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Western policies towards sovereign wealth fund equity investments: A comparison of the UK, the EU and the US

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Western Policies Towards Sovereign Wealth Fund Equity Investments: A Comparison of the UK, the EU and the US

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Abstract

This policy brief examines how Western nations respond to investment by sovereign wealth funds (SWFs). It sets out two polar positions on such investment: that it is an issue of national security, as it presents important dangers for Western countries; or that it is an economic governance issue, in which SWF investment can be beneficial to Western countries or its problems have been greatly exaggerated. The paper then compares the policies of the UK, EU and US towards equity investment in company equities. The EU and UK have treated SWF equity investment as a matter of free trade and movement of capital, and imposed few specific restrictions; indeed, they have often accepted and welcomed SWF equity investment. On the other hand, the US has often seen strong debates about whether SWF investment is a free trade or a national security issue, and has imposed much stronger legislative monitoring and restrictions.

1. INTRODUCTION

Sovereign wealth funds (SWFs) have grown rapidly since the early 1990s, becoming numerous and significant investors in world markets. They raise at least three sets of questions: why have SWFs been created? How do they operate? How do Western nations respond to investment by SWFs?

This policy brief examines the third question. In particular, it looks at policies towards SWF investment in company equities. Such investment is becoming ever more important because of the size and number of SWFs and the increasing financing needs of Western companies. The present paper compares policies and regulatory frameworks in three jurisdictions: the UK, the EU and the US. Although there are popular conceptions of 'Fortress Europe', the paper finds that, on the contrary, the EU and UK have treated SWF equity investment as a matter of free trade and movement of capital, and imposed few specific restrictions; indeed, they have often accepted and welcomed SWF equity investment. On the other hand, the US has often seen strong debates about whether SWF investment is a free trade or a national security issue, and has imposed much stronger legislative monitoring and restrictions.

The paper begins with a short summary of two polar positions concerning SWF investment, and then looks at the UK, EU and US in turn. For each it examines three elements: how the issue of SWF equity investment is generally defined by policy makers; the policy instruments used to regulate SWF investment; and the overall policy adopted. The conclusion

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then compares the three jurisdictions. The purpose of the paper is to analyse what policies have been adopted.

2. Two polar views of SWF equity investment

Sharply differing alternative conceptions of the issue of SWF investment exist in both the academic literature and policy debates. Two polar positions can be distinguished. One is that SWF inward investment is an issue of national security, as it presents important dangers for Western countries (e.g. Slawotsky 2008/9; for a more nuanced view see Backer 2010). It is argued that as state-owned entities, SWFs can take decisions on political rather than commercial grounds. This is dangerous because many SWFs are based in non-democratic states, often in unstable regions of the world, and lack transparency and accountability. SWFs may gain influence over strategic firms and sectors, and enjoy access to sensitive information and technology that may be transferred back to foreign state owners and then misused. Since SWF investment is judged in national security terms, policies must safeguard national interests, and strong legal restrictions are needed.

The alternative polar view is that SWFs are an issue of economic governance and that SWF equity investment can be beneficial to Western countries or that its problems have been greatly exaggerated (Truman 2010; Drezner 2008; Kirshner 2009; Xu 2009). Proponents argue that SWFs are small relative to global financial markets and to other actors such as banks, and in any case do not constitute a single coherent actor, since they are diverse in terms of size, purposes, legal basis, governance and national base. Moreover, several SWFs have features in common with other state-owned and private investment funds, such as pension funds, which have long been accepted as part of the financial system. Indeed, several empirical studies argue that SWFs are in fact long-term investors that rarely take controlling stakes (Bortolotti et al. 2009); cf. Ainina and Mohan 2010). Far from posing a uniform threat, SWF investment in the West can offset global financial and economic imbalances (including trade deficits, notably those of Western countries such as the US and UK) as they ‘recycle’ surpluses, especially those arising from commodity booms such as oil price rises, avoiding harmful global loss of demand. In so far as SWF investments pose dangers, these can be prevented or mitigated by regulatory measures (Rose 2008). These include codes of conduct on their internal governance and behaviour, such as the ‘Santiago Principles’ drawn up by an international working group on SWFs (IWG 2008), a wide-ranging set of general principles that many SWFs have accepted, or suggestions that SWF share voting rights could be limited or special dispute resolution mechanisms be established via the World Trade Organization or the Organization for Economic Cooperation and Development (Gilson and Milhaupt 2008; Cohen 2009).

Of course many trade-offs, mixtures and variants of these two polar views exist in practice (examined in e.g. Cohen 2009). But they offer a good initial guide to assessing policy responses to SWFs.

