

**Ilene Knable Gotts and Paul A. von Hehn on  
Sovereign Wealth Fund Investments—Risk of New Wave of  
Protectionism in the EU and the U.S.?**

**Cite as:** Gotts, Ilene Knable, and von Hehn, Paul A. "Sovereign Wealth Fund Investments—Risk of New Wave of Protectionism in the EU and the U.S.?" LexisNexis® Expert Commentary, (*Insert date you accessed the document online*).

Flush with dollar-denominated funds accruing from booming commodities prices and trade surpluses with the United States, sovereign wealth funds ("SWFs") – the investment vehicles of resource-rich or export-heavy countries – emerged during the second half of 2007 as an important and growing force in the U.S. equity investment and M&A arena and are also now beginning to make a significant impact on the European buy-out markets.<sup>1</sup> SWFs manage an estimated \$3 trillion in assets, a figure amounting to roughly 4% of global assets under management (as compared with 3% by hedge funds and 1% by private equity),<sup>2</sup> and in 2007, global investments by SWFs increased 165% to \$48.5 billion.<sup>3</sup> SWFs have been party to over a dozen major transactions in the U.S. since July 2007, including several multi-billion dollar infusions into some of the world's largest financial institutions ailing from the subprime mortgage crisis. European and United States officials, however, have raised concerns regarding the increased level of SWF investment and the emergence of SWFs in countries such as China and Russia. Concerned that the investment decisions of such SWFs could be motivated or influenced by the strategic and political considerations of their respective governments (as contrasted with the mainly economic agendas directing pension and investment funds of countries such as Norway and Canada), government officials in both the United States and European Union have held high-level discussions regarding what actions, if any, should be undertaken concerning SWF investments in their respective jurisdictions.

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\* The authors recognize the significant contributions to this paper of Shaun J. Mathew, a corporate associate at Wachtell, Lipton, Rosen & Katz.

1. See *Sovereign wealth funds – state investments on the rise*, DEUTSCHE BANK RESEARCH (Sep. 10, 2007), available at [www.dbresearch.com](http://www.dbresearch.com).
2. See *Asset-Backed Insecurity*, ECONOMIST.COM (Jan. 17, 2008), at 2, available at [http://www.economist.com/opinion/displaystory.cfm?story\\_id=10533428](http://www.economist.com/opinion/displaystory.cfm?story_id=10533428).
3. See Mark Kleinman, *Sovereign Funds Discover Gulf in Values*, TELEGRAPH.CO.UK (March 23, 2008), at 1, available at <http://www.telegraph.co.uk/money/main.jhtml?xml=/money/2008/03/23/ccswf123.xml>

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### **SWFs – the Basics**

SWFs manage a diversified portfolio of domestic and international financial assets from a pool of resource or export-generated sovereign wealth. Sustained surpluses for the oil-producing and Asian economies provide reserves well beyond the needs of exchange rate management.<sup>4</sup> However, while SWFs are generally funded from accumulated foreign-exchange reserves in their sponsor countries, they are managed separately from the official reserves.

SWFs have been in existence for several decades: Kuwait launched the first SWF in 1953,<sup>5</sup> and in the 1970s, other Arab states began investing their newfound oil revenues through their own SWFs.<sup>6</sup> While SWFs originally existed in a few oil-rich Gulf states, today more than thirty countries maintain SWFs, twenty of which were formed after 2000.<sup>7</sup> The value of assets under management by SWFs has quintupled since 1990 to \$3 trillion,<sup>8</sup> and according to the International Monetary Fund (IMF) estimates, this value is expected to quadruple to approximately \$12 trillion by 2015.<sup>9</sup>

The Abu Dhabi Investment Authority, the largest of the SWFs, manages, by some estimates, \$875 billion in assets<sup>10</sup>; other large SWFs include two separate funds in Singapore (Temasek (\$160B) and GIC (\$330B))<sup>11</sup>, Norway's Government Pension Fund

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4. See David Lawsky, *EU to Consider Sovereign Wealth Fund Voluntary Code*, REUTERS (Feb. 23, 2008), available at <http://www.reuters.com/article/ousiv/idUSL2373561420080223>.
  5. See Sean O'Grady, *EU to Agree Code of Principles for Sovereign Wealth Funds*, INDEPENDENT.CO.UK (Feb. 26, 2008), available at <http://www.independent.co.uk/news/business/news/eu-to-agree-code-of-principles-for-sovereign-wealth-funds-787357.html>.
  6. See James Surowiecki, *Sovereign Wealth World*, THE NEW YORKER (Nov. 26, 2007) at 1, available at [http://www.newyorker.com/talk/financial/2007/11/26/071126ta\\_talk\\_surowiecki](http://www.newyorker.com/talk/financial/2007/11/26/071126ta_talk_surowiecki).
  7. See *A Common European Approach to Sovereign Wealth Funds*, COMMISSION OF THE EUROPEAN COMMUNITIES (2008) at 3, available at [http://ec.europa.eu/commission\\_barroso/president/pdf/COM2008\\_115\\_en.pdf](http://ec.europa.eu/commission_barroso/president/pdf/COM2008_115_en.pdf).
  8. See Ian Traynor, *Brussels Moves to Rein in \$3 Trillion Sovereign Funds*, GUARDIAN.CO.UK (Feb. 26, 2008) at 2, available at <http://www.guardian.co.uk/business/2008/feb/26/europe.economy>.
  9. *Id.*
  10. See *Asset-Backed Insecurity*, *supra* note 2.
  11. *Id.*

