REASSESSING THE THREAT OF SOVEREIGN WEALTH FUNDS

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PRELIMINARY AND INCOMPLETE DRAFT. DO NOT CITE OR CIRCULATE.

This Article offers a markedly more skeptical account of sovereign wealth funds than is currently prevalent in the academic literature. Sovereign wealth funds ("SWFs") are investment funds owned and managed by national governments. The tension between these funds' nationalist and investment interests is well understood and extensively addressed in that literature and in the current (sparse) regulations governing SWFs in the United States and elsewhere. But the prior scholarship only partially grasps the potential threats posed by SWFs, offering an unduly constrained portrait of the types of harms they might generate. Virtually all of the articles addressing how SWFs might pursue nationalist agendas through their investment power conceptualize these funds as business owners who may exploit their holdings in particular businesses to nationalist ends. Thus, the literature and the accompanying regulatory regimes address questions like whether SWFs might purchase significant interests in companies with national security implications, or use their ownership stakes to pressure companies to disclose trade secrets, or encourage investees to divert company resources to sponsoring countries, like choosing to build a factory in country X because country X's fund is an investor. These concerns are legitimate but they are only part of the story.

SWFs may also pose unique threats not just as owners, but as market participants that can engage in market and price manipulation, insider trading, divestment campaigns, and other market-focused activities that can pose a direct threat to markets themselves. To illustrate these threats, this Article considers some real world examples, and also entertains some hypotheticals ranging from admittedly quite extreme and low probability scenarios (like the potential for a SWF to trigger a market panic like the "flash crash") to more realistic if mundane scenarios (like political event-driven insider trading). Of course, there are reasons for SWFs to avoid these activities too. We offer some evidence that market-targeted conduct is already taking place, though it is difficult to say how widespread it is. We also think there is reason to believe that it will get worse over time.

Having demonstrated the possibility of this threat from SWFs, this Article then demonstrates that the current legal and regulatory regime is unprepared to deal with it. There are few, if any, mechanisms internal to current securities law or regulation that can cope with this type of problem. The Article then identifies some frameworks for assessing the regulation of SWFs in an attempt to calibrate regulation to the threats identified. Of course, potential regulatory reforms come with costs of their own, costs that might outweigh their benefits, depending upon how one assesses the benefits of SWFs and the scope of the threats outlined here.

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INTRODUCTION

"In the old days, you built armies. Now, you build a sovereign wealth fund."—Jayne Bok, head of sovereign advisory in Asia for Towers Watson, Dec. 22, 2015, THE WALL STREET JOURNAL.

In December 2013, Russia's sovereign wealth fund, the National Welfare Fund, made a substantial investment in Russia's neighbor, Ukraine.[2] The fund purchased a two-year, $3 billion Eurobond from Ukraine with a maturation date of December 20, 2015.[3] On its face, the purchase was a bad deal for the Russian SWF. The interest rate on the bond was just 5%, half of what Ukraine was then paying on the market.[4] The market had forced Ukraine to pay such high interest because the country's economy was unstable, making it a credit risk. So why was the Russian sovereign wealth fund willing to make a massive investment in Ukraine at an unattractive interest rate at a time when Ukraine was vulnerable? The answer is because this was not an "investment" at all. In fact, if anything, Russia's hope was that the investment might fail, a hope that makes no sense for any type of investor other than a sovereign wealth fund pursuing political—and not investment—objectives.

The fund's purchase of the note was part of a larger $15 billion aid package negotiated between Russian President Vladimir Putin and his Ukrainian counterpart, Viktor Yanukovych.[5] As one commentator noted: "The loan was described by Russia as 'generous help to a brotherly

[2] http://www.reuters.com/article/us-russia-ukraine-bond-idUSBRE9BM0A120131223; http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question

[3] http://www.reuters.com/article/us-russia-ukraine-bond-idUSBRE9BM0A120131223 ("The non-tradeable Eurobond matures in two years and has a coupon of 5 percent."); http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question

[4] http://www.reuters.com/article/us-russia-ukraine-bond-idUSBRE9BM0A120131223

[5] http://www.nytimes.com/2013/12/18/world/europe/russia-offers-ukraine-financial-lifeline.html?_r=0 ("Russia would come to the rescue of its financially troubled neighbor, providing $15 billion in loans and a steep discount on natural gas prices.").

nation', but was viewed by almost everybody else as a bribe for Yanukovych to turn away from the E[uropean] U[nion]."[6] At the time, a struggling Ukraine was being pulled both west, to either symbolically join the EU, and east, to side with Russia and join the Customs Union.[7] Yanukovych did turn away from the European Union ("EU"), so far away that, two months after signing the deal with Putin, he abandoned the Ukrainian presidency and fled into exile in Russia under the threat of massive, pro-EU protests in Ukraine.[8] These protests were triggered by the deal Yanukovych had struck with Putin, among other things.[9]

Reading the fine print of the Russian sovereign wealth fund's purchase of the Ukrainian Eurobond reveals that, while it might have been economically generous to Ukraine, it was legally quite onerous and punitive in the event of default. The deal had several unusual features. First, loans between sovereigns are at least nominally supposed to be subject to negotiation under the Paris Club[10] rules, which involve direct negotiations between the parties in the event of a potential default, and set forth agreed upon rules for restructuring a country's debt. (Russia is a signatory to these rules).[11] But this loan was created by a special transaction in which the Ukrainian government issued a bond governed by English law through the Irish Stock

[6] To Pay or Not to Pay Article, http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question ; *see also* http://www.nytimes.com/2013/12/18/world/europe/russia-offers-ukraine-financial-lifeline.html?_r=0 ("Mr. Putin seemed to gain the upper hand over Europe and the United States in their contest for Ukraine . . . "); *see also* http://www.economist.com/blogs/freeexchange/2015/09/what-ukraine-owes-russia ("The bond was essentially a bribe to Viktor Yanukovych, Ukraine's now-ousted president, who was dithering between European and Eurasian integration.")

[7] http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question ;http://www.theguardian.com/world/2013/nov/20/ukraine-eu-association-agreement-europe-russia

[8] http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question ;http://www.reuters.com/article/us-ukraine-crisis-debt-russia-idUSKBN0UF1QT20160101 ("The bond was issued just two months before Yanukovich fled in the in the face of bloody street protests triggered by his seeking to halt Ukraine's swing toward European integration in favor of closer economic ties with Russia.").

[9] http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question ;http://www.nytimes.com/2013/12/18/world/europe/russia-offers-ukraine-financial-lifeline.html ("[T]housands of demonstrators remain encamped in Independence square, protesting [Ukraine's] failure to sign political and free-trade accords with Europe.").

[10] The Paris Club is an "informal group of official creditors that provides debt relief to low-income countries condition on strong economic performance." http://www.cfr.org/europe/paris-club-europe/p33671

[11] http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question

Exchange.[12] The bond was then purchased by the Russian SWF. This created some legal ambiguity as to whether the bond was privately enforceable or an official sector loan. (Ultimately, the International Monetary Fund would agree with Russia that this loan constituted a sovereign loan from Russia itself, and not a private loan. The ambiguity about its legal status as sovereign versus private may have lulled the Ukrainians into agreeing to it in the first place, since sovereign debts must be paid in their entirety before an IMF bailout. Private debts do not).[13] Second, the bond was callable immediately if Ukraine's debt-to-GDP ratio exceeded 60%, a provision *The Economist* called "bizarre".[14] It was 40% at the time the deal was struck, and commentators instantly projected it to breach the threshold within the loan term.[15] Given that bonds typically have cross-default provisions, Russia's ability to call the bond early could trigger default provisions on all of Ukraine's remaining outstanding debt, $21 billion in total.[16] Third, the Russian-held Eurobond lacked an aggregation clause. Ordinarily, aggregation clauses require that voting on any deal to restructure a debt be on the debt in total, and not on each particular issuance of debt. Thus, even if Ukraine's creditors overall voted to restructure Ukraine's debt, that vote would arguably not apply to, or be enforceable against, Russia's Eurobond. Thus, Russia could trigger everyone else's debt, but everyone else could not necessarily vote to "cram down" Russia's debt, even as part of a larger agreement. If this investment failed, which it did, it would give Russia enormous financial leverage over Ukraine's other creditors and Ukraine itself.

