systemic risk. The paper delineates the parameters of the debate. It evaluates the extent to which it reflects genuine pressing concerns or attempts to rewrite the rules governing financial liberalization owing to an incremental but perceptible and perhaps irrevocable transfer of economic and political power.*

## I. Introduction

The ongoing crisis in global commercial debt markets has exposed glaring deficiencies in operational and strategic risk management systems.<sup>1</sup> Effective and efficient capital markets depend on confidence in the integrity of financial institutions, the regulatory apparatus, and, ultimately, trust between market participants and financial intermediaries. Self-

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Note: This paper derives from presentations at the University of California at Berkeley; University of Cambridge; University of Glasgow; University of New Hampshire; Dayton Symposium on Accountability, Ohio; International Monetary Fund, Washington DC; and Lowy Institute for International Policy, Sydney. It will be published in revised form in JUSTIN O'BRIEN, *ENGINEERING A FINANCIAL SERVICES BLOODBATH* (2009). The reader should note that the IMF intends to publish overarching principles of best practice for the Sovereign Wealth Fund sector in October 2008. This paper is current as of September 28, 2008.

1. For global overviews, see SENIOR SUPERVISORS GROUP, *OBSERVATIONS ON RISK MANAGEMENT PRACTICES DURING THE RECENT MARKET TURBULENCE* (2008); FINANCIAL STABILITY FORUM, *REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE* (2008); John Lipsky, First Deputy Managing Dir., IMF, Speech at the Peterson Institute: Dealing with the Financial Turmoil: Contingent Risks, Policy Challenges, and the Role of the IMF (Mar. 12, 2008), <http://www.imf.org/external/np/speeches/2008/031208.html>; PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, *POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS* (2008).

evidently, trust like liquidity and solvency is now in very short supply, and confidence has evaporated. The collapse of Northern Rock in the United Kingdom, Bear Stearns in the United States, and dubious, if not criminal, underwriting practices in both jurisdictions exacerbate a wider systemic problem.<sup>2</sup> The decision by Washington to mount a rescue of Fannie Mae and Freddie Mac, two government-sponsored but ostensibly independent mortgage companies, leaves the U.S. taxpayer potentially liable for billions of dollars in losses and extends the reach of the crisis dramatically. While dispute continues on what should be done, there is fundamental agreement on the severity of the crisis and its implications for regulatory design.<sup>3</sup> For example, the former Deputy Governor of the Bank of England, Rachel Lomax, has referred to the unfolding multi-dimensional nature of the "largest ever peacetime liquidity crisis."<sup>4</sup> Alan Greenspan, the former Chairman of the Federal Reserve, agrees. He suggests the debacle "is likely to be judged in retrospect as the most wrenching since the end of the Second World War. . . . Those of us who look at the self-interest of lending institutions to protect shareholder equity have to be in a state of shocked disbelief."<sup>5</sup>

This assessment mirrors that of Timothy Geithner, the President of the Federal Reserve of New York:

[u]ncertainty about the future, and the greater complexity of leveraged structured products, created a dense fog around estimates of potential loss, making institutions and markets more vulnerable to an adverse surprise when conditions changed, and making it harder to manage the many principal agent problems inherent in the financial business. In effect, some major banks and investments banks made the choice to follow the market down as underwriting practices eroded.<sup>6</sup>

2. Press Release, U.S. Dep't of Justice, More Than 400 Defendants Charged for Roles in Mortgage Fraud Schemes as Part of Operation "Malicious Mortgage" (June 19, 2008). For the United Kingdom, see Jennifer Hughes, *Mortgage Fraud Crackdown on Brokers*, FIN. TIMES (London), July 19, 2008, at 1. For background on lending practices, see Giovanni Dell'Ariccia, Deniz Igan & Luc Laeven, *Credit Booms and Lending Standards: Evidence from the Subprime Mortgage Market* (International Monetary Fund, Working Paper 08/106, 2008); CHARLES R. MORRIS, *THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH* (U.S. Public Affairs 2008).

3. For information relating to the United States, see Timothy Geithner, President & CEO, Fed. Reserve Bank of New York, Speech at the Council on Foreign Relations Corp. Conference: The Current Financial Challenges: Policy and Regulatory Implications (Mar. 6, 2008) [hereinafter Geithner Speech]; Ben S. Bernanke, Chairman, U.S. Fed. Reserve, Speech at the Fed. Reserve Bank of Chicago Annual Conference: Risk Management in Financial Institutions (May 15, 2008). For information relating to Europe, see Charlie McCreevy, European Comm'r, Internal Market & Serv., Speech at the Workshops of the Alliance of Liberals and Democrats for Europe (Feb. 27, 2008) [hereinafter McCreevy Speech]. For information on the United Kingdom, see Rachel Lomax, Deputy Governor, Bank of England, Speech to the Institute of Econ. Affairs 25th Anniversary Conference: The State of the Economy (Feb. 26, 2008).

4. Lomax, *supra* note 3, at 5.

5. Alan Greenspan, *We Will Never Have a Perfect Model of Risk*, FIN. TIMES (London), Mar. 17, 2008, at 9. What is also clear, however, is that voluntary systems of oversight are grossly insufficient. The Securities and Exchange Commission (SEC), which emerged as key regulator of investment banks through the Consolidated Supervised Entities Program, devised in 2004 in part to avoid regulation of U.S.-based investment banks by the European Union, has abolished the initiative. In a statement, SEC Chairman Christopher Cox admitted, "the past six months have demonstrated that voluntary regulation does not work." Press Release, U.S. Sec. & Exch. Comm'n, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008).

6. Geithner Speech, *supra* note 3.

The search for yield has been replaced by an urgent need for recapitalization. Central banks in the United States, Canada, and Europe have enhanced the type of collateral accepted in return for short-term financing. In the case of the U.S. Federal Reserve, the range of institutional actors able to avail of its discount-lending window has been stretched to—and arguably surpasses—formal legal power.<sup>7</sup> Many leading banks have secured additional financing through rights issues. Continued share price declines have made each form of financing exceptionally problematic. Institutional investors are nursing major losses, thereby dulling enthusiasm for further issuance.<sup>8</sup> The limits of central bank capacity and the reticence of traditional institutional shareholders have necessitated the search for new sources of funding.

The most promising, although controversial, new source is funding from Sovereign Wealth Funds (SWFs). These state-backed asset management pools have become pivotal actors in the provision of the liquidity to minimize the solvency dilemma posed by declared cumulative losses of more than \$320 billion (U.S.) across the global banking sector.<sup>9</sup> SWFs invested \$24.8 billion (U.S.) in the first two months of 2008, just under half the total amount dispersed in 2007.<sup>10</sup> Since January 2007, \$60.7 billion (U.S.) of the total of \$72.9 billion (U.S.) invested in SWFs has been invested in the financial sector.<sup>11</sup> Despite media coverage on China and the Gulf, it has been the city-state of Singapore that has been the most aggressive, with portfolio enhancements of \$41.7 billion (U.S.).<sup>12</sup> It is, perhaps, indicative of the scale of the crisis that Barney Frank, the Democratic Chairman of the U.S. House of Representatives Financial Services Committee, plaintively admitted: “[w]e need the money. . . [w]e’d be worse off without it.”<sup>13</sup> A similar view pertains in Brussels. The European Commissioner for Internal Markets has wryly noted the “irony in the fact that the entities that were being demonized at that time [by vested interests in Europe] . . . have in recent months been the saviours rather than the demons.”<sup>14</sup>

At the same time, the reliance on SWFs raises much wider geo-political issues. Contestation centers on the perceived transparency and accountability deficit associated with their governance, particularly those from China and Russia. It is far from clear, however, whether the risks identified—financial contagion, the exercise of soft power, the need to protect legitimate national interests, and governance deficiencies—represent pressing dan-

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7. The most stringent criticism in this regard has come from a former chairman of the Federal Reserve itself. He argued that the erosion of trust and replacement of relational with transactional imperatives created a crisis of such magnitude that “the Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied powers, transcending certain long embedded central banking principles and practices.” Paul A. Volcker, Former Chairman, U.S. Fed. Reserve, Address at the 395th meeting of Economic Club of New York (Apr. 8, 2008).

8. See, e.g., Richard Wachman, *HBOS £4 bn Rights Issue is a Massive Flop: Mortgage Provider Prepares to Reveal the UK's Highest-Profile Funding Failure in 20 Years*, OBSERVER (London), July 20, 2008, at B1; Peter Thal Larsen, Chris Hughes & Dave Shellock, *Banks' Cash Calls Shunned*, FIN. TIMES (London), July 19, 2008, at 1.

9. John Burton, *Wealth Funds Exploit Credit Squeeze*, FIN. TIMES (London), Mar. 24, 2008, at 16.

10. *Id.*

11. *Id.*

12. *Id.*

13. David Enrich, Robin Sidel & Susanne Craig, *World Rides to Wall Street's Rescue*, WALL ST. J., Jan. 16, 2008, at A1.

14. Charlie McCreevy, European Comm'r, Internal Market & Serv., Speech at the Annual Dinner for the Society of Business Economists: Credit Crisis & the Aftermath (Feb. 6, 2008).

gers or thinly veiled protectionism. Moreover, the clumsy shoehorning of explicit political desiderata into economic policy within recipient countries cuts against the open investment policy that informs the stated aims of financial globalization.<sup>15</sup> This conflation, in turn, poses profound legitimacy and authority risks for international organizations, including the International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development (OECD) that are attempting to broker a compromise between competing trade and political imperatives.

Tentative agreement has been reached on a draft set of Generally Accepted Principles and Practices for SWFs—the Santiago Principles.<sup>16</sup> There remain, however, significant problems on how these principles can be implemented and enforced. Consequently, the remainder of the paper is structured as follows. First, it identifies how and why SWFs have been able to exploit deficiencies in the governance of major institutional actors within investment banking and their regulation. Second, it identifies the potential risks associated with the injection of liquidity from sources not governed by western market mores. Third, it evaluates the efficacy of current regulatory approaches, with particular reference to foreign investment review processes. Finally, the paper concludes with an assessment of the cogency of this framework and the impact of the debate on capital flows and financial globalization more generally.

## II. The Price of Failure

The combination of a commercial failure to exercise restraint and defective external oversight within the global investment banking community has offered an extraordinary commercial opportunity (and risk) to state-sponsored investment funds. Paradoxically, their capacity to take such large contrarian positions is linked to a deficit in direct and ongoing accountability. The lack of direct market oversight shields some of the larger funds from short-term pressures. It also exacerbates perceptions that the funds may be used to further political objectives—perceptions, that, it must be pointed out at the outset, have no empirical basis. Nevertheless, the rising power of the asset class has sparked an acrimonious debate on whether the “New Mercantilism” threatens legitimate national interests, or, more alarmingly, the capacity to maintain social cohesion in recipient countries.<sup>17</sup> Thus, while greater transparency and accountability of SWFs investment activity may limit the extent of formal political control over investment decisions, it is unlikely to address the geopolitical realities of what the Vice Chancellor of the Delaware Court of

15. ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD) INVESTMENT COMMITTEE REPORT, SOVEREIGN WEALTH FUNDS AND RECIPIENT COUNTRY POLICIES (Apr. 4, 2008) [hereinafter INVESTMENT COMMITTEE REPORT].