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(\$380B)<sup>12</sup>, the Kuwait Investment Authority (\$250B)<sup>13</sup>, the Russian Stabilization Fund (\$160B)<sup>14</sup>, the Qatar Investment Authority (\$50B)<sup>15</sup>, the Korea Investment Corporation (\$20B)<sup>16</sup>, and several affiliated funds in Dubai managing at least \$20 billion in the aggregate.<sup>17</sup> In 2007, China invested \$9.8 billion through 22 transactions to buy all or part of U.S. companies<sup>18</sup> and formed its own SWF, the \$200 billion China Investment Corp. (“CIC”).<sup>19</sup> CIC’s fund is still only a fraction of the \$1.5 trillion in Chinese currency reserves, which are growing at a rate of about \$500 billion per year.<sup>20</sup>

With the slow-down of M&A activity by hedge funds and private equity firms and the liquidity squeeze since mid-2007, SWFs have played an important role in the recapitalization of critical U.S. financial institutions and have helped to strengthen the global banking system and the institutional financial system as a whole. Equity infusions from SWFs proved essential in helping several of the world’s largest financial institutions quickly fill the multi-billion dollar balance sheet gaps that resulted from massive write-downs related to the subprime mortgage crisis. Abu Dhabi’s \$7.5 billion infusion into Citigroup<sup>21</sup> marked the beginning of a series of SWF infusions into troubled banks that

12. *Id.*

13. *Id.*

14. See *Aggregate Amount of the Stabilization Fund of the Russian Federation*, Ministry of Finance of the Russian Federation, available at <http://www1.minfin.ru/en/stabfund/statistics/aggregate/>. On January 31, 2008, the Russian Finance Ministry created the growth-oriented \$32 billion National Welfare Fund out of funds from the Stabilization Fund. See *Russia to create 32-bln-dollar fund to support pensions*, Agence France Presse English Wire (January 31, 2008).

15. See *Asset-Backed Insecurity*, *supra* note 2.

16. See Korea Investment Corporation Official Website, available at <http://www.kic.go.kr/en/?mid=co01>.

17. Dubai International Capital manages assets in excess of \$12 billion, see “Statement Issued on Behalf of Dubai International Capital in the Context of the Recent Media Reports Referring to Citigroup,” available at <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/03-05-2008/0004768773&EDATE=>, and Istithmar World, private equity fund controlled by the Dubai government, manages, by some estimates, manages a portfolio in excess of \$10 billion, see “Istithmar buys 3% in London hedge fund,” available at <http://archive.gulfnews.com/articles/07/06/25/10134738.html>.

18. See *China On Course to be a Top US Investor*, MSN.COM (February 12, 2008) at 1, available at <http://news.moneycentral.msn.com/ticker/article.aspx?Feed=AP&Date=20080212&ID=8179627&Symbol=COMS>

19. See Bob Davis, “Wanted: SWFs’ Money Sans Politics,” WALL STREET JOURNAL, Dec. 20, 2007, C1.

20. See Christopher S. Rugaber, *China, Mideast Nations Now Big U.S. Investors: Political Backlash over Potential Security Threat*, SF GATE (Feb. 13, 2008), available at <http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2008/02/13/BU9NV0VEN.DTL&hw=china+mideast&sn=002&sc=720>.

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ultimately included UBS (by Singapore's GIC and an unidentified Middle Eastern investor)<sup>22</sup>, Morgan Stanley (by China's CIC)<sup>23</sup> and Merrill Lynch (by Temasek, in the first instance).<sup>24</sup> Citigroup and Merrill each drew from the SWF pool twice, with Citigroup tapping several institutions including Singapore's GIC and the Kuwait Investment Authority for an additional \$12.5 billion in January of 2008;<sup>25</sup> Merrill raised a total of approximately \$10 billion, initially from Singapore's Temasek and later from funds in Korea, Kuwait and Japan, amongst others.<sup>26</sup>

SWFs will likely continue to grow in size and number, thereby intensifying both the opportunities they offer and the public attention they receive. For an overview of SWF investment in the U.S., see [“Sovereign Wealth Fund Investment in the U.S. – Just Warming Up?”](#).

### Why the Current International Scrutiny?

Is there a basis for governmental concern with sovereign foreign investment or is the political rhetoric simply the latest example of xenophobia? Given the tremendous benefits SWF investments offer to mature Western economies and corporations, it can be difficult to appreciate the growing concern they have elicited from Western government officials. From a business perspective, SWF investments offer a number of benefits, including long-term investment horizons and substantial tolerance for risk, absence of leverage, a stable capital base not subject to withdrawals, distributions or capital calls or other forms of “flight risk,” a perceived willingness to accept no- or low-governance arrangements, and, as several recent financial-sector investments illustrate, an ability to move capital quickly and in very large amounts as a source of liquidity for companies

21. See Robin Sidel, *Abu Dhabi to Bolster Citigroup with \$7.5 Billion Capital Infusion – Government Investment Arm to Become a Top Holder, With Up to a 4.9% Stake*, WALL STREET JOURNAL, Nov. 27, 2007, A3.

