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Sovereign Wealth Fund Investment in the U.S. – Six Months Later

Since our December 2007 memo, "[Sovereign Wealth Fund Investments in the U.S. – Just Warming Up?](#)", sovereign wealth funds (SWFs) have continued to grow in size and number and have continued to attract substantial political and media attention. A number of major new SWFs have been announced, including Russia's \$32B National Wealth Fund, Saudi Arabia's \$5.3B arm of its Public Investment Fund and Chile's planned \$6B fund. Several nations, including Japan, Brazil, Taiwan and India, are reported to be seriously considering launching their own SWFs. And for a brief period at the end of 2007 and into the opening weeks of 2008, the level of SWF investment activity reached new heights, particularly the large, much-needed capital infusions by SWFs into major financial institutions such as Citigroup, Merrill Lynch, UBS and Morgan Stanley. These investments were lauded for their speed and size, and notable for their nearly "no strings attached" (meaning no- or low-governance) approach. SWF investment in the U.S. appeared poised to take off. But, surprisingly, there has been only one significant direct SWF investment in the U.S. since the end of January.

A number of reasons for the slowdown have been suggested, but one that has been voiced with increasing regularity in recent weeks is that the uncertain political receptivity to SWF investments and heightened regulatory activity have chilled SWF interest in the U.S. by increasing the risks and costs of investment. Over the past several months, politicians and regulators in the U.S. and Europe have engaged in a variety of public activities – holding hearings, promoting legislation, pressing for voluntary codes of conduct – in search of a balanced regulatory approach that remains encouraging of foreign investment while addressing perceived risks – real or imagined – of SWF activity. Unfortunately, these activities appear to have created significant concern among several SWFs that the U.S. and some other nations are less than fully welcoming of their investments. In recent weeks, many in the U.S., from members of Congress to prominent business leaders, have expressed sympathy for this view and have argued that the U.S. must not allow political and regulatory efforts to inadvertently drive the SWFs away from U.S. investment.

U.S. and European regulators see their efforts as mild and reasonable – intended to ensure minimal standards of transparency and independence from political and other non-economic motivations – and not inconsistent with an overall encouragement of foreign investment. They have, for the most part, focused on voluntary codes of conduct, rather than mandatory legislation, as the appropriate approach for addressing perceived concerns without at the same time stoking protectionist impulses or pushing the SWFs to invest elsewhere (for a comparison of U.S. and E.U. regulatory responses, [see our May 2008 commentary](#)). U.S. Treasury Secretary Paulson has pressed for these voluntary codes, with some success. In March, he announced an agreement with the governments of Singapore and Abu Dhabi and two of their SWFs on policy principles for SWFs and countries receiving SWF investment. The Treasury Department continues to work with the OECD, the IMF and the EU to reach similar agreements with respect to other nations and their SWFs. Separately, in April the Treasury Department proposed regulations relating to the CFIUS (Committee on Foreign Investment in the United States) review process. The proposals would confirm that even investments involving less than 10% of the equity of the U.S. company may be subject to CFIUS review if control or other non-investment purposes are present (for more information [see our April 24, 2008 memo](#)), meaning that there is no automatic safe-harbor for such sub-10% investments.

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Despite the willingness of some SWFs to cooperate with limited conduct codes, SWFs generally believe the political concerns about SWFs to be unfounded, and many have pushed back against calls for formal regulation or overreaching voluntary codes of conduct. They have been vocal in their own defense, laboring to convince the public that SWFs exist to pursue economic returns (as opposed to political or strategic objectives) and that they rarely seek control. They emphasize that their stable, low “flight-risk” capital base, lack of leverage and long-term investment horizon makes them extremely valuable and somewhat unique as sources of capital, and distinguishes them significantly from other capital sources that may be much shorter-term in focus or less dependable in rocky markets. And they stress the need for fairness on both sides of the regulatory equation by calling for transparent, even-handed treatment by recipient countries; questioning, for example, why SWFs should be viewed differently than other non-regulated investors, such as hedge funds.

Earlier this month we participated, along with a number of senior Chinese government officials and leaders of Chinese business corporations, investment funds and banks, in a well-attended global cross-border investment and merger and acquisition conference, sponsored by Peking University, Cambridge University and New York University, in Beijing. It was made explicitly clear at this conference that the Chinese are still rankled by the treatment of CNOOC’s attempt to negotiate an acquisition of Unocal, and that investment and cross-border merger relations between China and the U.S. will not be normalized until the Chinese are convinced that they will not face a repetition of the highly politicized U.S. response to CNOOC’s efforts. If the U.S. wants to encourage and gain the benefits of major Chinese investments, mere words of assurance will not suffice; it will require real U.S. political receptivity of future Chinese acquisition transactions.

The sheer size of the SWFs and volume of dollar-denominated commodity and trade wealth held by a multitude of countries, together with the evident need for capital in several sectors of the U.S. economy, would suggest that SWFs should continue to be a major force in U.S. and global M&A and investment activity. But how to break the logjam? SWFs and companies considering investments should recognize that despite surface-level protectionist and regulatory activities, the U.S. remains highly open to and welcoming of SWF investment and, if anything, officials are anxious to prove this openness. The trick will be developing a track record of investments that work for the SWF investors, investee companies and their countries. As this track record develops, the political fears and concerns – on all sides – that appear to be currently dampening SWF investment should recede. Cooperative investing approaches, such as partnering with Western private equity firms and asset managers (rather than direct investment in operating companies), and continued experimentation with no-control, low-influence structures (as has been seen in Europe in recent months) may have a positive impact, as well. For those SWF transactions that do get to the negotiation phase, the critical issues will continue to include designing the appropriate type of security, assessing the need for lock-ups and standstills, structuring post-investment governance rights, addressing enforceability and jurisdictional aspects, and obtaining – or structuring around – shareholder approval.

Adam Emmerich
Mark Gordon
Sabastian V. Niles