16. It is indicative of the sensitivities involved that the principles themselves were not published when announced in September 2008. According to Mr. Al Suwaid, “there was a very frank exchange . . . . A lot of the discussion focused on the need to preserve the economic and financial interests of the sovereign wealth funds so as not to put them at a disadvantage when compared to the other types of investors such as hedge funds, insurance companies, and other institutional investors.” Press Conference Call, Int’l Working Group of Sovereign Wealth Funds, Comments on Release of Santiago Principles (Sept. 22, 2008), available at <http://www.iwg-swf.org/tr/swftr0801.htm> [hereinafter IWG Press Conference Call].

17. See Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism* (Sanford Univ. Law & Econ. Olin Working Paper Series, Paper No. 355 & Columbia Univ. Law & Econ. Working Paper Series, Paper No. 328, 2008), available at <http://ssrn.com/abstract=1095023>.

Chancery has, somewhat controversially, termed the rise of societies that “sink[] even deeper beneath the normative floor the West sets for the ethically and socially responsible conduct of corporate affairs.”<sup>18</sup> The policy challenge neutralizes this debate, ensuring that the normative benefits of greater transparency and accountability extend beyond the SWFs sector and are integrated with concomitant improvements in inward investment processes. To do otherwise preordains conflict at a time in which western leverage is severely compromised.

SWFs have been in existence without contestation for a number of years. The source of seed capital can derive from one-off windfalls, such as the proceeds from privatization.<sup>19</sup> Recurring foreign exchange receipts from natural resource exploitation provide a second revenue stream.<sup>20</sup> A third derives from the investment of profits accruing from adroit entrepot trading.<sup>21</sup> They form an increasingly important component of overarching macro-economic strategies to take advantage of a spike in commodity prices.<sup>22</sup> In part, the hoarding of cash reserves in foreign currency can be traced to a determination in emerging economies to reduce vulnerability to sudden capital outflows or commodity price declines. Individual funds, if mandated to invest overseas, can also lower domestic demand or inflationary pressures by diverting excess liquidity.<sup>23</sup> Unlike traditional stabilization funds, which tend to invest in easily convertible treasury bonds to ensure immediate access in the event of a sudden deterioration in critical export markets, the larger SWFs tend to adopt longer-term investment horizons. Moreover, there is an increasing propensity to diversify into a much broader range of equities and alternative asset classes, such as private equity, real estate, the U.S. film industry, and British soccer. At the same time, it is impossible to characterize SWFs as a homogenous group and, arguably, conceptually incoherent to devise an overarching regulatory approach to deal with such diverse pools of capital.

Governmental asset holdings have now eclipsed hedge funds and private equity in funds under management. It is estimated that the total investment pool (without leverage) could reach as much as \$10 trillion by 2012.<sup>24</sup> The European Commission has recognized SWFs now form an essential transmission belt within the engine of financial globaliza-

18. Leo E. Strine, Jr., *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 IOWA J. CORP. L. 1, 17 (2007).

19. The Australian Future Fund, established in 2006, received seed capital from the proceeds of the federal government's stake in Telstra, which was privatized the previous year.

20. Examples here include the Norwegian Government Pension Fund–Global and the Abu Dhabi Investment Authority.

21. The two Singaporean Sovereign Wealth Funds—the Government of Singapore Investment Corporation and Temasek Holdings—are paradigmatic examples.

22. Brazil, for example, has announced plans to set up its own Sovereign Wealth Fund, which will have an initial capitalization of \$10 billion. See Matt Moffett, *Brazil Joins Front Rank of New Economic Powers*, WALL ST. J., May 13, 2008, at A1.

23. Australia's new government, for example, has diverted part of \$22 billion (AUS) surplus arising (in part) from mineral exports into three separate infrastructure funds. It is unclear whether these funds will be time-limited and the likely effect, if any, of liquidation timed to synchronize with the political calendar. See Interview with Wayne Swan, Treasurer, Commonwealth of Australia, ABC Radio Nat'l Breakfast (May 14, 2008); Wayne Swan, Treasurer, Commonwealth of Australia, Speech at the Nat'l Press Club Canberra (May 14, 2008).

24. Simon Johnson, *The Rise of Sovereign Wealth Funds*, FIN. & DEV., Sept. 2007, at 56, available at <http://www.imf.org/external/pubs/ft/fandd/2007/09/straight.htm>.

tion.<sup>25</sup> Informal polling at the 2008 World Economic Forum in Davos characterized SWFs as both global powers and global power brokers.<sup>26</sup> The visibility has ensured that, like private equity and hedge funds before, the sector has attracted the attention of policy-makers. Critically, this concern was evident even before the implosion of the securitization market demonstrated serious flaws in the overarching regulatory systems of control.

The experience of large corporations in the industrialized world demonstrates that potential for error and abuse exists even in apparently highly rated and well-managed organizations. From a systemic perspective, transparency will facilitate the maintenance of openness to investment. What may have been tenable in a world where Sovereign Wealth Funds manage only several hundred billion dollars may not be tenable in a world where Sovereign Wealth Funds manage several trillion dollars.<sup>27</sup>

Policymakers in both London and Brussels remark candidly, if privately, that the core dilemma is how to engage a resurgent Beijing. The chair of the influential Treasury Select Committee, John McFaul, argues that "there is a paranoia, particularly in Washington, about China."<sup>28</sup> One of the most senior European regulators remarked to this researcher it was important "to be brutally frank. This is not about Singapore or Norway or even the Gulf Sovereign Wealth Funds; this is about how to deal with the power of China."<sup>29</sup> The rhetoric is much more pronounced in US discourse, in part because of the exigencies of the electoral calendar. Echoes can be found, however, across the Atlantic. Influential countries within the European Union—such as Germany and France—still remain deeply skeptical about the benefits of financial capitalism, irrespective of the source.<sup>30</sup> The more muscular foreign policy adopted by Russia serves to heighten skittishness precisely because of the difficulty in differentiating business and government interests. The suspi-

25. COMMISSION OF THE EUROPEAN COMMUNITIES, *A Common European Approach to Sovereign Wealth Funds, delivered to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions* (2008) [hereinafter COMMISSION OF THE EUROPEAN COMMUNITIES]; see also INVESTMENT COMMITTEE REPORT, *supra* note 15, at 2.

26. Michael Useem, *Lessons from Davos, One of Globalization's Best Classrooms*, KNOWLEDGE@WHARTON, Feb. 6, 2008, at 2, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1893>.

27. Press Release, U.S. Dep't of Treasury, Remarks by Acting Under Secretary for International Affairs Clay Lowery on Sovereign Wealth Funds and the International Financial System (June 21, 2007) [hereinafter Press Release, U.S. Dep't of Treasury].

28. Interview with John McFaul, in Glasgow (Apr. 7, 2008). For a discussion of anti-Chinese sentiment in Congress and its impact on policy, see Stanley Lubman, *The Dragon as Demon: Images of China on Capitol Hill* (Center for the Study of Law and Society Jurisprudence and Social Policy Program, Working Paper No. 18, 2004). This is not to downplay concern in Europe about a resurgent Russia. See, ROBERT KAGAN, *THE RETURN OF HISTORY AND THE END OF DREAMS* (Knopf 2008); EDWARD LUCAS, *THE NEW COLD WAR: THE FUTURE OF RUSSIA AND THE THREAT TO THE WEST* (Palgrave Macmillan 2008). For media coverage of the dispute over BP's Russian subsidiary, see Clifford J. Levy & Sophia Kishkovsky, *Fight over TNK-BP Revives Worries About Kremlin*, INT'L HERALD TRIB., June 17, 2008, at 18; Robin Pagnamenta, *'Harassed' TNK-BP Chief Quits Russia*, WEEKEND AUSTL., July 26, 2008, at 39.

29. Interview with Charlie McCreedy, European Comm'r, Internal Market & Serv., in Brussels, Belgium (Apr. 15, 2008).

30. The acrimonious debates on the alleged deleterious implications of private equity last year testify to the strength of this ideational tension. See Justin O'Brien, *Charting an Icarian Flightpath: The Implications of the Qantas Deal Collapse, in PRIVATE EQUITY, CORPORATE GOVERNANCE AND THE DYNAMICS OF CAPITAL MARKET REGULATION 295* (Justin O'Brien, ed., Imperial College Press 2007) [hereinafter *Charting an Icarian Flightpath*]; John W. Cioffi, *Corporate Governance Reform, Regulatory Politics, and the Foundations of Finance Capitalism in the United States and Germany*, 7 GERMAN L.J. 533 (2006).

cions that Russia is prepared to deploy its energy reserves strategically in order to advance political objectives, for example, are reinforced by the revolving door between Gazprom and the Kremlin.<sup>31</sup> The interlinked governance and investment principles proposed to alleviate the risk of political imperatives trumping economic ones in the context of an invigorated state capitalism will be explored more fully below. First, however, it is necessary to evaluate the precise nature of the problems allegedly posed by SWFs.

### III. The Repricing of Risk

The risks associated with SWFs can be usefully broken into three core areas: the risk of financial contagion; the exercise of soft political power; and national security considerations. Each will be briefly outlined and the cogency of the regulatory approaches suggested by the United States, Europe, and Australia evaluated. The final substantive section suggests that continued reliance on current conceptions of what effective corporate governance entails—based on the transformative potential of transparency and accountability—is itself fundamentally flawed.

#### A. THE RISK OF FINANCIAL CONTAGION

Significant investment banks have secured immediate survival by turning to SWFs operating out of the Middle East, East, and South East Asia (see table one). The U.S. Federal Reserve and the European Union along with the OECD emphasize the stabilizing role of SWFs in ameliorating the current crisis.<sup>32</sup> The size, scale, and degree to which investment strategies used by SWFs are disclosed differ dramatically, however. Variable opacity makes it difficult to gauge whether inappropriate or misguided investment expansion could potentially generate economic distortions. An apparent increase in risk tolerance, for example, may not be politically sustainable. Sharp commodity price fluctuation, large losses arising from misguided investment decisions, or further deteriorations in equity markets could test the faith of new market entrants. The publication of exact measures used to set performance is central to the argument that sudden capital outflows must be managed to prevent or at the least ameliorate wider contagion.<sup>33</sup> There is no evidence, however, that this risk is anything more than hypothetical.

Investment bankers in London and New York speak positively of their experience with executives from the major funds. One research director for a major investment bank suggested that the funds have become a magnet for rising stars within the asset management

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31. Andrew E. Kramer, *As Gazprom's Chairman Moves Up, So Does Russia's Most Powerful Company*, INT'L HERALD TRIB. (Online), May 11, 2008, <http://www.iht.com/articles/2008/05/11/business/11gaz.php>; Anders Aslund, Senior Fellow, Peterson Inst. for Int'l Econ., Speech Before the European People's Party, European Parliament, Russia Energy and the European Union: Perspectives on Gazprom (May 15, 2008); Andreas Goldthau, *Resurgent Russia? Rethinking Energy Inc.*, Policy Rev., Feb.-Mar. 2008, available at <http://ssrn.com/abstract=1137616>.