[12] http://www.economist.com/blogs/freeexchange/2015/09/what-ukraine-owes-russia ("The bond was arranged by Western law firms (including White & Case and Clifford Chance) and is listed on the Irish stock exchange."). http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question

[13] Kenneth Rapoza, "IMF Says Russia Right About Ukraine $3 Billion Loan," Forbes, Dec. 16, 2015.

[14] http://www.economist.com/blogs/freeexchange/2015/09/what-ukraine-owes-russia ("A bizarre clause in the bond says that if Ukraine's debt-to GDP ratio exceeds 60%, Russia can demand early repayment . . ."); *see also* http://www.reuters.com/article/us-ukraine-crisis-eurobonds-analysis-idUSKCN0HJ1E120140924

[15] http://www.economist.com/blogs/freeexchange/2015/09/what-ukraine-owes-russia; http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question

[16] http://www.economist.com/blogs/freeexchange/2015/09/what-ukraine-owes-russia; http://neweasterneurope.eu/articles-and-commentary/1704-to-pay-or-not-to-pay-that-is-the-question

In 2014, not long after consummation of the above transaction, armed forces of the Russian Federation invaded Ukraine, although the exact date of that invasion remains disputed.[17] Russian forces seized two Ukrainian provinces, the Donbass (the industrial heart of the country) and the Crimea (which was subsequently annexed).[18] That invasion had many economic, political, and humanitarian consequences, but for purposes of this Article, we will focus only on its economic consequences. The invasion immediately triggered a financial crisis in Ukraine.[19] By the end of 2014, the country's debt-to-GDP ratio had hit 71.5%, both because of the war and, in particular, because of the loss of the Donbass.[20] The debt-to-GDP ratio was projected to hit 95% by the end of 2015.[21]

Facing this financial crisis, Ukraine turned to the International Monetary Fund seeking as much as $40 billion in aid.[22] Following standard IMF procedure, a country applying for assistance must make structural reforms to its economy, including renegotiating its debt with private creditors. Ukraine began this process and partially succeeded in renegotiating its debt with one creditor, the Franklin Templeton fund.[23] But this is where the Russian SWF's investment in the Ukrainian Eurobond demonstrated its true, intended payoff, which was not an investment-driven payoff. As noted, under the terms of the Eurobond, Russia could immediately demand that Ukraine repay the $3 billion loan if Ukraine exceeded the 60% debt-to GDP

[17] http://www.worldaffairsjournal.org/article/ukraine-invasion-one-year-later

[18] Id.

[19] http://www.businessinsider.com/ukraine-is-on-the-brink-of-total-economic-collapse-2014-9

[20] http://www.wsj.com/articles/ukraine-debt-ratio-breaches-eurobond-terms-with-russia-1425330261

[21] http://www.osw.waw.pl/en/publikacje/osw-commentary/2015-08-05/ukraine-financial-front-problem-ukraines-foreign-public-debt

[22] http://www.wsj.com/articles/SB10001424052702304709904579408990399518818

[23] http://www.reuters.com/article/us-ukraine-crisis-debt-idUSKCN0T12FT20151112 ("Ukraine's other bondholders, led by Franklin Templeton, accepted a 20 percent principal writedown, a coupon increase to 7.75 percent, a four-year maturity extension and GDP warrants – additional annual payments linked to Ukraine's future economic growth.").

threshold, never mind the fact that Russia triggered the breach itself by invading the country.[24] Moreover, Russia could trigger a calling of Ukraine's $21 billion in total outstanding debt to private creditors—it itself was arguably one such private creditor, given the Eurobond's unique deal structure.[25] And because there was no aggregation clause in the Eurobond, the Russian SWF was positioned to unilaterally prevent a restructuring of Ukrainian debt, and therefore to hold up IMF aid.[26] As recently as May 17, 2016, Russian Finance Minister Anton Siluanov insisted that the $3 billion debt be repaid in full by Ukraine—otherwise, Russia would veto the IMF's proposed $17.5 billion bailout.[27] By sending in its armed forces, Russia physically seized two Ukrainian provinces. But through its sovereign wealth fund, Russia took Ukraine's economy hostage.

The Russian SWF's purchase of the Ukrainian Eurobond at an interest rate of one-half what Ukraine had previously been paying shows that: (1) the Russian SWF was not purely motivated by investment calculations in extending the loan, or in negotiating its unique provisions; (2) Russia's SWF was coordinating its purchase with the Kremlin as part of Russia's overall aid package to Ukraine; (3) the true purpose of the SWF's investment was not profit motive, but to allow Russia to economically encircle Ukraine, giving Russia the ability to block the IMF or any other institution from extending the country an economic lifeline.[28] Ultimately, Russia would acknowledge that its sovereign wealth fund's purchase of the Ukrainian bond was a

[24] *See supra* FN xx and xx and accompanying information.

[25] *See supra FN* xx and xx and accompanying information.

[26] http://www.reuters.com/article/us-ukraine-crisis-debt-idUSKCN0T12FT20151112 ("A Eurobond held entirely by Russia is included in the 14 sovereign and sovereign-guaranteed bonds Kiev is restructuring, but the Kremlin has refused to participate in the process, arguing the debt has the status of an official loan as opposed to a commercial one.").

[27] "Russia Says No IMF Aid for Ukraine Unless It Pays Its Debt," AP, May 17, 2016.

[28] As an interesting side note, the Ukrainians now claim that the government never received the money, that it left the country with Yanukovych. http://www.economist.com/blogs/freeexchange/2015/09/what-ukraine-owes-russia

governmental act—indeed, it would insist upon this interpretation—so that its debt could be classified as sovereign debt and therefore not reduced under IMF rules.

The Russian fund's Ukrainian loan is an example of a sovereign wealth fund acting not as an investor but as a political tool of its sponsoring nation state. And it is distinct from the usual sets of concerns that get raised about *how* sovereign wealth funds might pursue nationalist objectives. For the most part, concerns about SWFs pursuing nationalist interests conceptualize SWFs as business owners. Conceptualizing such funds as business owners narrows the range of concerns about such funds. Thus, CFIUS exists to regulate investments by foreign entities in companies with national security implications for the United States.[29] Most famously, Dubai Ports World retreated from a purchase that would lead to it managing the ports on the east coast of the United States in the aftermath of 9/11, when there was profound public concern about potential security threats to the country if its ports were under the control of a middle eastern country.[30] Also, SWF investments have raised concerns that SWFs might distort the business decisions of a company in favor of the fund's sponsoring state. An investment by China's SWF in Australia's Rio Tinto, a mining company, raised concerns that the SWF might encourage the company to sell its raw materials to China's industrializing economy rather than maximize price.[31] Similar concerns have been raised that such investments might encourage a company to build a factory in China instead of, for example, Mexico, to please China's SWF, or even to share trade secrets with that investor. All of these are legitimate concerns that have been addressed with varying degrees of depth in the academic literature,[32] if not in regulation.