22. See David Reilly and Matthew Karnitschnig, *Bargain or Bailout? – UBS Is the Latest to Seek Financial Aid in Asia, Middle East*, WALL STREET JOURNAL, Dec. 11, 2007.

23. See Andrew Edwards and Jed Horowitz, *Morgan Stanley Swings to Loss Amid Mortgage-Related Woes*, Dec. 19, 2007, available at <http://online.wsj.com>.

24. See Jed Horowitz and Donna Kardos, *Merrill Lynch Cuts Deal with Temasek, GE as Firm Seeks to Shore up Capital*, WALL STREET JOURNAL, Dec. 25, 2007, A1.

25. See David Enrich, Robin Sidel and Susanne Craig, *World Rides to Wall Street's Rescue*, WALL STREET JOURNAL, January 16, 2008, A1.

26. *Id.*

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facing crisis or distress. From a regulatory perspective, countries around the world, particularly Western nations, already have decades of experience dealing with the delicate challenge of promoting and regulating foreign investment generally; moreover, there is a long global history of government investment in industry, albeit by domestic governments (in Europe, governments even today own sizable positions in a number of major European corporations, as do several Asian governments in their respective domestic corporations,<sup>27</sup> and state-owned firms account for almost 80% of oil exploration and production throughout the world).<sup>28</sup>

On the other hand, the sovereign ownership of these funds raises serious concerns in Western governments that SWFs will be managed to achieve the political or strategic goals of their respective sovereigns rather than for pure business purposes, thereby raising the risk that SWF activity will undermine confidence in or distort global capital markets. Both U.S. Democratic Presidential candidates have expressly raised these concerns. Senator Barack Obama recently indicated that “if they are buying big chunks of financial institutions and their boards of directors influence how credit flows in this country and they may be swayed by political considerations or foreign policy considerations, I think that is . . . a concern.”<sup>29</sup> Similarly, on foreign investment, Senator Hillary Clinton said SWFs must be “more transparent,” and called on the World Bank, the IMF and the U.S. Federal Reserve to provide better oversight and impose rules, indicating that she would “like to see us move much more aggressively.”<sup>30</sup> Senator Charles E. Schumer, Chairman of the Congressional Joint Economic Committee echoed this concern, noting that “because they are government-owned, noneconomic factors may influence their decision-making and the pressure they put on companies that they own a piece of.”<sup>31</sup> In Europe, Commission President Jose Manuel Barroso recently stated that

27. See James Surowiecki, *Sovereign Wealth World*, THE NEW YORKER (Nov. 26, 2007), at 2, available at [http://www.newyorker.com/talk/financial/2007/11/26/071126ta\\_talk\\_surowiecki](http://www.newyorker.com/talk/financial/2007/11/26/071126ta_talk_surowiecki).

28. See Justin Blum, *National Oil Firms Take Bigger Role*, WASHINGTON POST, Aug. 3, 2005, D01, available at [http://www.washingtonpost.com/wp-dyn/content/article/2005/08/02/AR2005080201978\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2005/08/02/AR2005080201978_pf.html).

29. See *US Lawmakers Want Tougher Stance on Sovereign Funds*, ARAB TIMES (Apr. 1, 2008) at 1, available at <http://www.arabtimesonline.com/kuwaitnews/pagesdetails.asp?nid=12020&ccid=12>.

30. See *The Invasion of the Sovereign-Wealth Funds*, ECONOMIST.COM (Jan. 17, 2008), available at [http://www.economist.com/opinion/displaystory.cfm?story\\_id=10533866](http://www.economist.com/opinion/displaystory.cfm?story_id=10533866). See also Dana Cimilluca, *Hillary Clinton's Foreign Investment Logic*, THE WALL STREET JOURNAL (Jan. 16, 2008), available at <http://blogs.wsj.com/deals/2008/01/16/hillary-clintons-foreign-investment-logic/>.

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“[w]e cannot allow non-European funds to be run in an opaque manner or used as an implement of geopolitical strategy ... [by contrast, Norway’s SWF] is often seen as the gold standard of sovereign wealth funds. We would like some others to look at [its] ... example and move towards the rigorous standards that [it is]. .. applying here.”<sup>32</sup>

SWF investments in certain companies may also raise national security concerns.<sup>33</sup> A principal worry is that a SWF investment could potentially give foreign government officials non-public and sensitive national security information. Targets may also have access to technology, natural resources, and critical defense expertise that could be important for national strategic interests.<sup>34</sup>

Some commentators also contend that SWFs should have to compete on fair terms with private-sector investors by providing greater transparency regarding the value of assets under management, investment objectives and strategies, target portfolio allocations, risk management systems and internal controls.<sup>35</sup> Others posit the need for appropriate governance structures, such as guaranteeing a clear division of rights and responsibilities between sponsoring governments and SWF managers.<sup>36</sup>