32. Scott G. Alvarez, Gen. Counsel, SWFs, Testimony before the Fin. Serv. Comm., U.S. House of Representatives (Mar. 5, 2008); COMMISSION OF THE EUROPEAN COMMUNITIES, *supra* note 25; see also IMF Monetary & Capital Markets & Policy Development & Review Departments, *Sovereign Wealth Funds—A Work Agenda* 13 (Feb. 29, 2008) [hereinafter IMF, *Work Agenda*].

33. Press Release, U.S. Dep't of Treasury, *supra* note 27.



| INVESTMENT BANK | SUB-PRIME LOSSES | SWF INJECTION (US \$ BILLIONS)  | EQUITY STAKE      |
|-----------------|------------------|---|-------------------|
| Merrill Lynch   | 31.7             | 11 including<br>4.4 (Temasek, Singapore)<br>2.0 (Korea Investment Fund)<br>2.0 (Kuwaiti Investment Fund)<br>0.3 (New Jersey Division of Investment)                               | 9.4<br>3.0<br>3.0 |
| Citigroup       | 40               | 20.0 including:<br>7.5 (Abu Dhabi Investment Authority)<br>6.8 (Singapore Investment Corporation)<br>3.0 (Kuwait Investment Authority)<br>0.4 (New Jersey Division of Investment) | 4.9<br>3.7<br>1.6 |
| UBS             | 38               | 9.7 (Singapore Investment Corporation)  | 9.8               |
| Morgan Stanley  | 12.6             | 5 (China Investment Corporation)  | 9.9               |

Table 1: Sovereign Wealth Fund Investments

firmament.<sup>34</sup> Moreover, the larger funds emphasize the quality of external advice and internal controls. The leading Singaporean fund, Temasek Holdings, recently sent its executive director—Simon Israel—to a congressional hearing to impress upon U.S. lawmakers how the fund is insulated from political influence. Simon Israel noted that Temasek has an eight-member majority-independent board structure that is supplemented by an international advisory panel that includes William McDonough (Vice Chairman of Merrill Lynch) and David Bonderman (founding partner of Texas Pacific Group).<sup>35</sup> Similarly, the ranking civil servant responsible for the oversight of the Norwegian Government Pension Fund—Global, Europe's largest SWF, emphasized to Congress its own well-developed controls and the need for regulatory restraint.<sup>36</sup>

Not surprisingly, the governance structure adopted by the Norwegians is often presented as paradigmatic of best practice.<sup>37</sup> It invests across an investment universe with risk tolerance levels set and monitored by the Ministry of Finance.<sup>38</sup> The portfolio is diversified across geographic and sectoral dimensions.<sup>39</sup> As Thomas Ekeli, a senior official in the Department of Finance in Oslo has pointed out, "this balance ensures the fund can

34. Interview with Research Dir., Investment Bank, in London, (July 19, 2008).

35. Simon Claude Israel, Executive Dir. & Board Member, Temasek Holdings (Private) Ltd., Testimony before Fin. Serv. Comm., U.S. House of Representatives (Mar. 5, 2008).

36. Martin Skancke, Dir. Gen., Asset Mgmt. Dep't, Norwegian Ministry of Finance, Statement to Fin. Serv. Comm., U.S. House of Representatives (Mar. 5, 2008). The fund details all of its investments and conforms to an ethical code of practice. For the precise governance rules of the Norwegian Government Pension Fund—Global, see Norges Bank, Ethical Guidelines for the Government Pension Fund—Global, [http://www.norges-bank.no/Pages/Article\\_68360.aspx](http://www.norges-bank.no/Pages/Article_68360.aspx) (last visited Jan. 23, 2009).

37. See generally Simon Chesterman, *The Turn to Ethics: Disinvestment from Multinational Corporations for Human Rights Violations—The Case of Norway's Sovereign Wealth Fund* (N.Y.U. Sch. of Law Public Law & Legal Theory Research Paper Series, Working Paper No. 08-25, 2008), available at <http://ssrn.com/abstract=1082685>.

38. NORWEGIAN MINISTRY OF FIN., ON THE MANAGEMENT OF THE GOVERNMENT PENSION FUND IN 2006 38-43 (2006-07 Translation from Norwegian for Information Only).

39. *Id.* at 85-88.

ride out any short-term market fluctuations.”<sup>40</sup> While there has been much talk about replicating the checks and balances adopted by the Norwegian Government Pension Fund–Global, this move is not without substantial short-term destabilizing risks. As a leading investment banker in New York conceded to this researcher, “those who advocate a Norwegian solution clearly have not read the underpinning rules governing its operation.”<sup>41</sup> Many of the recent share acquisitions in global financial investment banks are substantial. The scale of individual contributions far exceeds the tolerance limits provided to Norwegian fund managers. Disinvestment on the scale necessary to ensure compliance with Norwegian norms could be exceptionally problematic.

A related problem centers on the activist approach taken by the Norwegian fund in the exercise of its obligations as a shareholder. Forcing SWFs to demonstrate independence from political considerations by adopting purely passive positions cuts against the trajectory of responsible corporate governance; a trajectory which has been taken very seriously by the Norwegian Pension Fund–Global.<sup>42</sup> Within the academy, this emasculating imperative has gone even further, with the suggestion that SWFs should be automatically stripped of ownership rights.<sup>43</sup> Two leading U.S. academics have proposed what they term a minimalist solution. They argue that the political problem of how to ensure that “market-based capitalist regimes are protected against incursion by new mercantilist regimes” can be resolved by “a simple corporate governance fix” whereby “the equity of a US firm acquired by a foreign government controlled entity would lose its voting rights, but would regain them when transferred to non-state ownership.”<sup>44</sup> Forcing SWFs to disengage from ownership responsibility is unlikely to solve one key dimension of the

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40. Interview with Thomas Ekeli, in Oslo, (Apr. 11, 2008). The evidence to date of the risk of sudden capital outflows derives not from funds such as Norway’s but those based in the South Pacific. A fund established in the Pacific island of Nauru invested solely in ‘lumpy’ real estate, while that of Tonga consisted of three holdings in major US corporations. In both cases, not surprisingly, the result was major losses. See Eric Le Borgne & Paulo Medas, *Sovereign Wealth Funds in the Pacific Island Countries: Macro-Fiscal Linkages* 20 (IMF Working Paper Series, Paper No. 07/297, 2007), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1087176](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1087176). There is demonstrable difference in the quality of the fund managers brought in to run the major operations in Russia, China, and the Gulf. Notwithstanding their expertise and standing, however, there is no way of predicting whether these agents have the capacity to moderate the behavior of their political masters in the event of an escalating trade or diplomatic dispute.

41. Interview with Investment Banker, in New York, (Apr. 25, 2008).

42. Most controversially, the Ethics Council of the Norwegian Pension Fund–Global advocated that the Fund disinvest from Walmart. This recommendation centered on fears that Walmart’s supply chain management was defective and could implicate the corporation, and therefore the fund as the owner of its shares, in the violation of International Labor Organization’s working condition standards. See generally Chesterman, *supra* note 37. It has also divested its \$500 million stake in Rio Tinto because of concerns that the management of the world’s biggest gold mine led to unacceptable and unethical environmental degradation. See Press Release, Norwegian Ministry of Finance, The Government Pension Fund Divests its Holding in Mining Firm (Sept. 9, 2008). Significantly, Rio Tinto is not involved in the operational management of the mine, which is in Indonesia. On the same day, the Ministry of Finance rejected a request to divest from Monsanto because of concerns over child labor, citing improvements in corporate governance. Rolleiv Solholm, *Pension Fund Divests its Holdings in Rio Tinto*, NORWAY POST (Online), Oct. 9, 2008, <http://www.norwaypost.no/cgi-bin/norwaypost/imaker?id=191807>.

43. See Gilson, *supra* note 17, at 10. But see Skancke, *supra* note 36, at 6 (stating that “we see no cause for regulations that would restrict the present investment activities of our Fund, or any regulation imposing restrictions on SWF over and above those applying to non-SWF investors”).

44. Gilson, *supra* note 17, at 10.

crisis—the failure of institutional investors to take their ownership responsibilities seriously enough. Indeed, as will be explored below, it is likely to exacerbate it.

A second wider source of concern centers on the complex relationship between SWFs and financial engineers. While the IMF has broadly welcomed SWFs, it has expressed concern that any tie up of private equity, combined with the danger associated with shorting particular stocks or sectors, could prove exceptionally destabilizing.<sup>45</sup> Its Director of Research has pointed out that “as sovereign funds grow in importance, they effectively become a significant unregulated set of intermediaries that may or may not invest with hedge funds in the future.”<sup>46</sup> An inevitable consequence is the potential amplification of market manipulation.<sup>47</sup> Despite regulatory suspicion that hedge funds may have colluded to put financial stocks into play,<sup>48</sup> there is no evidence that SWFs have either funded or directly engaged in such short-term asset management strategies. As with state-controlled corporations seeking to make strategic acquisitions, one further issue surrounds the risk of insider trading because SWFs may have access to and take advantage of price-sensitive information. Again, it is essential to emphasize that this risk is purely hypothetical. There is no evidence that any SWF has engaged in such activity.

Paradoxically, the increasingly shrill rhetoric emanating from recipient countries reinforces the dynamic interplay between SWFs and private equity. Some funds have sought to head-off criticism of disguised motives by developing indirect conduits, most notably through a deepening of collaborative ventures. The Chinese Investment Corporation has contributed to a major fund established by J.C. Flowers.<sup>49</sup> The Government Investment Corporation of Singapore has emerged as a key underwriter of a similar fund established by Texas Pacific Group.<sup>50</sup> Investment in distressed financial stocks and the leveraged acquisition of committed senior debt at fire-sale prices provides both sets of institutional actors with a clear commercial opportunity. It is a thought that is captivating private equity mandarins. The Abu Dhabi Investment Authority will, in time, “effectively replace Wall Street” according to Guy Hands, the head of Terra Firma, a leading private equity

45. Simon Johnson, *The Rise of Sovereign Wealth Funds*, FIN. & DEV., Sept. 2007, at 56.

46. *Id.*

47. The Securities and Exchange Commission (SEC) has flagged the asymmetrical informational issue and its application to Sovereign Wealth Funds and, more problematically, state-controlled funds with privileged access to market sensitive information. See Ethiopis Tafara, Dir., Office of Int'l Affairs, U.S. Sec. & Exch. Comm'n, Testimony Concerning Foreign Government Investment in the U.S. Economy and Financial Sector before the Fin. Serv. Comm., U.S. House of Representatives (Mar. 5, 2008).