[29] *See* infra FN xx – xx and accompanying text.

[30] *See* infra FN xx – xx and accompanying text.

[31] http://newsweekly.com.au/article.php?id=3649

[32] *See* infra FN xx – xx and accompanying text.

Russia's purchase of the Ukrainian bond raises a related but still different set of concerns about SWFs. Our argument is that we must also understand SWFs as market participants, not just as owners, capable of distorting markets away from their usual ends, affecting other investors, and having implications at the market level, not just the firm level...

It is true that other types of funds might pose risks that are similar to the risks that we describe here for SWFs. But several features of sovereign wealth funds distinguish them from other investors, heightening the risks they pose. First, as illustrated by the Russian-Ukrainian transaction, SWFs may have strong incentives to depart from value-maximizing investment activity to instead serve the interests of their state sponsors. They may even be willing to deliberately incur losses to advance nationalist ends. Second, unlike all other institutional investors, SWFs do not have liabilities: they do not have legal obligations to their investors, they are not required to maintain high levels of liquidity like mutual funds do, unlike pension funds, they are not legally obligated to provide meet retirement obligations. Third, SWFs are, for the most part, subject to regulation that requires less disclosure than other investment funds. Fourth, the very largest SWFs are massive: between five and ten times the size of the largest hedge funds and private equity funds. Finally, and most obviously, SWFs are the ultimate deep pockets in that they are backed by sovereign governments with the power to tax. This fact alone has led some to describe the rise of SWFs as the "New Mercantilism". Thus, the combination of their size, their distorted investment incentives, their lack of traditional constraints, their comparative secrecy, and their backing by state resources make SWFs more capable of exploiting market weaknesses than other investors. We will illustrate how these features matter throughout the argument.

We view SWF threats as falling into two basic categories: (1) SWF maximizing activity; and (2) SWF sponsor-maximizing activity. SWF maximizing activity includes investment activity designed to enhance returns to the SWF itself. Most SWF-maximizing activity is likely to conform to normal expectations of investment behavior, including unlawful investment behavior. Here, we argue that the usual risks of illegal conduct created by fund-maximizing activity—like insider trading and market manipulation—may be enhanced by SWF size, access to information, and comparative legal unaccountability. But what truly distinguishes SWFs from most other funds is the second category: SWF sponsor-maximizing activity. SWF-sponsor maximizing activity is investment activity that is not designed to increase fund returns but to advance political objectives of the sponsoring state. In particular, the prospect that a SWF might willingly incur losses to advance political goals makes most regulation of investor behavior ill-equipped to deal with SWFs.

Russia's investment in Ukraine falls into this second category. On its face, the Russian fund's Ukrainian investment was a bad one. It paid a low interest rate on a high-risk loan, which Ukraine had trouble repaying in large part because it was militarily attacked by its investor.[33] The investment only becomes comprehensible when we understand that the fund was willing to take a loss to advance the interests of its sponsor. The fact of the deal, its financial terms, but most importantly its unique structure meant that the Russian fund's investment served as an excellent vehicle for giving the fund's sponsor a trump card to play in shaping Ukraine's economic future.[34] The transaction is best understood not as an investment at all, but as something more akin to a diplomatic maneuver. Countries that do not have significant sovereign wealth funds simply do not have the option to exercise economic leverage in this particular form.

We use this framework to assess various market risks posed by SWFs. For example, we assess the risk of market manipulation and "insider trading" under both SWF and sponsor-

[33] *See supra* FN xx – xx and accompanying information.

[34] *See supra* FN xx – xx and accompanying information.

maximizing filters. (We use "insider trading" in quotes because much of this trading would not actually fit the legal definition of insider trading if it is undertaken with the approval of the employer and if it deals with commodities—for which there is no insider trading liability—but it nevertheless has the same effect of insider trading, which is that insiders trade on information they have in advance of the market in ways that can undermine trading). Thus, depending on how close the SWF leader is to the political leadership—and there is good reason to believe that such relationships are quite close in many of the most important SWFs—one can readily imagine opportunities for SWFs to trade on inside information, for example, to trade ahead of changes in oil prices or production, or ahead of political events. In fact, the SEC has already expressed concern about this issue, specifically, the concern that foreign regulatory entities stop cooperating with it on insider trading investigations when that investigation involves the foreign regulator's sovereign wealth fund.[35] One might imagine SWF maximizing activity in terms of market manipulation along similar lines. We use an example of the Singapore SWF's divestment from two Chinese companies. That act of divestment resulted in a sharp drop in the stock price of those companies based on the perception, if not the reality, that the Singapore SWF would have inside information about the Chinese companies it sold.

The second category, sponsor-maximizing activity, allows us to reassess the same conduct just described through a second filter. Returning to Temasek's sale of Chinese companies… such conduct may sometimes hover on the line between SWF and sponsor-maximizing…But it also enables us to consider the magnitude of the potential threats that SWFs pose at the market level, not just the firm level. We admittedly engage in some worst-case-thinking in this paper, in which we imagine what kind of damage a SWF that was committed to

[35] https://www.sec.gov/news/testimony/2008/ts020708lct.htm

disrupting or harming another market could do, if it were willing to take losses. This takes us far away from the standard investment calculus, in which we imagine a world in which investment staff of SWFs might seek out potential harms that could be caused by the SWF to benefit the sponsoring state, rather than the typical investment analyst calculus of maximizing returns to the fund. We recognize that the possibility of such funds acting in this way is low. The point of considering extreme scenarios—and potentially extreme responses to them—is to draw an outer boundary of worst case scenarios for SWFs, and then work backwards from these extemes to more mundane scenarios.

Recognizing the low probability of the following scenario, we illustrate the potential destructive power of such funds by discussing the possibility that a large fund like an SWF could deliberately trigger a market panic like the "Flash Crash of 2010".[36] We similarly demonstrate that the near total inability for either governments or private actors to detect the specific source of significant trading activity means it is highly unlikely that existing regulators could thwart the types of threats we raise here, other than by ex post sanctions, sanctions which come too late or may be insufficient to deter the conduct in the first place.[37] Fundamentally, we ask whether our systems of disclosure backed by ex post sanction is sufficient to address the challenges posed by sovereign wealth funds.[38] We view the threats addressed here to American markets as being vanishingly small in the near term, but think that smaller markets, particularly in states neighboring SWF-sponsoring states, are more vulnerable to such concerns.

As to SWF-maximizing conduct, we similarly demonstrate how powerless regulators are to stop this conduct, as recently expressed by the SEC in concerns about losing cooperation on

[36] *See supra* FN xx – xx and accompanying information.
[37] *See supra* FN xx – xx and accompanying information.
[38] *See supra* FN xx – xx and accompanying information.

international insider trading cases when that requires investigation of the sovereign wealth fund by a sponsoring state's regulator…

Our discussion of SWF behavior inevitably leads to a conversation about whether regulation is appropriate to coping with the threats identified, and if so, how it should be tailored. Here, we introduce a second framework for thinking through the regulatory analysis, in which we assess how particular threats can be addressed at: (1) the international level; (2) the national level; (3) the market level (or exchange level); and (4) the firm level...