To some extent, SWFs have mitigated the potential concerns raised by governmental entities to date by ensuring that their investments in certain high-profile companies remain small and passive. More recent transactions, however, exhibit significant variation and financial sophistication, ranging from structured minority-no-governance equity infusions (e.g., Citigroup, Advanced Micro Devices) to pre-IPO investments (e.g., Blackstone, Och-Ziff) to strategic joint venture investments (e.g., Bear Stearns, MGM Mirage) to full acquisitions (e.g., Barneys). We would expect that as SWFs test the boundaries

31. See Chuck Schumer on the Rise of Sovereign Wealth Funds, BUSINESSWEEK (March 6, 2008) at 1, available at [http://www.businessweek.com/magazine/content/08\\_11/b4075021424117.htm](http://www.businessweek.com/magazine/content/08_11/b4075021424117.htm).

32. See Rory Watson, *Europe Looks to Set Ground Rules for Sovereign Wealth Funds*, BUSINESS TIMES ONLINE (Feb. 27, 2008), available at [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article3441120.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3441120.ece).

33. See Ilene Knable Gotts and Leon Greenfield, *Does the US Foster National Champions? Foreign Acquisitions and National Security*, GLOBAL COMPETITION REVIEW (2007), at 2.

34. *Id.* at 2.

35. See Carter Dougherty and Stephen Castle, *EU Warns Against Overreaction on Sovereign Wealth Funds*, INTERNATIONAL HERALD TRIBUNE (Feb. 25, 2008), at 2, available at <http://www.ihl.com/articles/2008/02/25/business/fund.php>.

36. See Philipp M. Hildebrand, *The Challenge of Sovereign Wealth Funds*, VOX (Jan. 21, 2008), at 2, available at <http://www.voxeu.org/index.php?q=node/881>.

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of economically and politically feasible transaction structures, we will witness more frequent and larger investments as overseas accumulations of commodities profits and foreign exchange reserves continue to be deployed. As the presence of such SWF investment increases in size and scope more systemic and uniform policies may be needed to balance the interests in maintaining the proper functioning of free capital markets and the national security concerns from foreign sovereign involvement in the economy.

### **Responses and Reactions in Europe**

**European Member States.** The reaction in Europe to SWF investment can best be described as a “struggle for a policy.” The recent heightened investment activity by foreign firms with sovereign ownership has fueled a general fear of a “sell-out” of important strategic assets. Since the demarcation line between SWFs (and other forms of foreign investment) that may raise legitimate concerns and those that do not, is not always clear, the debate in Europe has very much focused on protection of “public policy and public security” interests.

The EU Commission was slow in reacting to the SWF investment uptake. Some Member States used this period of uncertainty and indecisiveness as an opportunity to strengthen existing legislative measures against “unwelcome” foreign investment. Most European Member States have some form of legal mechanism to protect so-called strategic assets such as telecommunications, transport, defense, etc. from takeover by foreign entities. The critical issue from a community standpoint is whether such provisions are limited to foreign investments that raise “public policy and public security” concerns – and thus are recognized exceptions from the EC Treaty’s principle of free movement of capital<sup>37</sup> – or instead are broader and, therefore, protectionist.

For instance, until 2007, Germany did not have a special law protecting strategic assets. Rather, its Foreign Trade and Payments Act of 1961<sup>38</sup> only provided the German government with the ability to stop transactions on national security grounds, a power that in practice, Germany had never invoked. Responding, however, to the dramatic increase in

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37. See Article 58.1(b) EC Treaty, available at [http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E\\_EN.pdf](http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E_EN.pdf).

38. BGBl I (Apr. 28, 1961), at 481.

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SWF transactions over the last several months, the German government recently agreed on a draft law that would establish an inter-ministerial commission similar in nature to the Committee on Foreign Investment in the United States (“CFIUS”) (see discussion below) that would be authorized to review and possibly veto acquisitions by government-controlled investment funds if they are seen to pose a risk for public order or national security. An acquisition of more than 25% in a German company could become subject to the review procedure under the new law, regardless of industrial sector. Key in the German debate – and illustrative of the current mood in Europe – is the composition of the inter-ministerial review commission. While the labor ministry, which had sought to allow the commission to block a deal if there was a risk of major job losses, will have “consultative rights,” the economics ministry, usually considered more liberal, will officially coordinate the new commission. The total composition of the commission will reportedly not be prescribed by law but instead be determined by non-public government-internal procedures.<sup>39</sup>

France makes the investment by foreign entities, whether SWFs or not, subject to governmental approval if the lesser of a controlling interest or a 33.3% share is acquired in certain sectors.<sup>40</sup> “Strategic” sectors viewed as sensitive for the national interest include gaming, security, toxic agents for terrorist purposes, certain dual use technology, cryptography, etc. The EU Commission reportedly conducted an inquiry to determine if inclusion of some of these sectors by France was protectionist rather than within the public policy and public security exemption, but, to date, the Commission has not taken any specific action against France.<sup>41</sup> Focusing specifically on the SWF debate, the French government recently announced that it would introduce legislative measures so that its *Caisse des Dépôts et Consignations*, which is essentially a SWF, could be used as “defense weapon” against investments by foreign funds including SWFs.<sup>42</sup>

39. See Sven Afhüppe, *Koalition legt Staatsfonds-Streit bei*, Handelsblatt (Apr. 10, 2008), available at [http://www.handelsblatt.com/News/Politik/Deutschland/\\_pv/doc\\_page/1/\\_p/200050/\\_t/ft/\\_b/1415322/default.aspx/koalition-legt-staatsfonds-streit-bei.html](http://www.handelsblatt.com/News/Politik/Deutschland/_pv/doc_page/1/_p/200050/_t/ft/_b/1415322/default.aspx/koalition-legt-staatsfonds-streit-bei.html).