48. The dissemination of totally unfounded rumors in March 2008 destabilized one of Britain's most conservative lenders, HBOS. The “trash and cash” operation prompted the Financial Services Authority (FSA) to release a terse statement castigating the market manipulation and promising a thorough investigation. See Ruth Sutherland et al., *Inside the Hunt for the City's Bank Raiders*, OBSERVER, Mar. 23, 2008, at 22-23. As a consequence, the FSA has introduced rules necessitating greater disclosure of shorting strategies. See Press Release, Financial Services Authority, Financial Services Authority Introduces Disclosure Regime for Significant Short Positions in Companies Undertaking Rights Issues (June 13, 2008). The SEC has gone further, banning short selling in nineteen major financial stocks. See Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,166 (July 15, 2008), available at <http://www.sec.gov/rules/other/2008/34-58166.pdf>.

49. Rick Carew, *Beijing Fund Will Take Private Equity Plunge*, WALL ST. J., May 27, 2008, at C3.

50. John Jannarone, *GIC, Via Private Equity, Targets Emerging Markets*, WALL ST. J. ONLINE, Apr. 17, 2008, <http://online.wsj.com/article/SB120837228322320301.html>.

provider.<sup>51</sup> Although tinged with hyperbole, it is indicative of growing interdependence.<sup>52</sup> The linkage magnifies, however, the opacity problems associated with the acquisition and divestiture of portfolio companies. If the aim of policymakers is to limit the short-term nature of contemporary market practice, it is surely counter-productive to force an arranged marriage between two largely unregulated sectors of the financial economy.

## B. THE EXERCISE OF SOFT POWER

SWFs represent a fundamental shift in market dynamics precisely because of the (potential) fusion of political and commercial imperatives. Their growth provides confirming evidence that the claim that the triumph of liberalism and global diffusion of western economic policies would inevitably lead to the demise of the state is, at best, premature.<sup>53</sup> For the larger established funds there is no evidence that investment strategies differ in substance from those of traditional pension funds. Indeed it is arguable that any short-term attempt to destabilize the market would be exceptionally counter-productive to longer-term interests precisely because the initial exit could easily be traced. The boom in commodity prices in particular, however, compounds the perception that investment strategies could be used to advance the potential exercise of political soft power.<sup>54</sup> A number of plausible concerns arise in this regard. Corporate takeovers and the acquisition of strategic stakes (particularly if accompanied by board rights) give state actors potential access to proprietary intellectual capital. Without appropriate and enforceable checks and balances, misuse of this information could be disseminated to a wider range of national champions. A related risk is that the investment could influence strategic imperatives (for example by skewing lending priorities towards projects favored by donor countries) thus undermining the efficacy of specific corporate governance controls.<sup>55</sup>

The more aggressive investment strategies developed by China and Russia, in particular, but also from authoritarian governments in the Gulf, have exacerbated these concerns. While there is no evidence that any SWFs have ever been used to further political ambitions, ascertaining the motives of secretive or authoritarian governments is a notoriously imprecise exercise. Notwithstanding the advantages of increased disclosure in helping to divine intent, it is important to emphasize that SWFs form only one component of state economic influence. The opacity level increases when strategic investments derive from state-controlled corporations. It clouds over completely when the acquisition comes from business oligarchs with discernible but informal links with political power in authoritarian regimes. The point here is that restricting SWF acquisitions or limiting voting rights to demonstrate passivity could lead to the expansion of even more opaque investment mech-

51. Martin Arnold, *Wealth Funds Fill Bank Gap for Buy-Out Groups*, FIN. TIMES (London), Feb. 28, 2008, at 1.

52. The involvement of a Texas Pacific Group founding partner on the international advisory panel set up by the Singaporean SWF, Temesek Holdings, indicates this. The governance procedures allow for Bonderman (or any other advisor) to be excused from deliberations in cases where a conflict of interest exists. See Israel, *supra* note 35.

53. For original formulation, see FRANCIS FUKUYAMA, *THE END OF HISTORY AND THE LAST MAN* (Maxwell Macmillan 1992).

54. See JOSEPH S. NYE, JR., *SOFT POWER: THE MEANS TO SUCCESS IN WORLD POLITICS* (Public Affairs 2004).

55. See IMF, *Work Agenda*, *supra* note 32, at 14.

anisms. The governance debate and its implications will be further explored below. First, it is necessary to evaluate how the national interest is defined, the impact of SWF investment on that definition, and the consequence for capital flows.

### C. THE PROTECTION OF THE NATIONAL INTEREST

Many countries impose restrictions on foreign direct investment in parts of the critical infrastructure because of strategic and cultural factors. These can include restrictions in dual-use technologies or protection of core communication portals, such as media markets, from undue foreign influence.<sup>56</sup> The restrictions can be complete, partial, or entail a review process that, in turn, may or may not privilege investment (dependent on the salience of wider security concerns). The problem centers on a lack of agreement on what "critical" means and the parameters that governments can use to define "national security" interests.<sup>57</sup> The inevitable consequence is a lack of transparency in investment review process. This lack of transparency makes the entire process susceptible to political and economic populism. The frameworks and the extent to which inward investment is compromised by injudicious political rhetoric are now evaluated by way of two extended examples.

#### 1. *The United States*

Concern over national security issues has become particularly acute in the United States. The imperatives governing the "war on terror" have sharpened the potential conflict between the benefits of global exchange and the impact on national security. The current legal framework dates from the 1988 "Exxon-Florio" amendment to the Defense Production Act.<sup>58</sup> The amendment authorized presidential right of veto if a foreign investment risked the integrity of national defense.<sup>59</sup> The investigative authority was delegated to the Committee on Foreign Investment in the United States (CFIUS), an inter-agency agency established thirteen years earlier to further inward investment. From the start two competing philosophical worldviews were in conflict.<sup>60</sup> As one of those involved in compiling the reports commented recently, "one side [representing Treasury and facilitative trade agencies] never saw a deal they didn't like, while the other [initially De-

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56. See U.S. GEN. ACCOUNTING OFFICE, FOREIGN INVESTMENT: LAWS AND POLICIES REGULATING FOREIGN INVESTMENT IN 10 COUNTRIES (Feb. 2008), available at <http://www.gao.gov/new.items/d08320.pdf> [hereinafter GAO Foreign Investment]; OECD, PROTECTION OF "CRITICAL INFRASTRUCTURE" AND THE ROLE OF INVESTMENT POLICIES RELATING TO NATIONAL SECURITY 6 (May 2008), available at <http://www.oecd.org/dataoecd/2/41/40700392.pdf> [hereinafter OECD Protection].

57. OECD, TRANSPARENCY AND PREDICTABILITY FOR INVESTMENT POLICIES ADDRESSING NATIONAL SECURITY CONCERNS: A SURVEY OF PRACTICES (May 2008) [hereinafter OECD Transparency].

58. 50 U.S.C. § 2170 (West 2007).

59. *Id.*

60. The potential dysfunction was highlighted to two critical reports by the Government Accountability Office. See U.S. GEN. ACCOUNTING OFFICE, DEFENSE TRADE: MITIGATING NATIONAL SECURITY CONCERNS UNDER EXON-FLORIO COULD BE IMPROVED (Sept. 2002), available at <http://www.gao.gov/new.items/d02736.pdf>; U.S. GEN. ACCOUNTING OFFICE, DEFENSE TRADE: ENHANCEMENTS TO THE IMPLEMENTATION OF EXON-FLORIO COULD STRENGTHEN THE LAW'S EFFECTIVENESS (Sept. 2005), available at <http://www.gao.gov/new.items/d05686.pdf>.

partment of Defense but extended in 1988 to include Department of Justice and Department of Homeland Security in 2003] never saw a deal they did.”<sup>61</sup>

The problems are exacerbated by a failure to define what constitutes national security in either the underpinning legislation or regulatory procedures.<sup>62</sup> There are of course sound policy reasons for such an approach. Most notably, it gives policymakers exceptional flexibility. Nevertheless, the abortive investment by state-owned Dubai Ports World in P&O’s stevedore operations on the U.S. eastern seaboard in 2005 demonstrates the unintended consequences. The failure to disentangle the national interest and to order potentially incommensurable commercial and military imperatives severely compromised the integrity of the regulatory system.<sup>63</sup> The controversy centered on the interpretation of an Executive Order. It had opined “certain national infrastructures are so vital that their incapacity or destruction would have a debilitating impact on the defense or economic security of the United States.”<sup>64</sup> Despite the support of the Bush administration, political pressure convinced Dubai that it had, in reality, little choice but to divest. This political pressure demonstrates that the voluntary system of review could be short-circuited by policy entrepreneurs.

The Foreign Investment and National Security Act of 2007 was designed to address this defect by codifying the entire foreign investment review process.<sup>65</sup> It reinforces earlier Executive Order imperatives in the definition of critical infrastructure. Significantly, financial services industry is omitted from the list of controlled sectors in the primary legislation. Individual agencies have maintained the sector as a component of critical infrastructure. As such, the CFIUS remains a politically charged arena. Moreover, the underpinning legislation specifically calls on CFIUS to take into consideration “the relationship of the acquiring country with the United States, specifically on its record of cooperating in counterterrorism efforts.”<sup>66</sup> This degree of politicization is particularly problematic for Chinese domiciled investors.

The scale of distrust was already evidenced in blocking the sale of a Californian-based oil company to the Chinese National Oil Corporation in 2006. This unease re-emerged in the machinations surrounding the recent attempted takeover of 3Com, a leading telecommunications firm. The deal was structured to give the Chinese conglomerate Huawei just 16.5 percent of the stock with the remainder held by a U.S.-based private equity group, Bain Capital.<sup>67</sup> It was derailed, in part, because of fears expressed outside the CFIUS process that the integrity of network security protocols could not be protected.

61. Interview with confidential source, in Washington, DC (May 28, 2008). Moreover, the OECD has found no evidence of specific country evaluation of how investment policy actually helps or impedes the furtherance of national security considerations. See OECD Protection, *supra* note 56, at 7.

62. The U.S. Department of Homeland Security, for example, defines as part of its mandate the need to protect “systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems and assets would have a debilitating impact on [national] security.” OECD Protection, *supra* note 56, at 3.

63. See generally, EDWARD M. GRAHAM & DAVID M. MARCHICK, U.S. NATIONAL SECURITY AND FOREIGN DIRECT INVESTMENT (Peterson Institute for International Economics 2006), available at <http://book-store.petersoninstitute.org/book-store/3918.html>.