One final introductory comment about SWFs…Apart from the prospect of making a value-destroying investment that has political payoffs, there is another noteworthy attribute to these funds: size. The largest SWFs dwarf most other investors. The largest hedge fund in the world has $75 billion in assets. The largest SWF—the Abu Dhabi Investment Authority—is more than ten times as large, with over $750 billion in assets under management.[39] Similarly the major SWFs of Norway, Kuwait, Saudi Arabia and China have almost $600 billion in assets under management each, Qatar has approximately $250 billion in assets.[40] This combination of size and the willingness and ability to take losses distinguishes these funds from other investors.

Finally, we begin to sketch out some potential private sector and regulatory responses to these problems. In so doing, we begin with what we view as an extreme regulatory response—daily disclosure of SWF trading activity to the SEC or some other regulator—and work back from there to more moderate reform possibilities. The extreme proposal remains politically unfeasible in the near term; SWFs will not submit to it. And it appears extreme because it is more onerous than what we require of all other funds currently. Yet, in the U.S., the trend is

[39] http://www.swfinstitute.org/fund-rankings/

[40] http://www.swfinstitute.org/fund-rankings/

towards greater disclosure by private equity funds and hedge funds… Still, it is important to emphasize that the costs of such disclosure are primarily political costs.

One national or international level reform that could substantially mitigate the concerns discussed here—one that would undoubtedly be resisted fiercely by SWFs—would be same-day disclosure of SWF trades to the Financial Stability Oversight Council or the SEC, at least for trades made in the United States or on U.S. markets. This disclosure need not be made public. The sharp resistance to such a reform would likely kill it in the near term, at least in a world in which most of our concerns about SWFs remain conjectural. Still, thinking through the reason for such resistance is itself illustrative of the problem we aim to describe. To the extent that SWF investment activity is fund-maximizing, there can be little concern that such private disclosure would undermine that goal. U.S. financial regulators are experienced in maintaining data confidentiality and in rooting out insider trading in their own ranks. The true impact of such a reform would be to undermine the ability of sovereign-maximizing SWF activity, activity that SWFs themselves almost always deny. Moreover, portfolio monitoring of this type already exists in the private sector, in which private law firms monitor portfolios of massive institutional clients for purposes of identifying losses due to fraud. Its costs—apart from SWF opposition—can be easily exaggerated...

There are many reasons for purpose of applying this multi-tiered analysis, but among the most practical is to aid in answering straightforward questions about juridisction. For example, in the U.S. context, we might use this framework to assess which regulators should be tracking these issues vis-à-vis SWFs? The SEC? The CFTC? The State Department? The Defense Department? The Federal Reserve?…

Part I provides background information about SWFs and the prior literature on SWFs, which has focused primarily on the challenges posed by SWFs as business owners. Part II explores the potential threats posed by SWFs, with particular focus on threats that have not been adequately addressed in the literature, specifically market manipulation, insider trading, and divestment. Part III addresses the current state of SWF regulation, with a particular focus on regulation's inability to address the threats of SWFs. Part IV argues for a robust role for financial regulators and private risk management firms in assessing these threats. Part V discusses potential regulatory reforms to reduce the risk of the behaviors described in Part II. A conclusion follows.

I. Background on Sovereign Wealth Funds

Sovereign wealth funds are special purpose investment funds that are owned and managed by national governments. First created in the 1950's by resource producing countries, sovereign wealth funds gained increasing popularity (and scrutiny) in the early 2000s as they shifted their investment strategy from debt instruments to focus on higher risk equity investments.[41] These funds are most popular in the Middle East, North Africa and Asia.[42] Sovereign wealth funds can serve a number of objectives and thus operate differently than most institutional investors, investing in a wide range of assets such as equities, bonds, private equity, real estate, hedge funds, exchange traded-funds, commodities, etc. These funds can be used to diversify national assets, save for future generations, or to stabilize the domestic economy against volatile commodity prices.[43] Additionally, many claim they can be used for strategic purposes.

[41] Epstein and Rose article – pg. 112 // http://www.nytimes.com/2007/08/21/business/worldbusiness/21wealth.html?_r=1 ("Sovereign wealth funds have been around for decades. The Kuwait General Reserve Fund was established in 1960. The Abu Dhabi Investment Authority was established in the 1970s . . . .").

[42] Bloomberg article (noting "the concentration in Asia, the Middle East and North Africa of 54 percent of all SWFs, accounting for 77 percent of total assets under management")

[43] Congress document

The International Forum of Sovereign Wealth Funds ("IFSWF") declared that sovereign wealth funds were the "fastest growing class of asset owner of the last decade."[44] Growth of sovereign wealth funds has typically been measured by assets under management, but also can be measured in number of funds, or number of deals completed per year. In 2008, sovereign wealth funds were estimated to manage between $2 trillion and $3 trillion in assets.[45] Original estimates predicted that sovereign wealth fund assets would reach $12 trillion by 2012, and possibly even $13.4 trillion by 2018.[46] However, those numbers were scaled back due to the financial crisis. Today, the IFSWF 2014 Annual Report suggests that overall assets under management have "grown about nine-fold from 2002 through 2014"[47] and it is estimated that the number of sovereign wealth funds will increase between 2013-2039 by 61 funds, from 74 to 135.[48] The sovereign wealth funds of the United Arab Emirates, China and Saudi Arabia have approximately $773 billion, $747 billion, and $685 billion of assets under management respectively.[49] Combined, just these three funds hold over $2.2 trillion in assets.[50] The assets under management for the four largest private equity funds pale in comparison. Apollo Global Management, The Blackstone Group, the Carlyle Group, and KKR hold approximately $150 billion, $146 billion, $123 billion, and $98 billion respectively.[51] Combined these four groups, thought to be some of the most powerful investors in the United States market today, hold less in assets than some of the smallest SWFS. CalPERS, the largest public pension fund in the United States, holds roughly $304 billion in assets, only half the size of some SWFs.[52]

[44] 2014 annual report
[45] Epstein and Rose article – pg. 115
[46] Gilson article
[47] IFSWF 2014 annual report
[48] https://globaljournals.org/GJMBR_Volume15/6-Analysis-of-Sovereign-Wealth.pdf
[49] http://www.swfinstitute.org/fund-rankings/
[50] http://www.swfinstitute.org/fund-rankings/
[51] http://www.pionline.com/gallery/20150408/SLIDESHOW2/408009999/7
[52] http://www.swfinstitute.org/fund-rankings/

Historically, SWFs have been passive, or more accurately, they have claimed--with some justification--that they are passive. [DW Note: While I think SWF activity has actually been passive, as part of a very preliminary investigation, I have found a total of 37 13-Ds filed by the top five largest SWFs since 2007, perhaps suggesting that they have been more active than previously expected. I have not yet analyzed these filings]. The primary reason for their passivity has been the reluctance to trigger the very concerns we raise in this paper, specifically, the concern that the funds act as government agents and not independent investors. Regardless of whether they have been passive, there is some evidence that SWFs are becoming more active. First, SWFs have changed their primary asset allocations. The days of SWFs primarily invested in government bonds have faded, and instead SWFs are investing in private equity, financial institutions, and international corporations. In 2008, property advisor CB Richard Ellis predicted that "sovereign wealth funds [would] own up to 20% of global real estate worth $725 billion by 2015," and they were not far off.[53] Both 2013 and 2014 saw a surge of SWF investment in real estate.[54] According to the 2014 IFSWF report, real estate represented 46% of total SWF investment value for 2014.[55] In particular, SWF real estate investments declined in developing nations, while increasing in more stable economies such as the United Kingdom and United States.[56]

Singapore's GIC Private Limited SWF ("GIC") currently holds the title of the largest real estate investment by an SWF with its 2014 $8.1 billion acquisition of Chicago based company, IndCor, which operates industrial properties throughout 29 markets in the United States.[57] GIC

[53] http://www.propertywire.com/news/global-news/sovereign-wealth-funds-global-real-estate-200812152258.html

[54] IFSWF 2014 annual report.