40. Financial and Monetary Code, Articles L151-153 and Decree 2005-1739 (Dec. 30, 2005), available at [http://www.legifrance.gouv.fr/jopdf/common/jo\\_pdf.jsp?numJO=0&dateJO=20051231&numTexte=45&pageDebut=20779&pageFin=20781](http://www.legifrance.gouv.fr/jopdf/common/jo_pdf.jsp?numJO=0&dateJO=20051231&numTexte=45&pageDebut=20779&pageFin=20781).

41. See Commission press release, IP/06/1353 (Oct. 12, 2006), available at <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/1353&format=HTML&aged=1&language=EN&guiLanguage=en>.

42. French Presidency press conference (Jan. 8, 2008), summary available at [http://www.premier-ministre.gouv.fr/chantiers/reforme\\_institutions\\_848/chef\\_etat\\_detaille\\_sa\\_58884.html](http://www.premier-ministre.gouv.fr/chantiers/reforme_institutions_848/chef_etat_detaille_sa_58884.html).

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Poland and other countries have “golden share” regimes for specific companies that reserve special veto rights for the government in case an investment or takeover in strategic assets is attempted. As a complement to these and other national measures, however, most Member States support the concept that there should also be a common European approach; otherwise circumvention would be too easy by using a country with “light” regulation as entry into the EU.

**European Council and European Commission Response.** The European Council and the Commission response at least at this stage provides for no new or specific EU legislation on SWF investments. At its spring meeting held on March 13 and 14, 2008, the Council endorsed a proposal made by the Commission in a Communication dated February 27, 2008 mandating a “common European approach to Sovereign Wealth Funds.”<sup>43</sup> The Council specifically emphasized the EU’s commitment “to an open global investment environment based on the free movement of capital” and supported the Commission’s proposal to work with the Organisation for Economic Co-operation and Development (OECD) and the IMF to develop an international voluntary code of conduct to address a variety of areas, including rules on separating responsibilities within fund structures, to render fund investment decisions independent of politicians.<sup>44</sup> The code would also provide for greater transparency through publication of an investment policy defining overall objectives, disclosure of general principles governing the relationship with the sponsoring government, and annual disclosure of investment positions and asset allocation, the use of loans, the size and source of the fund’s resources, and how the SWF exercises voting rights of stock it holds.<sup>45</sup>

By issuing the February 27 Communication, the European Commission seeks to avoid new protectionist measures by the Member States. In reaction to the debate and various legislative proposals discussed on a national level by Member States, it calls for a *common* European approach to ensure that a clear, predictable and reliable legal environment can be maintained. Moreover, the Commission clearly signals that SWF investments should be subject to the same rules and controls as other investments to which the EC Treaty’s principles of free movement of capital between Member States

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43. See Commission of the European Communities, *supra* note 7.

44. Presidency conclusions, 7652/08 at 36, available at [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ec/99410.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/99410.pdf).

45. See Commission of the European Communities, *supra* note 7.

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and between Member States and third countries apply. Finally, the Commission Communication confirms the applicability of the European Court jurisprudence on the free movement of capital as developed in its decisions on “Golden Shares.” Referring to the European Court’s 2002 decision concerning a Belgian “Golden Share” regime, the Commission explicitly states that any authorization system for foreign investment needs to comply with the principles of proportionality and transparency, and, in any event, any condition or restriction on foreign investment cannot be based on purely economic grounds.<sup>46</sup> This approach seems to have the support of the European business community: the Business and Industry Advisory Committee to OECD issued a press release on March 31, 2008 warning that “[g]overnments must avoid hastily conceived new regulations on sovereign wealth funds (SWFs) in their efforts to diminish recent rising public criticism against these investment vehicles.”<sup>47</sup>

**Some Consequences for Foreign Investment in Europe.** Where does this opaque situation leave the foreign investor, whether SWF or not? On the institutional level, i.e., Council and Commission, there is clearly resistance to any legislative action that would impose new restrictions on foreign investment. On the national level, on the other hand, the diffuse fears – albeit some of them legitimate – over SWF investments have resulted in a flurry of political and legislative activity some of which could raise concerns of new protectionism.

This is where the Commission’s February 27 Communication becomes critical and can prove to be helpful: legislative and other measures that Member States may adopt to deal with strategic investments by foreign entities, whether SWFs or not, need to comply with the principles developed by the European Court in its jurisprudence on “Golden Share” regimes. Specifically the Communication cites the European Court’s 2002 decision upholding a Belgian regime and rejecting three other regimes based on a number of criteria to assess the compatibility of an authorization system with the EC Treaty’s free movement of capital principles. These criteria include in particular a narrowly defined focus on specific strategic assets, strong procedural safeguards including subjecting the arrangements to judicial review, objective criteria by which the actions of the government could be measured, and strict time limits for any governmental action.