2.1. UK regulatory frameworks and policies

SWF equity investments in the UK have been numerous, including SWFs from outside Europe, notably from the Gulf. Table 1 sets out investments by the fifteen largest SWFs in UK and US firms. These investments might have been expected to result in serious debates about whether protectionist policies and instruments were needed. Yet UK policy makers have defined SWF investment as economic governance issue, with the policy choice as being between ‘free trade’ or ‘protectionism’. They have favoured the former, arguing that it is in the national interest to attract SWF inward investment because it aids British firms and production.

Both Labour and Conservative governments have rejected new legal controls based on overseas state ownership. On the contrary, legal controls over mergers and takeovers were reduced under the 2002 Enterprise Act. Previously, ministers could refer a merger or takeover to an independent regulatory agency, the Monopolies and Mergers Commission (MMC, now called the Competition Commission); if the Commission judged that it was ‘against the public interest’, ministers could block the takeover or merger. However, the 2002 Act reduced this power and today ministers can only order such an investigation on much narrower grounds, notably a potential threat to national security, media pluralism or financial stability.

Instead of legal restrictions, UK policy makers have sought an institutional framework based on voluntary ‘soft law’ instruments to protect ‘competitive markets’. Thus a report on corporate governance in the financial sector by a senior banker (Sir David Walker) recommended that SWFs should be subject to the same UK code of conduct for corporate governance as private equity firms (Walker 2009, recommendation 21). However, the main focus of regulatory attention has been through voluntary international agreements, notably the ‘Santiago Principles’. In terms of UK law, SWFs are not treated differently from privately owned firms.

UK policy makers have generally pursued a policy of accepting and indeed welcoming SWF equity investment. They have not intervened in a series of high-profile equity investments by SWFs. Thus, for instance, the Qatar Investment Authority bought a significant

Table 1. *Publicly known equity purchases in the US and UK by the fifteen largest SWFs*

Country	Fund name	Assets in US$ billion	Inception	Origin	Deals US as of 2012 (no.)	Deals UK as of 2012 (no.)
United Arab Emirates	Abu Dhabi Investment Authority	627.0	1976	Oil	5	119
Norway	Government Pension Fund Global	611.0	1990	Oil	1,257	436
China	SAFE Investment Company	567.9	1997	Non-commodity	n.a.	n.a.
Saudi Arabia	SAMA Foreign Holdings	532.8	n.a.	Oil	n.a.	28
China	China Investment Corporation	439.6	2007	Non-commodity	7	5
Kuwait	Kuwait Investment Authority/Kuwait Investment Office	296.0	1953	Oil	4	129
China – Hong Kong	Hong Kong Monetary Authority Investment Portfolio	293.3	1993	Non-commodity	n.a.	n.a.
Singapore	Government Investment Corporation	247.5	1981	Non-commodity	7	29
Singapore	Temasek Holdings	157.2	1974	Non-commodity	158	1
Russia	National Welfare Fund	149.7	2008	Oil	n.a.	n.a.
China	National Social Security Fund	134.5	2000	Non-commodity	n.a.	n.a.
Qatar	Qatar Investment Authority	85.0	2005	Oil/gas	2	15
Australia	Future Fund	73.0	2004	Non-commodity	n.a.	n.a.
United Arab Emirates	Investment Corporation of Dubai	70.0	2006	Oil	4	7
Libya	Libyan Investment Authority	65.0	2006	Oil	10	8
Total					1,454	777
Total excluding Norway					197	341

Sources: Thomson ONE Banker (2012), Sovereign Wealth Funds News.com (2009), Libyan Investment Authority Report (2010), SDC Platinum (2012). Reports: Monitor Group, Reuters, Bloomberg, *Wall Street Journal*.

stake (7 per cent) in the large British bank Barclays, and a major stake in the London Stock Exchange. In 2011, the Abu Dhabi Investment Authority took a significant stake in one of Britain’s largest water suppliers, Thames Water, followed by the China Investment Corporation in 2012. SWFs have also bought shares in firms that enjoy high public support in

Britain and are linked to national ‘identity’. Thus the Investment Corporation of Dubai bought Madame Tussauds in 2007, while the Qatar Investment Authority bought Harrods in 2010. In banking, UK policy makers have seen SWFs as welcome potential purchasers of government shares bought as part of rescue packages in the 2007–8 financial crisis, notably in the Royal Bank of Scotland.