[55] IFSWF 2014 annual report, pg. 16

[56] IFSWF 2014 annual report, pg. 16

[57] IFSWF 2014 annual report, pg. ___, http://www.bloomberg.com/news/articles/2014-12-02/gic-to-buy-blackstone-s-indcor-properties-for-8-1-billion

purchased the company from Blackstone Group LP, who had previously entertained the idea of an initial public offering for the company.[58] For GIC, the deal increased its already substantial estimated real estate holdings, which included office buildings in Tokyo and student housing in Australia.[59] The Sovereign Wealth Fund Institute estimates that GIC manages approximately $320 billion in assets, with 7% of its portfolio invested in real estate.[60]

Another notable 2014 SWF investment was the acquisition of London's Canary Wharf by the Qatar Investment Authority ("QIA") and Canadian investor Brookfield Properties from Songbird.[61] In an attempt to acquire Canary Wharfs, QIA and Brookfield launched a takeover bid of Songbird in which QIA bought a 28.6% stake in the company.[62] While Songbird hoped to find another buyer offering more money, QIA and Brookfield gained support from some of Songbird's largest investors, including Simon Glick, Morgan Stanley and the China Investment Corporation.[63] After QIA and Brookfield attained majority support, Songbird announced in January of 2015 that it would recommend the offer to its smaller investors.[64] The approach taken by QIA and Brookfield is unusually aggressive for SWFs who have avoided active investment in fears of stirring political concerns and is more reminiscent of the mergers and acquisitions takeover market where buyers often buy up toe-holds in companies where they don't expect their advances will be welcome.[65]

Sovereign wealth funds have access to accumulated wealth from foreign nations, and are potential long term investors. Additionally, because they are essentially just accumulated wealth

[58] http://www.bloomberg.com/news/articles/2014-12-02/gic-to-buy-blackstone-s-indcor-properties-for-8-1-billion
[59] http://fortune.com/2014/12/02/blackstone-to-sell-indcor-properties-to-singapores-gic-for-8-1-billion/
[60] http://fortune.com/2014/12/02/blackstone-to-sell-indcor-properties-to-singapores-gic-for-8-1-billion/
[61] http://www.theguardian.com/business/2015/jan/28/canary-wharf-qatar-brookfield-sale-london
[62] http://www.theguardian.com/business/2015/jan/28/canary-wharf-qatar-brookfield-sale-london
[63] http://www.theguardian.com/business/2015/jan/28/canary-wharf-qatar-brookfield-sale-london
[64] http://www.theguardian.com/business/2015/jan/28/canary-wharf-qatar-brookfield-sale-london
[65] IFSWF Annual Report 2014, pg. 18.

pooled into a fund, they are generally liability free. As compared to a hedge fund or pension fund, there are no capital requirements or investor demands that can force them to liquidate positions.[66] As noted above they can invest in almost any asset class, and have generally exercised their right to do so. In spite of this freedom that in many ways makes SWFs ideal investors, it is their ties to their foreign governments that have drawn the suspicion of legal theorists to date.

As sovereign wealth fund investments in the United States began to rise around 2008, a number of news sources began to question the destabilizing effects and political motivations of such investments. There was some fear that sovereign wealth funds could destabilize markets by pushing up prices,[67] or selling assets abruptly,[68] but the primary fear was political. Were SWF investments politically motivated?[69] Would the economic capital and political ties behind SWFs cause them to make investments that were not market oriented and thus provide an opportunity for SWFs to use their monetary capital to gain investment information, such as trade secrets, that other investors don't have access too?[70] This fear was especially pertinent in sensitive industries with direct ties to national security concerns.[71]

These fears brought legal theorists, financial writers and even the Securities and Exchange Commission ("SEC") to the table. The SEC confirmed that the unique position of SWFs, their "power derived from being governmental entities," did create "potential for these powerful market participants to obtain material non-public information, either by virtue of their

[66] Epstein article, pg. 117
[67] http://www.nytimes.com/2007/08/20/business/worldbusiness/20iht-wealth.4.7186699.html
[68] http://www.nytimes.com/2007/08/21/business/worldbusiness/21wealth.html?_r=0
[69] http://www.nytimes.com/2007/08/21/business/worldbusiness/21wealth.html?_r=0
[70] Sovereign Wealth Funds: The New Intersection of Money and Politics by Christopher Balding, pg. 53
[71] Slawotsky article, pg. 1249 ("Due to their affiliations with foreign governments, SWFs are motivated not just by profit, but also by non-financial reasons. Some of these motivations could place the funds at odds with U.S. national security interests.").

financial and governmental powers or by use of those powers, to engage in illegal insider trading using that information."[72] More pertinently, when discussing their reliance on international cooperation, the SEC touched on the inevitable conflict of interest that would arise in the event the SEC or US Government ever needed to conduct an investigation regarding a SWF:

> "Given the inherent difficulties of conducting a cross-border investigation halfway around the world . . . cooperation is essential for our effectiveness and the need for the cooperation is increasing. In the context of sovereign wealth funds, we are concerned that if the government from which we seek assistance is also controlling the entity under investigation, the nature and extent of cooperation could be compromised. Indeed, in other contexts, we have seen less than optimal cooperation when foreign governments have an interest in the issue or person we are investigating."[73]

However the SEC concluded their statement with a promise to investigate the potential issues caused by the growth of SWFs, while noting that SWFs are subject to the federal securities laws and that the disclosure regulations in place, and other institutional checks and balances, were sufficient to protect against potential harms.[74]

Ronald Gilson and Curtis Milhaupt addressed these concerns in their 2008 article, "Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism."[75] Gilson and Milhaupt note that the recent attention to SWFs arises from two factors – "one economic, and the other tied to national regulation."[76] The accumulated wealth of export rich nations, such as China, have created large amounts of capital within nations who are now seeking higher rates of return and greater diversification.[77] In seeking such returns, many foreign nations are looking to the United States, and creating "high-profile, and highly

[72] https://www.sec.gov/news/testimony/2008/ts020708lct.htm
[73] https://www.sec.gov/news/testimony/2008/ts020708lct.htm
[74] https://www.sec.gov/news/testimony/2008/ts020708lct.htm
[75] 60 Stan. L. Rev. 1345 (2008).
[76] Id. Pg. 1347
[77] Id. Pg. 1347-1348 ("Even the Norwegian Government Pension Fund, the most conservative of the sovereign wealth funds, has increased its allocation to equity by half – from 40% to 60% of its portfolio.").

controversial investments."[78] Large controlling investments like the ones detailed above are subject to the review of the Committee on Foreign Investment in the United States ("CFIUS"). CFIUS has the authority to review all pending foreign acquisitions of control in a U.S. company and subsequently to determine if a specific transaction poses a threat to national security. If CFIUS determines that such a threat exists, they recommend to the president that a specific transaction be blocked. Specific industries in the U.S. also prohibit or limit foreign ownership of controlling stakes within their industry, such as the airline industry and the nuclear power industry.[79]

II. Potential Damage

- Event driven insider trading
- Investment/divestment volatility
- Flash crash
- Smaller Examples

Event Driven Insider Trading

[Technically, SWFs trading on political events driven by the sovereign, or on "insider information" do not actually fall under the insider trading definition. This trading is not even illegal. There is no insider trading liability in commodities. But such trading is a threat to other investors, and has the same market effects as insider trading itself…]
[INTRO PARAGRAPH]

Investment/Divestment Volatility

[Norwegian SWF divestment from Israeli companies].