64. Exec. Order No. 13,010, 61 Fed. Reg. 37,347 (July 15, 1996).

65. Foreign Investment & National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246.

66. See GAO Foreign Investment, *supra* note 56, at 34.

67. Stephanie Kirchgaessner, *U.S. Insiders Point to Bain Errors over 3Com*, FIN. TIMES (London), Mar. 3, 2008, at 30.

The alleged links between Huawei and the Chinese Peoples' Liberation Army represented an even more nebulous concern. Recognition that these concerns could not be readily dismissed—at least in the court of public opinion—led to the withdrawal of the offer for \$2.2 billion (U.S.).<sup>68</sup>

Be this as it may, it is questionable whether a Chinese-controlled investment vehicle, in particular, can gain ongoing political support in Washington absent a fundamental overarching agreement on how to deal with expanded state reach.<sup>69</sup> Administration support appears conditional on adherence to a further generic set of principles that operate outside of the formal legal and regulatory guidelines that underpin the CFIUS procedure. This adherence requires an explicit commitment that “investment decisions should be based solely on commercial grounds, rather than to advance, directly or indirectly, the geopolitical goals of the controlling government.”<sup>70</sup> According to the U.S. Treasury, “[g]reater information disclosure. . . in areas such as purpose, investment objectives, institutional arrangements, and financial information. . . can help reduce uncertainty and build trust in recipient countries.”<sup>71</sup> While national security has been deliberately framed to give “the broadest latitude” possible, reinstating the financial sector does give rise to understandable ire on the part of SWFs that see the current debate of geo-political gamesmanship devoid of policy cohesion.<sup>72</sup>

It is also important to note that there are important structural and policy differences between the 3Com deal and those recently consummated within the financial sector.<sup>73</sup> The recent financial acquisitions have been scoped to ensure that they remain below mandatory government review thresholds. Under U.S. law, if there are no accompanying voting rights (or the portfolio investment is below 10 percent), then the investment is automatically deemed passive and therefore not subject to formal review. Secondly, as noted above, the passage of the Foreign Investment and National Security Act explicitly deleted financial services from the list of prescribed sectors. This change does not mean, however, that monetary policymakers lack the capacity to block financial investments. The Bank Holding Company Act requires U.S. Federal Reserve approval before direct or indirect investment of more than 25 percent of voting shares can be authorized. In addition, a controlling interest that is defined as having 10 percent of voting shares can trigger

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68. *Id.*; Stephanie Kirchgaessner, *Washington Obstacle Course Sees Chinese Companies Re-Examine Their U.S. Ambitions*, FIN. TIMES (London), Mar. 4, 2008, at 30.

69. Evan Bayh, chairman of the Senate Banking Sub-Committee on Security and International Trade and Investment, suggests that the current regulatory approach is “naïve.” Evan Bayh, *Time for Sovereign Wealth Rules*, WALL ST. J., Feb. 13, 2008, at A26. Three members of the House Financial Services Panel, including its chairman, Barney Frank, have written to the U.S. Treasury Secretary asking for confirmation that the 10% threshold will not be interpreted literally. Associated Press, *Lawmakers Want CFIUS Rules Clarified*, WALL ST. J., Mar. 14, 2008, at A12; see also Alvarez, *supra* note 32.

70. Press Release, U.S. Dep't of Treasury, *Treasury Reaches Agreement on Principle for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi* (Mar. 20, 2008).

71. *Id.*

72. Oral comments provided to the author by a representative of a conglomerate of SWFs at a seminar, on which this paper is based, given to the International Monetary Fund, in Washington, D.C. (May 27, 2008).

73. It is also important to emphasize that the main source of foreign investment in the United States comes from Europe, particularly the United Kingdom, France, and Germany. Despite the sharp spike in Sovereign Wealth activity, as a sector it remains relatively small provider of overall foreign direct investment in the United States. See GAO Foreign Investment, *supra* note 56, at 8.

a formal review. The critical question is whether the CFIUS can or should have the capacity to second-guess the U.S. Federal Reserve.

## 2. *Australia*

The global demand for resources has been central to Australia's relative insulation from the effects of the credit crisis. The country has significant reserves of alumina, zircon, and tantalum as well as liquid natural gas, nickel, and iron ore. Much of it lies in Western Australia. The state is the world's leading producer of bauxite, rutile, and zircon.<sup>74</sup> Western Australia has the largest known reserves of nickel and the second largest supply of iron ore, gold, bauxite, and diamonds.<sup>75</sup> The state has been a magnet for inward investment. Between 1998 and 2007, mining operations expanded from \$5 billion to \$15 billion (Aus.).<sup>76</sup> Chinese concerns have become some of the most significant competitors to the dominant domestic holdings—BHP Billiton and Rio Tinto, which are dual listed on the London market—and the increasingly important Fortescue Metals Group. China is now Western Australia's most significant trading partner, both as consumer of its products and provider of inward investment, particularly low metal content iron ore. While the investments to date have generally been structured as joint ventures, the number of hostile bids for medium sized Australian operations has increased.<sup>77</sup> There are, of course, clear commercial grounds for such an approach. From the Chinese corporate perspective, synergies produce economies of scale, reduce dependency on the major Australian exporters, and minimize the risk of reliance on volatile spot markets. Conversely, the facilitation of inward capital flows may also depress prices in cases where the same entity extracts and uses the resources. The fear expressed in Canberra centers on the fact that this linkage could benefit disproportionately the customers of Australian resources, namely the Chinese.

The policy implications have sharpened because of a strategic raid by Chinalco and its (junior) American partner, Alcoa, on the Rio Tinto share register in London, which was itself the target of BHP Billiton's audacious attempt to consummate the largest takeover in history. Legal advice to Chinalco held that the \$12 billion (Aus.) raid was not covered by either Australian law or policy. As a consequence, there was no requirement to notify or seek prior federal approval. Two weeks after the raid, the Australian federal government attempted to reconcile competing objectives by refining the principles used to evaluate potentially controversial commercial deals. The effect, however, has been to introduce uncertainty in the marketplace.

Under Australian law, foreign investment is evaluated under the Foreign Acquisitions and Takeovers Act of 1975. The Act delegates the analytic function to a Foreign Investment Review Board (FIRB), an advisory arm of the Department of Treasury.<sup>78</sup> The principles make clear that the FIRB retains an advisory role. Ultimate decision-making

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74. Data supplied by the Department of Industry and Resources, Western Australia.

75. *Id.*

76. *Id.*

77. The most significant example in this regard was the hostile bid of \$1.36 billion (AUS) for control of iron ore producer Midwest. Opposition to the deal related primarily to the price not the principle. See Jamie Freed, *Sinosteel Gets Control, but Likely to Have Company at Midwest*, SYDNEY MORNING HERALD, July 8, 2008, <http://business.smh.com.au/business/sinosteel-gets-control-but-likely-to-have-company-at-midwest-20080708-3bu5.html>.

78. Foreign Acquisition and Takeovers Act, 1975 (Austl.).



authority remains with the Treasurer. The principles do little to provide clarity. Indeed, the clarification has politicized the issue and ratcheted up tension with Chinese conglomerates.

The first principle covers the investor's independence from the relevant government (to monitor for actual foreign government control).<sup>79</sup> It is unclear what degree of independence is deemed appropriate. Moreover, it is uncertain whether this provision could be enforced against a publicly listed entity in which a state or regional government held a formal but minority interest. Second, the Board will review the investor's litigation record and "common standards of business behaviour" (i.e. the extent to which investor has clearly expressed commercial objectives and the quality of its corporate governance).<sup>80</sup> It is equally uncertain whether this review process would apply to a newly listed corporation or one with no previous litigation history. Third, the FIRB will assess the impact of the investment on competition (to be determined in consultation with the Australian Consumer and Competition Commission).<sup>81</sup> Such an approach may have value in the case of major acquisitions, such as BHP Billiton's proposed takeover of Rio Tinto. It is questionable what impact the transfer of a mid-tier company could have on competition policy, making the provision largely irrelevant unless invoked for short-term political reasons. Fourth, the FIRB will evaluate the impact of the proposed investment on government revenue or other policies, including tax and environmental protection.<sup>82</sup> It is hard to see how this approach could be utilized only against state-owned investment vehicles without compromising equity of treatment principles. Fifth, FIRB will evaluate national security considerations, which includes undefined "strategic interests."<sup>83</sup> Sixth, the board will determine the impact on the operation and direction of Australian business, "as well as its contribution to the Australian economy and broader community," which includes taking into consideration "the interests of employees, creditors and other stakeholders."<sup>84</sup>

The Federal Treasurer, Wayne Swan, has sought to display his pro-inward investment credentials and displace concern by suggesting his office is swamped by Chinese proposals. He has publicly stated that the government had approved a Chinese investment once every nine days since coming to office.<sup>85</sup> He also intimated, however, that Chinese investment proved exceptionally complex; it required a more detailed examination, which in turn allowed for an expansion of the timeframe for approval beyond thirty days.<sup>86</sup> The

79. AUSTRALIAN LABOR PARTY, PRINCIPLES GUIDING CONSIDERATION OF FOREIGN GOVERNMENT RELATED INVESTMENT IN AUSTRALIA (Feb. 17, 2008), available at <http://www.alp.org.au/media/0208/mstres170.php>.

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. See Wayne Swan, Treasurer, Commonwealth of Australia, Speech delivered at Australia-China Business Council in Melbourne (July 4, 2008), available at <http://www.treasurer.gov.au/>.

86. Under Australian law, foreign investors can withdraw an application if it has not been accepted within the timeframe, thereby guaranteeing confidentiality. In one recent case involving Sinosteel, a Chinese-based corporation, the government refused the request for withdrawal and allowed the proposed investment to be gazetted. According to a senior representative of the Chinese firm involved, this decision was contrary to its wishes and demonstrated "discriminatory practice." Interview with Jiang Baocai, Sinosteel, in Beijing (Sept. 5, 2008). The government eventually approved an application limiting the investment to 49.99 percent on the grounds that a controlling interest would be contrary to competition policy. Rebecca Sharp, *Sinosteel Gets*

proposals have generated considerable ire in Western Australia. They also suggest that linking the national interest to the need to separate supply and demand misunderstands the dynamics of the mining industry. This message is precisely the one the Federal Treasurer promulgated in a recent speech in Melbourne:

The key is that investments are consistent with Australia's aim of maintaining a market-based system in which companies are responsive to shareholders and in which investment and sales decisions are driven by market forces rather than external strategic or political considerations. . . . Our predisposition is to more carefully consider proposals by consumers to control existing producing firms. We usually welcome and encourage some participation by the buyer . . . [b]ut we need to ensure that investment is consistent with Australia's aim of ensuring that decisions continue to be driven by commercial considerations and that Australia remains a reliable supplier in the future to all current and potential trading partners.<sup>87</sup>

The rationale for such an interventionist approach was explicitly justified by reference to the international debate on the regulation of SWFs. The empirical basis for such an assertion is hard to justify.<sup>88</sup> Not surprisingly, it is a theme also developed by Chinese and Chinese-linked mining concerns. Interviews conducted by this researcher in Beijing in recent months make it clear that both components are both puzzled and annoyed at what they perceive to be an admixture of discriminatory practices, bad faith, and policy incoherence. One of the most significant investments in Western Australia, for example, has come from a subsidiary of CITIC Pacific, a listed Hong Kong corporation, in which the Chinese government retains a 57.66 percent passive stake.<sup>89</sup> The director of CITIC Pacific's Australian operation is scathing about what he sees as the apparent lack of knowledge in Canberra of either Chinese realities or the economics of iron ore extraction. Wang Gongcheng believes that Australian mindset remains wedded to outmoded conceptions of Chinese management:

Things are very different now to when I first negotiated the agreement for China's first substantial foreign investment [with Hammersley Mines in Chennar, now a joint

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*Approval to Life Stake in Australia's Murchison*, FIN. TIMES, Sept. 22, 2008, <http://www.ft.com/cms/s/0/ff2feae0-883e-11dd-b114-0000779fd18c.html>.