46. C-503/99, *Commission v Belgium*, [2002] ECR I-4809.

47. Available at [http://www.biac.org/comms/releases/80331\\_BIAC\\_press\\_release\\_SWFs-final.pdf](http://www.biac.org/comms/releases/80331_BIAC_press_release_SWFs-final.pdf).

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Thus, in principle, and notwithstanding the Member States' prerogative for national rules to protect public policy and security interests, the Court's jurisprudence on the free movement of capital will be an important element in determining if a foreign investor (whether SWF or not) that is faced with undue restrictions or conditions, were to have any rights or recourse. Given, however, the often politicized context which frequently is the driver for such restrictions, legal arguments will likely be only one instrument of defense. As would not be unusual in these types of situations, legal arguments may have to be supported by other, less formal actions on the Member State and EU levels, something which requires familiarity and extensive expertise with the EU's internal procedures and processes.

### **U.S. Takes a Similar Approach, Albeit with a Strong Foreign Investment Regulatory Regime Already in Place**

In addition to foreign ownership restrictions in several regulated sectors (e.g., TV and radio stations, airlines),<sup>48</sup> the United States, as well as many other jurisdictions, has had in place for a few decades laws that govern foreign investment in domestic companies that raise national security implications. The Committee on Foreign Investment in the United States ("CFIUS") is a multi-agency body that oversees the national security review of transactions that may transfer "control" of a U.S. company or U.S. assets to a foreign entity.<sup>49</sup> CFIUS has the power to make recommendations to the President as to whether to restrict a foreign acquisition on national security grounds.<sup>50</sup> The Treasury Department regulations governing the CFIUS review process include a very open-ended definition of "control" that can encompass a broad array of arrangements that may provide the power to "determine, direct or decide matters affecting an entity."<sup>51</sup> Such a power can be either direct or indirect, and need not be actually exercised by the foreign party to meet the defi-

48. See Ilene Knable Gotts and Leon B. Greenfield, *Telecom Without Borders? The Impact of US Pre-Merger Regimes*, Competition Law International (Oct. 2006) at 40.

49. See Ilene Knable Gotts, Leon B. Greenfield, and Perry Lange, *Is Your Cross-Border Deal the Next National Security Lightning Rod? Identifying Potential National Security Issues and Navigating the CFIUS Review Process*, 16 Business Law Today (July/August 2007) at 32.

50. *Id.* at 33.

51. 31 C.F.R. § 800.204 (existing regulation); see also Leon B. Greenfield, Ilene Gotts, and Timothy Schnabel, *Caveat Emptor: the Long Tentacles of "Control" Under Exon-Florio Act Can Surprise the Unwary*, 11 MERGERS & ACQUISITIONS LAW REPORTER, 267 at 268 (Apr. 7, 2008) available at <http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.15477.08.pdf>.

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dition of control. These can include, for example, the ability to withdraw critical funding or the right to veto corporate actions that the minority foreign shareholder does not like. The regulations provide a safe harbor for certain purchases of voting securities solely for the purpose of investment. There are two applicable criteria: (1) to qualify as a purchase solely for the purpose of investment, the acquirer must have “no intention of determining or directing the basic business decisions of the issuer”; and (2) the acquisition will not be deemed to confer control only if, (a) the foreign person would hold ten percent or less of the outstanding voting securities of the U.S. person or (b) the purchase is made directly by one of several enumerated types of investment entities “in the ordinary course of business for its own account, provided that a significant portion of that business does not involve the acquisition of entities.”<sup>52</sup> Many of the recent investments in U.S. businesses by SWFs have been structured to fall within this “investment only” carveout, including Temasek’s \$4.4 billion investment in Merrill Lynch (9.4% stake)<sup>53</sup> and CIC’s \$5 billion investment in Morgan Stanley (9.9% stake).<sup>54</sup> Merely structuring an investment under the ten percent ownership threshold, however, will not necessarily provide comfort to transaction parties: the Treasury Department released proposed rules on April 21, 2008 that clarify that even foreign investments below 10% will not be immune from CFIUS review if they exhibit control or “take any action inconsistent with acquiring or holding its interest solely for the purpose of investment.”<sup>55</sup>

In addition, in some circumstances, foreign investors may obtain large percentage equity stakes in U.S. businesses without CFIUS review by divorcing their equity stake from any ability to control the activities of the U.S. entity. For example, some foreign investors have acquired interests in U.S. businesses by investing in a limited partnership that has a U.S. person serving as the limited partner.<sup>56</sup> Whether these types of equity stakes

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52. Leon B. Greenfield, Ilene Gotts, and Timothy Schnabel, *supra* note 51.

53. See Jed Horowitz and Donna Kardos, *Merrill Lynch Cuts Deal with Temasek, GE as Firm Seeks to Shore up Capital*, THE WALL STREET JOURNAL, Dec. 25, 2007, at 1, available at <http://online.wsj.com/article/SB119850086138148639.html>. <http://www.marketwatch.com/news/story/singapore-investment-company-temasek-reports/story.aspx?guid=%7BD7B39057-3EC4-4B4C-8D97-F7C84052B6CE%7D>.