[Luxemburg pensions divest from Israeli banks and companies].

[When Temasek Holdings, the Singaporean SWF, sold two Chinese companies, their investors panicked, figuring that Temasek knew something in advance of the rest of the market…Also, risks of political divestment]

[78] Id. 1348; *see also See also* *http://ebooks.cambridge.org/pdf_viewer.jsf?cid=CBO9780511976834A020&ref=true&pubCode=CUP&urlPrefix=cambridge&productCode=cbo;*

[79] *See* 49 U.S.C. Sec. 40102(a)(15)(C) (airline industry); 42 U.S.C. Sec. 2133(d) (nuclear power industry).

Risks Posed by One Large Trader

While the potential fear discussed in this article may seem far-reaching, the "flash crash" in the U.S. stock market on May 6, 2010 was inadvertently triggered by a single fundamental trader, a mutual fund complex. May 6, 2010 began as a fairly turbulent day for markets due to the European debt crisis, marked by trades that created high volatility and declining liquidity.[80] In slightly more than half an hour, U.S. stock markets dropped 9%, causing $1 trillion in lost market capitalization, much of it attributed to trades by one large fund.[81] Prior to 2:30 PM, the E-Mini S&P 500 futures contracts (the "E-Mini") had experienced a 55% decline from their early morning levels.[82] This rapid decline caused many traders to attempt to sell E-Mini's as a way of hedging existing equity positions. One such trader, a mutual fund complex, initiated an automatic execution algorithm to sell 75,000 E-Mini contracts, valued at approximately $4.1 billion.[83] This program makes trades based on prior trading volume, but does so without regard to price or time.

In the past, automatic trade programs for similar contract sizes had taken more than 5 hours, but on May 6, 2010 the program executed the trades in 20 minutes.[84] Initially, a majority of these contracts were absorbed by high frequency traders ("HFTs") who also began to sell their E-Mini contracts between 2:41 and 2:44 PM.[85] The increase in trades among E-Mini contracts due to the HFTs just served to increase the trades made by the automatic execution program created by the mutual fund complex. The combined effect of the trades by the automatic execution program, HFTs and other traders created a 3% decline in the price of the E-Mini in

[80] SEC Report on 2010 Flash Crash, pg. 1-2.
[81] http://money.cnn.com/2010/05/06/markets/markets_newyork/
[82] SEC Report on 2010 Flash Crash, pg. 1
[83] SEC Report on 2010 Flash Crash, pg. 2
[84] SEC Report on 2010 Flash Crash, pg. 2
[85] SEC Report on 2010 Flash Crash, pg. 3

under four minutes.[86] The price decline caused a decrease in buy demand which led the HFTs to engage in "hot-potato" trading where they began to quickly buy and sell contracts to each other.[87] Ultimately, "between 2:45:13 and 2:45:27, HFTs traded over 27,000 contracts, which accounted for about 49 percent of the total trading volume, while buying only about 200 additional contracts net."[88]

Liquidity in the E-Mini market had essentially vanished, and taken the price of E-Minis down with it.[89] At 2:48:28pm, the Chicago Mercantile Exchange Stop Logic Functionality was triggered which paused trading long enough to allow the sell-side pressure to decrease, buy-side pressure to increase, and liquidity and price of the E-Mini to rise.[90] After trading resumed, the automatic execution program continued to execute trades for approximately 3 minutes.[91]

A second liquidity crisis occurred shortly thereafter in the equities market as automated trading systems paused in response to the sharp price decrease in the E-Mini market.[92] The automated markets are designed to pause when prices are moving beyond certain thresholds to give traders and risk managers time to assess market conditions before trading resumes.[93] According to a report promulgated by the SEC after the crash, such participants had to quickly assess several factors, including the impact on the severe price movements on risk and position limits, the likelihood of their firms being long or short on a certain stock or a certain side of the market, whether their system was capable of handling the high volume of trades and orders that were being processed, and if there was some significant event of which they were not aware

[86] SEC Report on 2010 Flash Crash, pg. 3
[87] SEC Report on 2010 Flash Crash, pg. 3
[88] SEC Report on 2010 Flash Crash, pg. 3
[89] SEC Report on 2010 Flash Crash, pg. 4 ("In the four-and-one-half minutes from 2:41 p.m. through 2:45:27 p.m., prices of the E-Mini had fallen by more than 5% . . . .")
[90] SEC Report on 2010 Flash Crash, pg. 4
[91] SEC Report on 2010 Flash Crash, pg. 4
[92] SEC Report on 2010 Flash Crash, pg. 4
[93] SEC Report on 2010 Flash Crash, pg. 4

causing the price movements.[94] After such assessment, a "significant number withdrew completely from the markets" and others began to trade manually instead of through the automated systems.[95] The sudden decrease in price led to a subsequent decline in liquidity.

High frequency traders and over the counter market makers continued to try to execute trades but faced issues due to the liquidity decline. Once "liquidity completely evaporated in a number of individual securities and ETFs," traders who could find no buy (or sell) interest executed at "irrational prices as low as one penny or as high as $100,000."[96] Between 2:40 p.m. and 3:00 p.m., "over 20,000 trades across more than 300 separate securities, including many ETFs, were executed at prices 60% or more away from their 2:40 p.m. prices."[97] By 3:00 p.m. the market had essentially returned to normal and there were no more major price fluctuations throughout the day. At the close of the equities market on May 6, 2010, the exchanges and FINRA jointly agreed to cancel all trades made between 2:40 p.m. and 3:00 p.m. under the "clearly erroneous" trade rules.[98]

While a number of factors came together to create the 2010 flash crash, including the volatile market, the automated execution program, and the HFTs – the lesson is the same. One large fundamental trader, executing one large sell program, especially one that does not take into account time and price, has the power to severely move markets. And not only the market in which the automated program is in. The original flash crash started in the equities market, but the price movements were so severe that it created a subsequent crash in the equities market. Even if such movement is limited in time, as was the May 6, 2010 crash. In response to the May 6, 2010

[94] SEC Report on 2010 Flash Crash, pg. 4-5.
[95] SEC Report on 2010 Flash Crash, pg. 4
[96] SEC Report on 2010 Flash Crash, pg. 5
[97] SEC Report on 2010 Flash Crash, pg. 6
[98] SEC Report on 2010 Flash Crash, pg. 6

flash crash, the SEC implemented a circuit break program which would "pause trading across the U.S. markets in a security for five minutes if that security has experienced a 10% price change over the preceding five minutes."[99] While this circuit breaker system would be effective at stopping rapid declines in one security, it does still allow for a 5 minute decline (similar to that experienced in the 2010 flash crash) and does not preclude a potential bad actor from targeting multiple securities simultaneously.

Fear of Foreign Acquisitions

[THIS SECTION WILL BE EDITED DOWN AND CAN BE SKIMMED FOR NOW].

There have been several high profile foreign acquisitions, by SWFs and other entities that have raised concerns among United States citizens about foreign investments.