87. Swan, *supra* note 85.

88. As with the United States, the rate of Chinese investment considerably lags international competitors. In 2006-2007, the United States was the single largest investor in Australia with \$45 billion (US). In total \$156.4 billion (US) were invested, with China contributing only \$10 billion (US). Michael Stutchbury, *Swan's Line in the Sand Risks Turning Chinese Investors Away*, AUSTRALIAN, Sept. 5, 2008, <http://www.theaustralian.news.com.au/story/0,25197,24295032-30538,00.html>. According to one of Australia's leading political economists, Peter Drysdale, an emeritus political economy professor at the Australian National University, "the current ambiguities are damaging to Australia's economic and long-term political-strategy interests." Peter Drysdale & Christopher Findlay, *Chinese Foreign Direct Investment in Australia: Policy Issues for the Resource Sector 30* (Sept. 4, 2008) (Unpublished Paper for Presentation at Crawford School Public Seminar, Australian National University). Drysdale, along with Christopher Findlay, argues in a recent paper: "Unnecessary regulation of capital from this source into the Australian market will not only be detrimental to Australian economic interests by driving it to other markets, possibly less supportive of reform of corporate structures and corporate behaviour, but is likely to encourage a retreat to appeals to the power of the state in ways that are likely to be damaging to both our long-term economic and political interests." *Id.* at 28-29.

89. C. Chan, *Citic Pacific Bailout is Best Option*, S. CHINA MORNING POST, Dec. 20, 2008, A2

venture with Rio Tinto]. Economic decision-making is now devolved totally to the enterprises themselves, which have responsibility for sourcing the necessary financing. In such circumstances, it is understandable that enterprises are seeking to secure supply. It is in their commercial interests to do so.<sup>90</sup>

While it is arguable that CITIC Pacific could be construed as a private company, it cannot be vouchsafed because CITIC Beijing controls a 30 percent stake.<sup>91</sup> For mainland-based corporations, navigating the foreign investment review process in Australia has become exceptionally problematic. The General Manager of the International Cooperation Department at Sinosteel, for example, argues “that on the surface the Australian government guidelines have not changed,” but its treatment indicates, to him, a profound change in policy has occurred.<sup>92</sup> The decision to limit Sinosteel’s acquisition in a neighboring mining corporation is inconsistent with OECD guidelines and with Australia’s own corporation law that mandates a takeover offer if holdings increase beyond 20 percent. Not only does such an arrangement severely limit Sinosteel’s capacity to deliver clear commercial objectives, it also curtails the systematic development of the infrastructure and curtails the emergence of competition. In a scathing aside, the Sinosteel manager wonders, with reason, whether current policy “can be consistent with Australia’s conception of itself as a market economy.”<sup>93</sup>

#### D. THE LIMITS OF TRANSPARENCY

The most considered policy framework to address the symbiotic nature of the problem of SWF regulation has been proposed by the European Union.<sup>94</sup> Its proposed code of conduct suggested the need for common disclosure standards in both host and recipient countries. These are designed, specifically, to ensure policy coherence within recipient nations (i.e. a common definition of what constitutes the public interest). There are sound policy reasons for advocating such an approach. The European Union President, Jose Manuel Barroso, has warned that support for open markets is waning across the community.<sup>95</sup> In this context, the absence of an overarching agreement on what constitutes the national interest risks the further politicization of foreign investment review processes across the European Union.<sup>96</sup> The fear is that any further advance of economic populism and protectionist rhetoric at national level may distort the authority and credibility of

90. Interview with Wang Gongcheng, CP Mining Mgmt. Prop. Ltd., in Beijing (Sept. 5, 2008).

91. Adding to the confusion is the extent to which the protection of the national interest entails investment from non-state actors from ostensibly democratic regimes. This situation is far from hypothetical. Russian oligarchs have also moved aggressively into the Australian resources sector.

92. Interview with Jiang Baocai, *supra* note 86.

93. *Id.*

94. COMMISSION OF THE EUROPEAN COMMUNITIES, *supra* note 25.

95. Lionel Barber & Tony Barber, *Barroso Protectionism Alert*, FIN. TIMES (London), March 3, 2008, at 1. This framework echoed earlier calls at a summit in London between the leaders of Britain, France, Germany, and Italy to reject “futile attempts to stem financial globalisation.” *Barroso Tells EU Leaders to Avoid Protectionism*, FIN. TIMES (London), Jan. 31, 2008, at 1; see also Philip Stephens, *Uncomfortable Truths for a New World of Them and Us*, FIN. TIMES (London), May 30, 2008, at 11.

96. The chairman of China Investment Corporation, Lou Jiwei, has ruled out investment across parts of Europe because he “feels extremely unwelcome there.” Bob Davis, *China Investment-Fund Head Says Focus is on ‘Portfolios’*, WALL ST. J., Feb. 1, 2008, at A13.

wider competition policy. This shift, argues the European Commission, is counter-productive to collective strategic interests. Such lofty aspiration is not, however, matched by realities on the ground.

As the OECD has commented, transparency “involves offering concerned parties the opportunity to comment on new laws and regulations, communicating the policy objectives of proposed changes, allowing time for public review and providing a means to communicate with relevant authorities.”<sup>97</sup> Moreover the OECD maintains the need for international cooperation. This cooperation is necessary “to ensure policy transparency by defining common standards [of procedural fairness] and providing support for multilateral peer review and capacity building.”<sup>98</sup> The OECD’s table of procedural transparency and predictability speaks volumes about serious wider deficiencies in the accountability regime at national recipient level. The lack of formal requirements to publicly announce outcomes, table reports to legislative bodies, or publish an annual report with sufficient information to ascertain review pattern is the norm in all countries surveyed with the exception of the United States and (partially) Australia.<sup>99</sup> Introducing policy changes in an incremental manner through bilateral agreements, as in the United States, runs counter to OECD principles. In Australia, the articulation of FIRB principles was not subject to external debate or validation. Rather, the initiative was presented as a bureaucratic clarification. As such, it did not require prior notification to or consultation with interested parties. In both cases, the introduction of new criteria to adjudication of state-owned or controlled investment entities reflect discriminatory impulses.

Given their role in providing liquidity to the financial sector, it is inevitable that SWFs have entered onto the political radar. As examined above, however, additional geopolitical concerns complicate matters considerably. It is entirely appropriate for national governments to protect legitimate national interests. If the process is opaque, though, there may be a concomitant undermining of legitimacy. Authority requires clearly defined parameters. In addition, the rationale must be explained and the rules applied in a proportionate impartial manner. To do otherwise obviates longstanding principles of equity in international investment. As such, proposals to regulate SWFs must be linked to foreign direct investment processes and to a wider recalibration of what is expected of institutional shareholders in the control of major corporations. At the same time, it is also clear that the generation of new norms or principles of best practice need to take account of changing power relations. The transfer of capital from south to north and east to west partially rebalances the center of political and economic power and reveals, in the process, glaring deficiencies in western conceptions of what constitutes (or should constitute) regulatory best practice.<sup>100</sup>

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97. OECD Transparency, *supra* note 57, at 2.

98. *Id.*

99. *Id.* at 9.

100. For recently announced plans to change the governance structure of the IMF reflect and reinforce this broader shift see IMF EXECUTIVE BOARD REPORT, REFORM OF QUOTA AND VOICE IN THE INTERNATIONAL MONETARY FUND (Mar. 28, 2009).

#### IV. Achieving Accountability

While SWFs have traditionally shunned the media spotlight, there are already clear signs of bristling at what is seen as a partial and self-serving rewriting of the rules governing financial globalization. This trend is most notable in the case of the Abu Dhabi Investment Authority (ADIA). The Emirate remains deeply suspicious of the benefits of disclosure; its website consists of five sparsely populated pages.<sup>101</sup> Nonetheless a clear message has been transmitted to Washington. The investment authority has stated explicitly that the Abu Dhabi "government has never and will never use its investment organizations or individual investments as a foreign-policy-tool."<sup>102</sup> It emphasizes that financial experts manage 80 percent of its investments.<sup>103</sup> Further, ADIA "has operated predominantly as a passive investor, with the overwhelming share of its portfolio consisting of minority stakes in companies that have included no control rights, no board seats and no involvement in the management or direction of the receiving companies."<sup>104</sup> The phrasing is instructive in its ambiguity. The passivity is predominant but not exclusive. It is unclear whether the portfolio balance is based on size or value. Furthermore, the lack of control, board representation, and directional guidance may not necessarily be used in all cases. More generally, it is mistaken to believe that the absence of voting rights precludes the exertion of influence. No entrenched management team is likely to ignore the voice or (perceived) interests of significant shareholders. The problem is that the current lack of disclosure means that there is no way of knowing what advice, if any, has been dispensed. Likewise there is no ongoing mechanism to hold the fund to account.

Along with the mollification has come an unsubtle warning. The ADIA cautions that "[i]n a world thirsty for liquidity, receiving nations should be mindful of the signals sent through protectionist rhetoric and rash regulation."<sup>105</sup> The chairman of Dubai World has argued that the introduction of formal regulatory oversight is unwarranted and contrary to the interests of recipient states.<sup>106</sup> Similarly, the chief executive of Dubai International Capital, which holds strategic stakes in both Standard Chartered and HSBC, has bluntly stated that leading investment banks may not be able to survive without SWF financing.<sup>107</sup> He told a conference "it would take a lot more money [than already secured from Abu Dhabi, Singapore, and Kuwait] to rescue Citigroup"—one of the most over-extended investment houses and the first to seek recapitalization.<sup>108</sup>

101. See Abu Dhabi Investment Authority, <http://www.adia.ae/default.asp> (last visited Jan. 28, 2009).

102. Yousef al Otaiba, *Our Sovereign Wealth Plans*, WALL ST. J., Mar 19, 2008, at A16.

103. *Id.*

104. *Id.*

105. *Id.*

106. Sultan Ahmed Bin Sulayem argued that "If somebody comes with regulations that make it difficult for someone from certain geographical locations to invest in Europe or the west, people will take their investment somewhere else." BBC News, *Dubai Fund Hits Back at Criticism* (Feb. 29, 2008), <http://news.bbc.co.uk/1/hi/business/7271007.stm>. He also claimed however that political interference was a red herring. "If you put a politician in charge of an investment, believe me, that investment fund will not last for a very long time." *Id.*

107. See Mirna Sleiman & Andrew Critchlow, *Gulf Investors May Not Save Citigroup, Dubai Executive Says*, MARKETWATCH, Mar. 4, 2008, available at <http://www.marketwatch.com/News/Story/gulf-investors-may-not-save/story.aspx?guid={6C374435-5314-4A8E-B689-B8916D529B7B}>.