54. See Andrew Edwards and Jed Horowitz, *Morgan Stanley Swings to Loss Amid Mortgage-Related Woes*, THE WALL STREET JOURNAL, Dec. 19, 2007, at 1.

55. Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons (proposed April 21, 2008) (to be codified at 31 CFR Part 800) at 47, 54-55 (§§ 800.223, 800.302(c)), available at [http://www.treas.gov/press/releases/reports/proposed\\_regulations42108.pdf](http://www.treas.gov/press/releases/reports/proposed_regulations42108.pdf); see also *Proposed Treasury Regulations Provide that Small Investments in U.S. Firms May Be Subject to CFIUS Review*, available at [www.wlrk.com/docs/proposedFINSAregeulations.pdf](http://www.wlrk.com/docs/proposedFINSAregeulations.pdf).

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constitute control will, however, depend on a careful evaluation of the structure of the investment vehicle and the foreign investor's rights under the criteria indicated above.

CFIUS has an initial 30-day review period to determine whether to launch an additional 45-day investigation because the transaction threatens to impair the national security of the U.S.<sup>57</sup> In late 2007, Congress passed the Foreign Investment and National Security Act ("FINSA")<sup>58</sup>, which provides, in relevant part, that an extended review is presumed more likely when the transaction would result in "foreign government control" or in foreign control of "critical infrastructure."<sup>59</sup> At the conclusion of the 45-day investigation, CFIUS will submit a recommendation to the President.<sup>60</sup> The President has 15 days from the date of referral to clear, prohibit, or suspend the transaction.<sup>61</sup>

In the post-9/11 environment, concerns about sovereign foreign investment in U.S. domiciled companies has increased. For instance, CFIUS related concerns caused the abandonment of the 2003 proposed acquisition of Global Crossing's fiber optic network by a consortium including Hutchison Whampoa Ltd of Hong Kong (which reportedly had ties to the Chinese military);<sup>62</sup> concerns regarding the timing and likelihood of obtaining CFIUS approval resulted in the ultimate withdrawal of China National Offshore Oil Corp.'s 2005 bid for Unocal;<sup>63</sup> CFIUS objections cratered the bid of Dubai Ports World, a state-owned company from Dubai to purchase Peninsular and Oriental Steam Navigation Company, a British firm holding the rights to manage cargo operations at major U.S. ports in 2006.<sup>64</sup>

56. Leon B. Greenfield, Ilene Gotts, and Timothy Schnabel, *supra* note 51, at 3.

57. Ilene Knable Gotts, Leon B. Greenfield, and Perry Lange, *supra* note 49, at 33.

58. Foreign Investment and National Security Act of 2007 (FINSA), [Pub. L. 110-49](#); see also Lynn Charytan and Leon B. Greenfield, *The U.S. CFIUS Foreign Investment Review Process: A Regime in Flux*, 2008 Competition Law and Policy Forum, Langdon Hall, Cambridge, ON, WilmerHale, Feb. 6-8, 2008, at 1.

59. Lynn Charytan and Leon B. Greenfield, *supra* note 58, at 9. The proposed regulations define "critical infrastructure" as "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of the particular systems or assets of the entity over which control is acquired pursuant to that covered transaction would have a debilitating impact on national security." Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, *supra* note 55 at 40 (§ 800.207).

60. Ilene Knable Gotts, Leon B. Greenfield, and Perry Lange, *supra* note 49, at 33.

61. *Id.*

62. *Id.*

63. Gotts and Greenfield, *supra* note 33, at 39.

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and, in late March 2008, CFIUS objections thwarted an attempt by China's Huawei Technologies (a telecommunications company reportedly with ties to the Chinese military) to buy 16.5 % of 3Com Corp.<sup>65</sup> As demonstrated by these recent examples, the involvement of foreign governments—especially governments that are not U.S. allies – can be a critical consideration in obtaining CFIUS clearance.

Even against this backdrop of CFIUS enforcement, several U.S. lawmakers continue to raise concerns regarding SWF investments, particularly by China's SWF, the CIC. On February 7, 2008, for example, the US-China Economic and Security Review Commission held a hearing to examine the nature of SWFs in general and whether Chinese investments should be treated differently from other countries' investments so as to protect national security.<sup>66</sup> The White House urged lawmakers to be "very, very careful" when considering legislation that could curb SWF investments, instead focusing on the need for SWFs to be transparent and seek economic, rather than political gains, from their investments.<sup>67</sup> On March 20, 2008, the Bush Administration announced that it had reached agreement with officials from the Abu Dhabi Investment Authority and Singapore's Temasek to develop a set of best practices and had been granted assurance that these funds would not be employed to serve the political goals of their respective sovereigns.<sup>68</sup> Treasury Secretary Henry Paulson has stated that the United States "welcomes sovereign wealth investment and looks forward to continuing to work with these two countries and others to support the initiatives under way at the IMF and the OECD to develop best practices" for the funds and countries where the funds are making investments.<sup>69</sup> Secretary Paulson noted as well that one of the underlying principles for countries receiving the investment, however, is that they "should not erect protectionist barriers to portfolio or direct investment."<sup>70</sup> Time will tell how well the U.S. and other major economies strike this fine balance.