Dubai Ports World Controversy

In spite of an increasing interest in diversified investments by SWFs, there are some investments and business ventures that Congress views as off limits. In February 2006, Dubai Ports World ("DP World"), a state owned Dubai company, announced their proposed acquisition of a Peninsular & Oriental Steam Navigation, a British company that held leases at six major United States seaports. The ports at issue were some of the busiest in the U.S., including ports in New York, Newark, Baltimore and Miami.[100] The sale received approval from both the Committee on Foreign Investment in the United States ("CFIUS") and under the Hart-Scott Rodino Antitrust Improvements Act ("Hart Scott.").[101]

[99] SEC Report on 2010 Flash Crash, pg. 7

[100] http://www.nytimes.com/2006/03/10/politics/10ports.html?pagewanted=all&_r=0

[101] DP Paper by Shoemaker – pg. 4

However, the acquisition faced bipartisan congressional opposition by many who feared port security falling into foreign hands.[102] The House of Representatives attempted to block the lease transfer via any means available, including through a procedural vote or a new CFIUS review.[103] President Bush supported the deal and appealed to both houses in an attempt to avoid a political clash.[104] DP World originally proposed to "segregate" the port operations so that they would be managed separately from the main business.[105] DP World then requested a second step review from CFIUS to further examine any risks to national security.[106] President Bush would have final say over the second review if CFIUS was unable to come to a conclusion.[107]

Prior to receiving the final review from CFIUS, a House of Representatives panel voted 62-2 to prevent any Dubai based firm, including DP World, from taking control of the United States port operations.[108] President Bush vowed to veto such a measure if passed by Congress.[109] On March 9th, 2006, DP World completed the transaction but continued to hold the U.S. ports business separately pending resolution of the controversy.[110] Subsequently on the same day, Dubai Ports indicated that it would divest the U.S. ports leases in the Peninsular deal, in an attempt to preserve "the strong relationship" between the U.S. and the Arab Emirates.[111] In December 2006, DP World sold 100% of its wholly owned subsidiary that controlled the ports leases to AIG Global Investment Group.[112]

[102] http://www.nbcnews.com/id/11604179/ns/us_news-security/t/bush-says-he-remains-supportive-ports-deal/#.Vt-GpDYrK8U /// http://www.wsj.com/articles/SB114071649414581503 - Joe Bidens comments
[103] Id at 5.
[104] http://www.nbcnews.com/id/11604179/ns/us_news-security/t/bush-says-he-remains-supportive-ports-deal/#.Vt-GpDYrK8U
[105] http://www.wsj.com/articles/SB114071649414581503
[106] http://www.nbcnews.com/id/11604179/ns/us_news-security/t/bush-says-he-remains-supportive-ports-deal/#.Vt-GpDYrK8U // http://www.wsj.com/articles/SB114071649414581503 (feb 26th)
[107] see outline of CFIUS review below.
[108] http://www.wsj.com/articles/SB114071649414581503 - March 8th
[109] http://www.wsj.com/articles/SB114071649414581503 - March 8th
[110] http://www.wsj.com/articles/SB114071649414581503
[111] http://www.wsj.com/articles/SB114071649414581503
[112] http://web.dpworld.com/wp-content/uploads/2014/01/11-December-2006-POPNA_PRESS_RELEASE.pdf

Citi and ADIA

In November 2007, Citigroup Inc. publicly announced that it had brokered a deal with the Abu Dhabi Investment Authority (ABIA), a sovereign wealth fund owned by the United Arab Emirates, to sell $7.5 billion worth of Citigroup Equity Units.[113] The investment was important for a capital starved Citigroup at the time, however it still came with limitations. ADIA's ownership would not be worth more than 4.9% of Citigroup's total shares outstanding.[114] Additionally, the investment would not create special rights of ownership, control, management or governance within Citigroup for ADIA, including no right to designate a member of the board of directors.[115] Typically, such a large investment would provide an investor with such rights. This suggests that while there was no outright issue with ADIA's investment, there is concern about foreign SWFs control and involvement with management.

Fast forward one year after ADIA's initial investment, Citigroup had collapsed and subsequently been bailed out. ADIA lost almost its entire $7.5 billion investment.[116] The only remedial route available to ADIA to claim fraudulent misrepresentation and inducement against Citigroup was arbitration.[117] ADIA lost its arbitration in October 2011 and filed a lawsuit in the Southern District of New York in January 2012 asking that the arbitration decision be vacated on the basis of incorrect law.[118] While the details of the case and the outcome are not particularly relevant or interesting, the secrecy involving the case and the arbitration are. The arbitration record was sealed, the original complaint filed by ADIA was sealed, and the ADIA attorneys requested that the federal court sealed.[119] An attorney for ADIA, Peter Calamari, explained that

[113] http://www.reuters.com/article/citi-abudhabi-idINN2643967220071127
[114] http://www.reuters.com/article/citi-abudhabi-idINN2643967220071127
[115] http://www.reuters.com/article/citi-abudhabi-idINN2643967220071127
[116] http://www.bloombergview.com/articles/2012-12-09/citigroup-s-amazing-abu-dhabi-adventure
[117] Id.
[118] Id.
[119] Id.

such secrecy was imperative because ADIA is "a government agency" and the record contains "information about their investment practices . . . . that should not be made public."[120] The full record and the arbitration record are still not publically available.

III. Existing Legal and Regulatory Regime

- Can't track stock movements
- Disclosure Obligations
    - Hart Scott Rodino
    - Williams Act
    - Compliance unenforceable?
- Penalties
- Insider Trading Regulation
- How other countries regulate

Much of the existing literature, as discussed above, indicates that our current regulatory regime is enough to combat any ill effects of ownership interests by sovereign wealth funds.[121] Epstein and Rose suggest that in the event a fund is trying to influence firm-specific behavior other than shareholder wealth maximization there are several safeguards in place to prevent bad acting.[122] First, they suggest the size of a sovereign wealth fund stake would be relatively small compared to other equity holders.[123] In the event the fund acquired greater than 5% stake in the company, the fund would be required to disclose their stake under the existing securities laws.[124] Epstein and Rose then suggest that sovereign wealth funds that invest strategically would be wary of detection of their investments by the American public and thus would not seek such a high stake in a company.[125] But it is exactly that desire not to be detected that is the issue.

[120] Id.
[121] *See also,* Chamalish, Global Investment Regulation and Sovereign Wealth Funds (2012); https://ww3.piie.com/publications/working-papers/currency-undervaluation-and-sovereign-wealth-funds-new-role-world-trade
[122] Epstein and Rose - pg. 123 – 130.
[123] Epstein and Rose - pg. 128
[124] Epstein and Rose - pg. 128
[125] Epstein and Rose - pg. 129

Stock Watch Problem – Detection

[This section describes the near impossibility of determining who owns the stock of any particular company. When a CEO of a publicly held company wants to know who owns the company stock, answering this question is immensely complicated. Highly-skilled professionals with in-depth experience monitoring markets offer “shareholder identification” services that are remarkably primitive. One of the best of these services described for me how they were able to discern that Carl Icahn had taken a substantial position in a company’s stock just because they recognized significant trading movements through particular custodial banks that Icahn favored. This skill is admirable but the very fact that it requires so much skill and guesswork to make these straightforward determinations illustrates the problem.

Sovereign wealth funds that were willing to take losses to advance political ends could easily obtain substantial positions in markets or specific companies while remaining largely undetected. The best way to guard against this problem would be to have real time disclosure of SWF trades. Such disclosure need not be made public, but could be available to regulators].

Securities Laws

Yes, it is true that if a sovereign wealth fund was to acquire larger than a 5% stake in a U.S. company, the existing securities laws requires disclosure of their holdings. The Securities and Exchange act of 1934, as amended by The Williams Act in 1968, specifically requires that any person who directly or indirectly acquires the beneficial ownership of more than five percent of certain classes of equity securities, including those deemed the beneficial owner through security based swaps, must file a statement with the SEC containing certain information within ten days of the acquisition.[126] The exact form filed with the SEC and the information required to be disclosed depends on the motivation of the security holder.