108. *Id.*

Similar sentiment is evident in Beijing. The vice president of the China Investment Corporation, Jesse Wang, has expressed irritation at the calls for a code of conduct, saying it was "unfair" and "[t]he claim that sovereign-wealth funds are causing threats to state security and economic security are groundless. . . . We don't need outsiders to come tell us how we should act."<sup>109</sup> The IMF is exceptionally cognizant of the sensitivities involved in brokering a solution. It has signaled that a heavy-handed one-sided approach could backfire. The IMF Deputy Managing Director, John Lipsky, has argued that "[i]f there were a sense that somehow 'best practices' were decided by someone else and dictated to the funds, that could be extremely counterproductive."<sup>110</sup> It was against this volatile background that the IMF and representatives of twenty-six SWFs agreed to a voluntary set of guidelines in Santiago this September.

The Santiago principles set out the legal, institutional, and macroeconomic strategies adopted by each fund, including information about the risk appetite. According to the co-chair of the International Working Group drafting committee, the

governance and accountability arrangements give considerable comfort especially in the area of the separation of operations of the sovereign wealth fund from its owner, and the investment policies and risk management together with the other things are intended to make it clear that sovereign wealth funds act from a commercial motive and not other motives.<sup>111</sup>

Although no formal surveillance mechanism is envisaged, Hamid al Suwaidi, the co-chair of the International Working Group and the Under Secretary at the Abu Dhabi Department of Finance, gave an explicit assurance that compliance could be achieved: "this is a voluntary set of practices. The sovereign wealth funds will publicly announce their adoption of the GAPP once it's approved. And then it's for the public really to see where the respective funds are adhering to these principles and practices."<sup>112</sup> What that means in practice is exceptionally difficult to determine.

The governance procedures followed by the Norwegian Government Pension Fund-Global provides one potential way forward. Its terms of reference necessitate that detailed information is provided about where it invests and how it exercises its ownership

109. Victoria Ruan, *China's Investment Fund Pushes Back, Says G-7 Plan Is Unfair*, WALL ST. J., Mar. 7, 2008, at A6; Edward Wong, *Turning the Tables: China Scolds U.S. A New Confidence in Economic Talks*, INT'L HERALD TRIB., June 17, 2008, at 1; see also Stephen Schwartzman, *Reject Sovereign Wealth Funds At Your Peril*, FIN. TIMES (London), June 20, 2008, at 9.

110. Bob Davies, *US Pushes Sovereign Funds to Open to Outside Scrutiny*, WALL ST. J., Feb. 26, 2008, at A1.

111. IWG Press Conference Call, *supra* note 16 (comment by David Murray).

112. *Id.* (comment by Hamad al Suwaidi). At the same time, distinct limits on disclosure are envisaged. The Australian representative noted:

sovereign wealth funds have to compete in the market, and there are two implications of that, one in terms of the confidentiality of arrangements that other people make with sovereign wealth funds and the protection of that confidentiality, and the confidentiality of their day-to-day transacting, but also the notion that if other parties in the market believe that a sovereign wealth fund can be forced to disclose certain information, then that would close down the range of people who would be prepared to deal with sovereign wealth funds.

So disclosure is important, but as with any other institutional investor, there must be a limit which protects confidentiality of dealings for sovereign wealth funds and their counter parties.

*Id.* (comment by David Murray).

obligations.<sup>113</sup> While there are corporations that the fund simply will not invest in (for example those involved in the arms trade), the fund also adopts a pragmatic teleological or consequential approach to ownership. It “aims to be a leader in active ownership and develop strategies and priorities which can win the support of others.”<sup>114</sup> As its most recent annual report makes clear, there is “[a]n expectation . . . [by] the Norwegian people and their political representatives—that the fund managers should act responsibly and look after their financial assets in an ethically acceptable way.”<sup>115</sup> Presuming the current financial crisis stems primarily (if not exclusively) from ethical failure, then it necessarily follows that it is only through responsible ownership that effective oversight can return. As noted above, proposals to curtail voting rights risk delivering a suite of unintended consequences, not least of which is a reversal of the work done by the Norwegian Pension Fund–Global to embed integrity in its operating model. Moreover, forcing SWFs to abdicate responsibility exacerbates the problem of the separation of ownership and control within individual corporations and undermines the salience of regulatory theory.

The appropriate pricing of risk by private actors is arguably a commercial calculation. It is necessary, however, for the managers, board directors, and owners of the providers of structured finance products to recognize responsibility for a systemic crisis of confidence. The seizing of the global securitization market demonstrates the malign consequences of an emasculated approach to corporate governance and risk management. As the President of Federal Reserve Bank of New York has pointed out, the “conventional risk-management framework today focuses too much on the threat to a firm from its own mistakes and too little on the potential for mistakes to be correlated across firms.”<sup>116</sup> In somewhat plainer language, the European Commissioner for Internal Markets and Services refers to a toxic cocktail of “stupidity, ignorance [and] misplaced optimism.”<sup>117</sup> He suggests the failure of internal risk management systems derive from that the fact that “[s]everal CEO’s of large financial institutions have admitted in their more candid moments that they did not understand many of the new products that their firms were designing, underwriting and trading.”<sup>118</sup> The strength of the elixir and the abandon with which it was consumed also demonstrates the continuing failure of controls within and between four distinct orders of accountability: legal, managerial, political, and bureaucratic.<sup>119</sup>

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113. NORGES BANK INVESTMENT MANAGEMENT, 2007 SUMMARY ANNUAL REPORT 40 (2008), available at <http://www.norges-bank.no/upload/nbim/reports/2008/annual%20report%202007.pdf>. This process is buttressed by an external Council on Ethics. The Council has the power to exclude a specific corporation in the event that investment is deemed to carry a significant risk of complicity. This message has been exported in recent weeks by the Governor of the Norges Bank. See Svein Ingvar Gjedrem, Governor, Cent. Bank of Norway, Dinner Speech at the Conference for Investing for Future: Ethics and the Government Pension Fund–Global (Jan. 16, 2008); Kristin Halvorsen, *Norway’s Sovereign Fund Sets an Ethical Example*, FIN. TIMES (London), Feb. 15, 2008, at 9.

114. NORGES BANK INVESTMENT MANAGEMENT, *supra* note 113, at 41.

115. *Id.* at 40.

116. Timothy Geithner, President & CEO, Fed. Reserve Bank of New York, Remarks at the Economic Club of New York: Reducing Systemic Risk in a Dynamic Financial System (June 9, 2008) [hereinafter Geithner Remarks].

117. McCreevy Speech, *supra* note 3.

118. *Id.*; see also Volcker, *supra* note 7.

119. Barbara S. Romsek & Melvin J. Dubnick, *Accountability in the Public Sector: Lessons from the Challenger Tragedy*, 47 PUB. ADMIN. REV. 227 (1987); for application of accountability model to corporate sector, see Melvin J. Dubnick, *Sarbanes-Oxley and the Search for Accountable Corporate Governance*, in PRIVATE EQUITY,

In the United States—the epicenter of the crisis—formal legal changes to corporate governance practices in the Sarbanes-Oxley Act of 2002, passed in the immediate aftermath of the Enron and related financial reporting scandals, offered little more than symbolic reassurance.<sup>120</sup> Homogenous application of risk management procedures to attest internal controls—mandated under section 404 of the Act—discounted application of critical thinking within both the corporation and the provider of external audit services.<sup>121</sup> At a broader level, a profound miscalculation of risk salience resulted in suboptimal regulatory oversight. Deepening market integration ensured that risk, while diversified geographically, remained undiluted. From northern Norway to rural New South Wales, local councils bought securitized products on the basis of misplaced trust in the efficacy of internal controls, the strength of independent directors to hold management to account, the attestation provided by external auditors, legal due diligence, the assurances of those providing corporate advisory services (including inherently conflicted rating agencies), and, ultimately, the robustness of the overarching regulatory system.

The very fact that the crisis metastasized so quickly across regulatory systems is exceptionally revealing. The moral hazard can be traced to regulatory incoherence in both rules and enabling regimes. The President of the Federal Reserve Bank of New York has conceded the U.S. regulatory system “has evolved into a confusing mix of diffused accountability, regulatory competition, an enormously complex web of rules that create perverse incentives and leave huge opportunities for arbitrage and evasion, and creates the risk of large gaps in our knowledge and authority.”<sup>122</sup> Moreover, the allegedly superior

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CORPORATE GOVERNANCE AND THE DYNAMICS OF CAPITAL MARKET REGULATION 265, 284-88 (Justin O'Brien, ed., Imperial College Press 2007) [hereinafter *Sarbanes-Oxley*].

120. MURRAY EDELMAN, *THE SYMBOLIC USES OF POLITICS* (Univ. of Illinois Press 1967); for application of “symbolic lens” to Sarbanes-Oxley, see JUSTIN O'BRIEN, *REDESIGNING FINANCIAL REGULATION: THE POLITICS OF ENFORCEMENT* (2007); *Sarbanes-Oxley*, *supra* note 119.

121. See Dell'Ariccia, *supra* note 2, at 4, 11-12 (suggesting that “aggressive” lending at precisely the most vulnerable part of the market was a critical amplifier. Paradoxically, lending standards on prime applications simultaneously tightened, exacerbating a herding dynamic towards “gambling on speculative borrowers”). For a persuasive analysis that suggests “a large chunk of money has effectively been recycled to a developing economy [of the poorest and least creditworthy borrowers] that exists within the United States own borders,” see Carmen M. Reinhart and Kenneth S. Rogoff, *Is the 2007 US Sub-Prime Financial Crisis So Different? An International Historical Comparison* (Nat'l Bureau of Econ. Research, Working Paper No. 13761, 2008), available at [http://www.economics.harvard.edu/faculty/rogooff/files/Is\\_The\\_US\\_Subprime\\_Crisis\\_So\\_Different.pdf](http://www.economics.harvard.edu/faculty/rogooff/files/Is_The_US_Subprime_Crisis_So_Different.pdf). On gambling impulses within investment banking, see KEVIN PHILLIPS, *BAD MONEY: RECKLESS FINANCE, FAILED POLITICS, AND THE GLOBAL CRISIS OF AMERICAN CAPITALISMS* 19-22 (Penguin Group 2008); SUSAN STRANGE, *MAD MONEY* (Manchester Univ. Press 1998); CHARLES P. KINDLEBERGER, *MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES* (4th ed. 2000). For managerial failings, see MICHAEL POWER, *ORGANIZED UNCERTAINTY: DESIGNING A WORLD OR RISK MANAGEMENT* 9 (Oxford Univ. Press 2007). For empirical examples drawn from the millennium stock market analyst conflicts of interest, see *Charting an Icarian Flightpath*, *supra* note 30. For more recent examples, see David Gauthier-Villars, *The Buzz Behind a Trading Scandal*, WALL ST. J., May 24, 2008, at B3 (quoting the conclusion of an internal investigation into a recent multi-billion dollar trading scandal at French Bank Societe Generale that “despite numerous alerts, which provided grounds for vigilance of investigation, the supervision . . . failed.”); Amir Efrati, *Are Borrowers Free to Lie?*, WALL ST. J., May 31, 2008, at B2 (citing the holding of *Nat'l City Bank v. Hill*, 2008 LEXIS 1668 (Bankr. N.D. Cal. May 23, 2008) that lenders had a prudential obligation to vet the representation of borrowers); see generally, *Barbarians at the Vault: A Special Report on International Banking*, ECONOMIST (London), 16 May 2008, at 1-18, available at [http://www.economist.com/opinion/displaystory.cfm?story\\_id=11376185](http://www.economist.com/opinion/displaystory.cfm?story_id=11376185).