The only major exception to this policy of accepting SWF equity investment came in 1988, when the UK government referred the purchase by the Kuwait Investment Authority (KIA) of a substantial stake (22 per cent) in the oil company BP to the MMC. The MMC reported that the purchase was likely to be ‘against the public interest’, mostly on grounds of national security and potential conflicts of interest between the UK and the KIA, because Kuwait is a sovereign state with its own broad interests which it might pursue through its stake, especially given the strategic importance of oil. However, analysis of this exceptional case reveals a key difference from debates after 2000, namely that the government treated it as a national security issue rather than an economic governance one. Indeed, there has been no similar case involving SWFs since then in the UK.

2.2. EU regulatory frameworks and policies

The EU might also be expected to have sought restrictions on SWF equity investment, especially given ‘statist’ traditions in certain member states and indeed legislation or discussion of legislation in major member states.[1] However, British policy makers and businesses have argued for an ‘open Europe’ and opposed new EU controls, presented as leading to a ‘Fortress Europe’. In 2007–8, the then chancellor, Alistair Darling, specifically rejected the idea of even a ‘vetting’ process for SWF investments, while within the European Commission the then trade commissioner, Peter Mandelson (a former Labour minister who later returned to Gordon Brown’s government as business secretary), opposed new EU controls and instead sought an EU voluntary code of conduct.

The European Commission issued a Communication on SWFs in 2008. It largely treated SWF equity investment as a question of economic governance and especially of free trade and the Single European Market. Although it expressed concerns that SWFs may lack transparency and might use their investments ‘for ends other than maximising return’ and ‘unduly pursue political advantages’ (European Commission 2008), it also pointed out that

[1] For instance, in France, with the Décret no. 2005-1739 du 30 décembre 2005 réglementant les relations financières avec l'étranger et portant application de l'article L. 151-3 du code monétaire et financier, which regulates foreign non-EU investment in ‘sensitive’ sectors, or the German Foreign Trade and Payments Act 2004 (Aussenwirtschaftsgesetz) and an 18 April 2009 amendment, Dreizehntes Gesetz zur Änderung des Außenwirtschaftsgesetzes und der Außenwirtschaftsverordnung, that also regulates non-EU investments.

thus far, SWFs have been portfolio investors. Most importantly, it set out what it regards as the most relevant EU laws. One is Article 63 of the Treaty on the Functioning of the European Union (TFEU), which prohibits ‘all restrictions on the movement of capital between member states and between member states and third countries’. It is noteworthy that this Article extends free capital movement to non-EU countries, and that the European Court of Justice has a wide definition of capital movements, including portfolio investments and ‘direct investments’. The other is Article 49 of the TFEU, which allows freedom of establishment throughout the EU. The Commission expressed concern about the danger that ‘an uncoordinated series of responses [by member states] would fragment the internal market’ and underlined the point that ‘one of the main goals of EU trade policy is to open third country markers to EU investors … these efforts would be more difficult if the EU was seen as imposing barriers within the EU’. Investment by SWFs was a global issue and so a multilateral approach was needed.

In the light of its analysis, the Communication set out five principles:

- a commitment to an open investment environment in order to avoid protectionist attitudes;
- to support international organizations in open dialogue with SWFs, and to create multilateral legal framework for SWF investments;
- to use existing legal instruments to regulate SWFs;
- to avoid measures that breach international and EU law; and
- to ensure the proportionality and transparency of any measures taken by EU member states.

Thus the EU has avoided restrictions specific to SWFs and instead seen regulation of their investments as a matter of economic governance, in which it supports free trade and multilateralism. In so far as it has concerns, these are centred on ensuring ‘good governance’ by SWFs, notably by assessing the degree of possible political interference in their operation, and then by measures such as the allocation and clear separation of responsibilities in the management body, the preparation and publication of an investment strategy and the existence of operational autonomy, and ensuring transparency, so that activities can be monitored to ensure that they do not deviate from their stated objectives.

2.3. US regulatory frameworks and policies

Investment by SWFs in US companies became a major political issue in the 2000s. Table 1 above sets out major examples, and suggests that unlike in the UK, many SWF investments have been made from Norway and Singapore. Nevertheless, in contrast to the case in Britain, the definition of the issue – notably whether SWF investment was a national security issue (both defence and wider economic security) or an economic governance one – has been highly contested. Often the presidency has argued for the latter, presenting the issue as one of free trade, which was advantageous for the US, notably for employment, versus restrictions that would constitute damaging protectionism, risking retaliation by other countries and with negative effects for foreign policy (Kimmitt 2008; Bush 2007). In contrast, many members of Congress (both Democrats and Republicans) have treated SWF inward investment as a question of national security and presented SWFs as foreign government agents (e.g. Dodd 2008). However, their definition of national security went beyond defence to encompass forms of 'economic security', notably protecting 'strategic sectors and technologies' from control by foreign governments, which they claimed could allow transfers of confidential knowledge and expertise to hostile powers and could be linked to non-commercial issues, since foreign governments were not subject to 'market discipline'.