Ordinarily persons fulfilling the above requirements would file a Form 13D with the SEC to alert them of their security holdings. However, under Sec. --- (b), a person may file the shorter Form 13G if they acquired such a position in the ordinary course of his or her business and not with the purpose to effect or influence the control of issuer, or for a transaction having such an effect. Additionally to file such a form the person must be of a type listed in the regulation, including a registered broker or dealer, an insurance or investment company, an employee benefit plan, or in the potential case of a SWF, a non-U.S. institution that is the functional equivalent of the others listed within the statute and has a regulatory scheme substantially comparable to that of the U.S.[127] Sec. ---(c) however does allow filing of a Form 13G for people who acquired the position as long as they have not acquired the securities with a purpose to control or effect change.[128]

Thus the majority of SWFs making controlling investment in U.S. companies are in fact able to file the shorter and less intensive Form 13G.[129] In 2008, it was noted that "[t]o date, individual SWFs have generally declined to acquire a stake large enough to trigger formalized reporting requirements,"[130] but that is no longer the case. For example, a quick SEC Edgar search of Singapore's GIC Private Limited SWF, mentioned above, reveals that they have filed multiple Form 13G's and even the occasional 13D over the last few years.[131]

[126] 15 USC Sec. 78m(d)(1).

[127] https://www.law.cornell.edu/cfr/text/17/240.13d-1

[128] https://www.law.cornell.edu/cfr/text/17/240.13d-1

[129] example: https://www.sec.gov/Archives/edgar/data/840489/000119312516494830/d154232dsc13g.htm

[130] Slawotsky pg. 1256.

[131] https://www.sec.gov/cgi-bin/browse-edgar?action=getcompany&CIK=0000936828&owner=include&count=40&hidefilings=0

Additionally, as pointed out in a 2008 article, Joel Slawotsky addressed the threat of SWFs from the same sovereign or ideologically aligned sovereigns working in concert. He noted that "[m]ultiple nations may seek to control a company by purchasing individual stakes small enough to avoid reporting requirements, while jointly owning a controlling percentage."[132] Rule 13d-5 does provide for group aggregation for the purposes of reporting under Sec. 13(d) and 13(g) if "two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer , the group formed thereby shall be deemed to have acquired beneficial ownership . . . .".[133] However, there is no commanding law on what constitutes an "agreement" or a "group."

Hart Scott Rodino

Additionally, The Hart-Scott-Rodino Antitrust Improvement Act of 1976 ("Hart Scott") requires certain proposed acquisitions of voting securities or assets be reported to the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ") prior to effectuating the transaction to aid in their antitrust review.[134] The exact transactions to be disclosed depends on the size and value of the securities or assets being acquired, and the minimum value was increased in 2016.[135] At a minimum, clearance under Hart Scott can take 30 days while the FTC and DOJ evaluate any potential antitrust concerns and additional time may be tacked on if they determine further action is needed.[136] If either agency finds that the transaction could create antitrust violations they may seek an injunction to prevent the consummation of the transaction.[137]

[132] Slawotsky, pg. 1256.
[133] 17 CFR 240.13d-5(b)(1).
[134] 15 USC Sec. 18a
[135] 15 USC Sec 18a (2). /// https://www.cooley.com/2016-hart-scott-rodino-antitrust-thresholds-final
[136] Evolving Perceptions Article, pg. 5
[137] Id.

Hart Scott is insufficient to handle the concerns addressed in this article for two reasons. First, the purview and power of the FTC and DOJ in conducting their review is limited to antitrust concerns, and thus does not envelope national security concerns. Second, it is unclear whether sovereign wealth funds are required to disclose under Hart Scott at all.[138] By statute, foreign states, foreign governments and an agency thereof are excluded from the definition of entities required to file premerger notifications under Hart Scott.[139] The FTC Premerger Notification Office ("PNO") has established a test to determine if an entity constitutes an agency formed by the government, and thus is exempt under the statute, or a corporation engaged in commerce, which would be required to comply.[140] Additionally, even if a SWF was found to not be an agency, could be excluded if it was not formed as a corporation, or if it was a corporation but does not issue voting securities.[141] The number of loopholes and exemptions within Hart Scott make it entirely possible that a SWF could be formed strategically to avoid the disclosures required under the regulation.

CFIUS Review

The Committee on Foreign Investment in the United States ("CFIUS") is an inter-agency committee authorized under Section 721 of the Defense Production Act of 1950, as amended by the Foreign Investment and National Security Act of 2007 ("FINSA").[142] CFIUS' purpose is to review transactions whose result would be "control" of a U.S. business by a foreign person or entity.[143] There is no bright line test for control, but the regulations suggest that at a minimum it

[138] *See* Evolving Perceptions, pg. 5
[139] Id.
[140] Id.
[141] Id.
[142] https://www.treasury.gov/resource-center/international/Pages/Committee-on-Foreign-Investment-in-US.aspx /// 50 USC Sec. 4565
[143] Id.

requires “the power, direct or indirect, whether or not exercised, . . . to determine, direct, or decide important matters affecting an entity . . . or to cause decisions regarding” certain matters as defined in the regulation.[144] The review process operates to determine if such a controlling interest or controlling transaction would create national security threats and thus places an emphasis on critical industries.[145]

The CFIUS process typically begins with a joint filing by all of the parties, although filing with CFIUS at all is voluntary.[146] If a filing is accurate and complete as per the regulations, a review period of up to 30 days will begin.[147] During the review period, CFIUS members “conduct an investigation of the effects of [the transaction] on the national security of the United States” and should consider relevant factors[148] Examples of factors to be reviewed include: domestic production needed for national defense requirements, the control of domestic industries and commercial activity by foreign citizen as it affects the capabilities and capacity of the U.S. to meet the requirements of national security, and the potential effects of the proposed or pending transaction on United States internal technological leadership in areas affecting United States national security.[149] The list of factors for consideration was expanded after the Dubai Ports incident discussed above to include the potential effects on critical infrastructure of the United States.[150]

CFIUS has the authority to take “any necessary actions in connection with the transaction to protect the national security of the United States.”[151] The CFIUS review board may extend the

[144] 31 CFR sec. 800.204
[145] Id.
[146] https://www.treasury.gov/resource-center/international/foreign-investment/Pages/cfius-overview.aspx
[147] Id.
[148] 50 USC Sec. 4565(b)(2)(A)
[149] 50 USC Sec. 4565(f)
[150] 50 USC Sec. 4565(f)(6)
[151] 50 USC Sec. 4565(b)(2)(A)

review period for an additional 45 days if it believes that (i) the transaction threatens to impair the national security of the US and the threat has not been mitigation prior to or during the initial review, (ii) the transaction is a foreign government controlled transaction, or (iii) the transaction would result in control of critical infrastructure by or on behalf of a foreign person, it could impair national security, and such concerns have not been mitigated during the initial review.[152] If within the additional 45 day period CFIUS cannot come to a conclusion regarding the threat to national security of the proposed transaction, it must request a recommendation from the President.

IV. Legal and Regulatory Approaches

- International Level
- National Level
- Market Level
- Firm Level
- Was the IMF right to characterize the Russian purchase of the Ukrainian bond as a sovereign act?

[The purpose of this section is to attempt to sketch out a framework for appropriately matching market and regulatory responses to threats.]

V. Conclusion

[152] 50 USC Sec. 4565(b)(2)(B)