122. Geithner Remarks, *supra* note 116.



responsive principles-based regulatory regime in the United Kingdom proved equally defective in securing more than mechanistic (and ultimately valueless) compliance.<sup>123</sup>

Despite two decades of corporate governance reform instituted, in the aftermath of scandal, we are no closer to finding a moderating mechanism. Instead, the deleterious effects of a dysfunctional system that allows for private profits and socialized risk have emerged into clear view. Irrespective of the dimension, accountability proved elusive because of essentially ideographic and therefore incommensurable representations of what fealty to the concept entails. The problem intensifies as one cascades through the mechanisms used to measure accountability performance, such as transparency, responsibility, and responsiveness.<sup>124</sup>

The scale of the crisis has produced a paradigmatic tipping point. The unprecedented nature of central bank intervention mirrors the admission by the chair of the most influential lobby group in investment banking that he "no longer believe[s] in the market's self-healing power."<sup>125</sup> While it may be inopportune to engage in structural reform in the midst of a crisis,<sup>126</sup> it is clear that the normative advantages of embedding a corporate form of "associational democracy" without reference or subservience to wider societal goals have been falsified.<sup>127</sup> At a more fundamental level, the restraining power associated with enhanced transparency within and between each accountability dimension has also been eroded.<sup>128</sup> The securitization of risk was, after all, perfectly legal: the risks were disclosed but discounted by allegedly sophisticated investors, who, in the main, jettisoned reason in the search for yield. A more appropriate and integrated response is to enhance the narrative basis of accountability based on an agonistic understanding of what business integrity means in practice. To be effective, this approach needs to transcend the desultory reality of the much vaunted but now partially discredited "comply or explain" model of financial reporting advanced by the United Kingdom.<sup>129</sup> This task is not as impossible

123. For a critique suggesting that the rules versus principles dichotomy is overstated, see David Kershaw, *Evading Enron: Taking Principles Too Seriously in Accounting Regulation*, 68 MOD. L. REV. 594 (2005).

124. Mark Bovens, *Two Concepts of Accountability* (Presented at Kettering Symposium on Public Accountability, Dayton, OH, May 22-24, 2008), <http://www2.ku.edu/~kupa/kettering/pdfs/Bovens.pdf>.

125. Jeff Randall, *When the Going Gets Tough, Banks Yelp for Nanny*, DAILY TELEGRAPH, Mar. 26, 2008, <http://www.telegraph.co.uk/finance/comment/jeffrandall/2786970/When-the-going-gets-tough,-banks-yelp-for-nanny.html>.

126. For a description of major structural changes outlined by the U.S. Department of Treasury, see Press Release, U.S. Dep't of Treasury, Remarks by Secretary Henry M. Paulson, Jr. on Blueprint for Regulatory Reform (Mar. 31, 2008). This approach has been criticized by a leading New York investment banker as akin to "re-arranging the deckchairs on the Titanic." Interview with Investment Banker, New York (Apr. 21, 2008).

127. The strategic imperative governing contemporary regulatory design takes as a starting point the failure of 'command and control' as an ordering mechanism. Despite multiple examples of failure, across a range of regulatory settings, 'associational governance' remains proffered as a normative and practical improvement. For original formulation, see WOLFGANG STREECK & PHILIPPE SCHMITTER, *Community, Market, State—and Associations*, in PRIVATE INTEREST GOVERNMENT: BEYOND MARKET AND STATE 1-29 (Sage Publication 1985); IAN AYRE & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (Oxford Univ. Press 1992); CHRISTINE PARKER, *THE OPEN CORPORATION: EFFECTIVE SELF REGULATION AND DEMOCRACY* (Cambridge Univ. Press 2002); see generally, Power, *supra* note 121, at 36-42.

128. For application to US financial market regulation, see *Charting an Icarian Flightpath*, *supra* note 30.

129. See Kershaw, *supra* note 123.

as it may appear. A useful precedent can be found in the indirect ways in which private equity was persuaded to enhance its accountability.

The transformative potential (and risk) of private equity occurs at a number of levels. The involvement of existing management in private equity bids creates intractable conflicts of interest. The processes through which initial exit is managed raise difficult questions about the efficacy of existing rules governing control transactions. The narrow focus on financial performance, alongside the shortened timeframes in which ownership is exercised, may produce short-term gains but negatively impact on the longer-term sustainability of the enterprise and its relationship with key internal and external stakeholders. Paradoxically, the primary virtue associated with private equity, namely its capacity to evade the public disclosure regime, ultimately became its Achilles Heel. It made the industry particularly vulnerable to critiques based on transparency and accountability deficiencies.

While opacity is common to many alternative investment vehicles, private equity has a very public face. Moreover, the extent to which iconic (and profitable) corporations were being de-listed and restructured had an immediate market as well as socio-political impact. In such circumstances, stonewalling by the industry was simply untenable. As the industry-sponsored review into its operations in the United Kingdom acknowledged: "The context for this enquiry is that a position that full disclosures and reporting to limited partners, the ultimate owners of private equity, are alone sufficient is no longer politically and otherwise sustainable, at least in respect of the largest portfolio companies."<sup>130</sup> According to the review, the only way to reduce contestation was to attend to the interlocking needs of legitimacy and authority. As Walker maintains:

the source of business legitimacy is economic success, and the means of maintaining the undisturbed authority of business and business leaders is by clear and continuous demonstration of that success. On this approach, the legitimacy of authority, importantly including that of the leaders of private equity, is likely to be easiest to defend in a competitive market—where commercial success and the authority and rewards that go with it are the direct result of demonstrable superiority in meeting consumer needs.<sup>131</sup>

In order to achieve this legitimacy, the Walker Guidelines maintain that attention to integrity dimension is crucial.

What is meant by decency and integrity is more substantive than conformity with contractual provision or the law: it relates to a set of principles and values that cannot be encapsulated in a detailed set of rules. Standards of conduct are contagious, and any degree of malpractice in a particular business situation can have a negative effect on general expectations of what is and what is not normal business conduct and weaken the legitimacy of corporate structures as a whole.<sup>132</sup>

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130. David Walker, *Guidelines for Disclosure and Transparency in Private Equity* 40 (Walker Working Group 2007), [http://walkerworkinggroup.com/sites/10051/files/wwg\\_report\\_final.pdf](http://walkerworkinggroup.com/sites/10051/files/wwg_report_final.pdf)

131. *Id.* at 41.

132. *Id.*

Walker goes further, however, by attending to the controversial question of whether implicit contracts (determined by context) require attention:

[T]he effective mechanism of enforcement of such implicit contracts is not legal process but the requirements of the parties to go on doing business together. . . . This does not of course mean that implicit contracts are merely what all stakeholders would like them to be. . . . But it does mean that reasonable expectations as to behaviour in matters such as appropriate communication, including its style and timeliness, should not be disappointed.<sup>133</sup>

A similar dynamic is now facing the SWFs. Indeed it is in the sector's interest to take a much more active approach in overseeing portfolio corporations, if only to safeguard their investment. Misguided reliance on the bureaucratic, legal, and political domains in developed markets has demonstrated that need all too clearly. The critical question is how to generate the leverage to ensure that the codes of conduct gain widespread adoption. Here the omens are not auspicious. Brazil, for example, is setting up its SWF with no input to or from the discussions now taking place at the IMF in Washington. Moreover, despite a communiqué from the OECD to accompany a ministerial meeting in June highlighting support for the IMF discussions and the need for recipient countries to implement a code of practice governing investment principles, there is no formal coordination between the working groups in Washington and Paris. Such an approach is not only misguided, it is likely to preordain conflict.

## V. Conclusion

There are a number of sound policy reasons to request greater disclosure from SWFs. Firstly, greater disclosure could provide an early warning system of volatile build-ups of capital within particular sectors. Secondly, greater oversight reduces the potential of sudden capital withdrawals causing or amplifying financial crises. Thirdly, it serves broader public aims, including an increased hope for transparency in overarching domestic fiscal policy. Fourthly, requiring SWFs to render explicit their investment strategies reduces the perception that foreign policy objectives trump commercial ones. This judgment, however, is a subjective one, which, if applied, could intensify rather than ameliorate tension. The critical but as yet unresolved policy question that remains, therefore, is how to ensure compliance to a substantive code that has the potential to deliver meaningful transparency and accountability. Success in this endeavor can only be vouchsafed if clarification extends to foreign investment review processes that guarantee commitment to long-standing principles governing equity of treatment. Notwithstanding tentative agreement in Santiago, resolution of political contestation requires that adequate attention is placed on this dimension of the equation. There is, however, an unacceptable degree of ambiguity in the proposals emanating from Brussels, Washington, and Canberra. Each maintains political discretion over ill-defined "strategic interests."

At a more fundamental level, the crisis in global markets requires an acceptance by recipient countries that financial liberalization has generated players more adroit at playing global markets. This is not to suggest that power has migrated fully; rather it is to

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133. *Id.*

argue that saving Wall Street requires cognizance of the limitations of pursuing a losing geo-political and economic strategy. The forced expansion of financial liberalization in the 1980s and 1990s through the conditionality criteria associated with the Washington Consensus did much to undermine the authority of global institutions such as the IMF and the OECD. How they respond to the issues raised by the transfer of capital from south to north and east to west will determine not only their own legitimacy and authority but also the capacity to engender stabilization.

The search for accountability is therefore a symbiotic process that requires careful sequencing. SWFs need to address deficiencies in their own governance. How the sector responds will speak volumes about commitment to the principles of free trade or narrow mercantile capitalism. As Daniel Cohen has perceptively observed, "the principal problem with . . . globalization is that it does not keep its promises. . . . It creates an image of new closeness between nations that is only virtual, not real."<sup>134</sup> If, however, proposals to regulate SWFs are used merely as a cover for a nascent protectionism, the cause of financial liberalization will be set back. Much more problematically, the opportunity to ameliorate what Joseph Schumpeter famously described as the "creative destruction" of capitalism will have been squandered. In such a scenario, both lender and recipient will be egregiously impoverished.

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134. DANIEL COHEN, *GLOBALIZATION AND ITS ENEMIES* 165-66 (MIT Press 2007).