The contending views of SWF investment have played out in debates about legislation and in reactions to individual SWF equity purchases. Congress sought greater controls on SWF investment, while the executive sought to limit these and ensure that it had discretion about whether to investigate or restrict SWF investment.

Since 1975, foreign equity investment has been covered by the Committee on Foreign Investment in the United States (CFIUS), composed of agency heads and chaired by the Treasury Department. It was designed to monitor overseas investment in the US and was progressively strengthened in the 1980s and 1990s, mostly due to Congressional initiatives arising from debates about overseas takeovers of US firms in the defence and high technology sectors.[2] Nevertheless, notification to CFIUS is voluntary, and CFIUS can decide whether to launch a full investigation, or whether to conclude informal 'mitigation' agreements with the parties to meet national security concerns. Prohibition requires 'credible evidence' and the lack of other legal avenues to protect national security. Moreover, CFIUS was traditionally dominated by the Treasury and made little use of its formal powers.[3] Thus between 1997 and

[2] The Exon-Florio Amendment of 1988 empowered the president to suspend or prohibit foreign mergers or acquisitions when 'such control threaten[s] to impair national security'. Then the Byrd Amendment of 1993 required the president to review any attempted merger or acquisition by 'an entity controlled by or acting on behalf of a foreign government … that could affect the security of the United States', which included 'potential effects' on US overseas defence sales and on the US technological advantage.. For analyses, see Young (2008: 46-47) and Weimer (2008/9).

[3] Although it engaged inconsiderable informal discussions and the threat of its interventions may have influenced overseas investment.

2004, there were 470 notifications but only eight investigations, of which six led to withdrawal, leaving only two presidential decisions (GAO 2005: 14–18).

Debates about foreign equity purchases grew, however, in the 2000s. Unlike earlier debates, they were more explicitly focused on state inward equity investment, including by SWFs (cf. Rose 2008). Two purchases caused particular controversy after 2000. One was the attempt in 2005 by the Chinese state-owned energy company CNOOC to buy a US oil company, Unocal, which was met with a Congressional resolution urging President Bush to block the purchase on grounds of national security (Young 2008). There was great concern that Chinese state companies had expanded internationally and could buy strategic US assets in key industries such as energy, which might then be used for political aims. In the face of the political reaction, CNOOC withdrew its bid. The other was the purchase in 2006 of five US ports, including New York Port Authority, by Dubai Ports World (DP World), itself owned by a SWF, Dubai World.

The 'Dubai ports case' is important both for its effects on later legislation and in illustrating the conflicting definitions of SWF investment. The five ports were already foreign owned, being part of the British firm P&O, which was bought by DP World. The parties chose to notify CFIUS, which conducted an investigation both before and after the formal notification (see Young 2008 for details). CFIUS members met DP World, and negotiated formal letters of guarantee concerning security matters. The Bush administration accepted the purchase in January 2006 and indeed defended it, in terms of Dubai's being a US ally in the Middle East and also of advantages for employment. Yet there was a Congressional outcry, from both Democrats and Republicans, on grounds of national security. They argued that a foreign government entity should not operate US ports, which were presented as 'critical infrastructure', and underlined the risks from the Middle East. The issue gained public attention, and an opinion poll question by CBS News showed 70 per cent of respondents believed the US should not allow a United Arab Emirates SWF to buy US ports. Buoyed by such support, the House Appropriations Committee voted by sixty-two to two to force DP World to give up its purchase. Although the purchase was defended by the Bush administration and reported significant safeguards over control were offered by DP World,[4] Congressional opposition continued and DP World agreed to sell off the ports.

These CNOOC and DP World episodes sparked major Congressional debate centred on possible threats to national security and reconsideration of controls over foreign

[4] E.g. giving the Department of Homeland Security a right to veto the choice of senior executives or a promise that a super-majority of directors would be US citizens.

investments in US companies, especially by SWFs and state-owned entities. They led to the House and Senate passing bills in 2006–7 that became the 2007 Foreign Investment and National Security Act (FINSA; Young 2008).[5]

FINSA greatly strengthened regulation by CFIUS of inward investment, especially for state-owned entities such as SWFs. It required a CFIUS investigation of ‘foreign government-controlled’ covered transactions.[6] This is automatic unless the initial review led by a senior official decides that the transaction will not impair US national security.[7] This automaticity differs from other transactions involving only privately owned parties, for which the launch of an investigation requires that the transaction ‘could impair national security’. The 2008 Treasury Rules made clear that transactions controlled by foreign governments are covered ‘regardless of whether the transaction has a purely commercial and market-driven basis’, even if the entities operate on a commercial basis or are controlled only indirectly by a foreign government (Treasury, Department of the, 2008: 70709).[8] This suggests that SWFs widely defined (i.e. including those owned and operated at arm’s length from governments) are caught by FINSA.