64. Charytan and Greenfield, *supra* note 58, at 7.

65. See Greenfield, Gotts and Schnabel, *supra* note 51, at 267.

66. See Hearing on "China's Views of Sovereignty and Methods of Access Control", Feb. 27, 2008, U.S.- China Economic and Security Review Commission, [www.uscc.gov](http://www.uscc.gov), available at [http://www.uscc.gov/hearings/2008hearings/hr08\\_02\\_27.php](http://www.uscc.gov/hearings/2008hearings/hr08_02_27.php).

67. *White House urges caution on foreign investment curbs*, AFP, Feb. 7, 2008, available at <http://afp.google.com/article/ALeqM5ievh5HGaoymmMDPjrq5ApwtbOA>.

68. See Martin Crutsinger, *Sovereign Wealth Funds Discussed*, SFGATE ( Mar. 20, 2008), at 2, available at <http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2008/03/20/national/w124056D25.DTL>.

69. *Id.*

70. *Id.*

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The government attention being focused on SWF investments is a continuation of the increased focus on foreign investments generally, particularly in the post-9/11 environment. The heightened scrutiny afforded to transactions involving foreign investors, including SWFs, should be taken into account when evaluating a potential investment that might raise national security issues. To date, both European and U.S. regulators have limited their focus on SWFs to legitimate issues of national security and have not used the opportunity as a means for favoring domestic acquirers or engaging in protectionism more generally. However, while the CFIUS process in the U.S. outlines a relatively clear procedural path, in Europe, the possible combination of national legislation, Community principles of free movement of capital as interpreted by the European Court and political sensitivities can create a more complex process for both the target and the investor. Targets need to take into account the additional time and risk that may be associated with investments by foreign entities, particularly from countries that are not considered “friendly” at this time. Bids involving SWFs, for instance, may need to be more proactive in making commitments to address the risk of national security and economic concerns, including in the structuring of the post-investment governance of the target investment, particularly when competing against domestic bidders. In any event, transaction parties, whether in Europe or the U.S., should plan in advance to navigate through these foreign investment issues to minimize the potential for surprises and challenges to their transaction.

**For more information on antitrust law**, see Antitrust Laws and Trade Regulation, chapters 9 and 10 (Matthew Bender).

**For more information on European Merger Control Law**, see European Merger Control Law (Matthew Bender).

**For more information on European Competition Laws**, see European Competition Laws (Matthew Bender).

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began her career as a staff attorney in the Bureau of Competition of the Federal Trade Commission in conduct and merger investigations, and in the Federal Trade Commission Bureau of Consumer Protection.

In 1995, Ms. Gotts served as the President of the Washington Council of Lawyers. She was the Chair of the Antitrust and Trade Regulation Section of the Federal Bar Association from 1995-1997. An active participant in the Section of Antitrust Law of the American Bar Association, Ms. Gotts is currently the Vice Chair and will be the Chair of the Section in 2009-2010. She previously served as the International Officer and the Chair of the Antitrust Section's Task Force on the Merger Review Process, and as a member of the International Task Force, as well as the Chair on the Section's Mergers Committee, and Vice Chair of the Intellectual Property Committee. In 2006 - 2007, Ms. Gotts was the chair of the Antitrust Section of the New York State Bar Association. Ms. Gotts is regularly recognized as one of the world's top antitrust lawyers, including being recognized in both the 2006 and 2007 Editions of *The International Who's Who of Business Lawyers*, as one of the top 15 global competition lawyers, in the first tier ranking of Chambers USA Guide, and the "leading individuals" ranking of PLC *Which Lawyer Yearbook* 2007 Edition.

Ms. Gotts edited both the second and third editions of the ABA's treatise on the Antitrust Merger Review Process and has had published over 120 articles on antitrust issues relating to mergers and acquisitions and Hart-Scott-Rodino compliance. She also is a frequent lecturer on antitrust topics. She serves on the advisory boards of *Antitrust and Trade Regulation Report*, *Antitrust Counselor* and *Antitrust Report*.

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Europe, including CIS and Russia. Mr. von Hehn's practice ranges from corporate and international transactions to compliance, including investigations and corporate governance issues.

Mr. von Hehn's practice has a strong focus on regulated industries with particular experience in the telecoms and aviation sectors. He has helped companies structure complex international M&A and joint venture transactions and has pioneered prominent industry alliances in the communications and aviation sectors.

He has represented fixed and mobile telecommunications operators, advising them on network sharing arrangements and international strategic alliances to broaden their footprints, as well as providing strategic advice on the "conversion" issues related to the Internet, IT and the relationship to the media industry in general.

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Mr. von Hehn was a visiting instructor at the Rome-based International Development Law Institute (IDLI) and taught courses on concessions, joint ventures and infrastructure investments in the telecommunications and transport sectors. He has written and spoken on telecommunications topics, developments in European Community law, US banking and securities laws, China developments, and corporate investigations and compliance.

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