FINSA (Section 4, amending Section 721 (f) of the 1950 Act) added new criteria for whether a transaction affected national security and hence whether it can be suspended or prohibited. One was whether it is ‘a foreign government-controlled transaction’. Another was ‘the potential national security-effects on United States critical infrastructure, including major energy assets’ and ‘critical technologies’. These assets and technologies were broadly defined; for example, the former referred to physical or virtual systems or assets whose ‘incapacity or destruction … would have a debilitating impact on national security’. A further factor was whether the overseas country adhered to arms control agreements and its relationship with the US relative to counter-terrorism efforts.

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[5] The bills were followed by a 2008 Executive Order and government regulations (Treasury, Department of the, 2008).

[6] FINSA Section 2, amending Section 721 of the Defense Production Act of 1950; ‘covered transactions’, building on previous legislation, are defined as those in which a foreign person gains control of a US business engaged in interstate commerce through a ‘merger, acquisition or takeover’.

[7] The decision must involve both the Department of the Treasury and the lead agency in the review and be taken by a deputy secretary or above.

[8] ‘Control’ is a key concept for FINSA, as it affects both whether a transaction is covered and whether an entity is a foreign government or foreign-controlled one, but is not defined in the Act. However, Treasury regulations (Treasury, Department of the, 2008) make it clear that there are no ‘bright lines’, and instead all relevant factors are considered together. The size of the shareholding and whether board seats are held are relevant but not conclusive. Conversely, if a foreign entity or person owns less than 10 per cent of the voting shares and does so ‘solely for the purpose of passive investment’, then it may lack control and hence its transaction may fall outside FINSA. The latter seems quite difficult to prove for a party and hence allows CFIUS much scope for determining that the transaction is covered.

Overall, FINSA has increased the statutory possibilities for CFIUS investigations and restrictions. The legislation has broadened the concept of security to include aspects of economic security, linked to state ownership, the nature of that state and the importance of the asset being purchased.

3. CONCLUSION

Comparison of the UK, the EU and the US indicates differing policies towards SWF equity investments. The present paper has focused on overall policies and regulatory frameworks – regulatory decisions vary across individual cases, and informal discussions can also be very important. Nevertheless, the formal rules set a framework for decision making. Using the two polar views set out initially, we see that the UK and the EU have generally treated SWF investments as a question of economic governance, and then seen the choice as being between free trade and protectionism. Both have favoured the former, and as such, have not instituted specific legal restrictions on SWFs. Instead, they have favoured 'soft law' such as codes of conduct and transparency requirements. Overall, they have accepted and sometimes welcomed SWF equity investment. In contrast, the nature of the SWF issue has been contested within the US, notably between the presidency and Congress. The former has presented it in a similar manner to those of the UK and EU, but the latter has argued that it is a national security matter. As a result, Congress has greatly strengthened legal restrictions on equity investment, especially by state-owned bodies such as SWFs, and treated some SWF investments with suspicion. Table 2 compares the three jurisdictions.

Table 2. *A comparison of the UK, EU and US approaches to SWF equity investment*

	UK	EU	US
Definition of issue of SWF equity investment	Free trade	Free trade and single European market	Contested between free trade and national security
Policy instruments to regulate SWF equity investment	No specific legal restrictions; preference for codes and soft law	No specific legal restrictions; preference for codes and soft law	Legal framework: FINSA 2007 and CFIUS
Overall policy	Welcome most SWF investment	Accept SWF investment as part of free movement of capital	Contested between acceptance as part of free trade and restrictions on grounds of national security

Forecasting future policies is difficult. One possibility is that increasing SWF investment and economic crisis lead to greater concerns about economic security and more restrictions on SWF equity investments. But the opposite might well also occur: that Western countries become accustomed to SWFs and/or that SWFs adopt governance mechanisms that allay concerns, so that SWF investment becomes treated as a matter of economic governance and free trade.

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Second generation non-nationals in Kuwait: Achievements, aspirations and plans
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Financial market development in the GCC and the impact of the global financial crisis
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