

2009

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Recommended Citation

Zhao Feng, *How Should Sovereign Wealth Funds Be Regulated?*, 3 Brook. J. Corp. Fin. & Com. L. (2009).
Available at: <https://brooklynworks.brooklaw.edu/bjcfcl/vol3/iss2/7>

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HOW SHOULD SOVEREIGN WEALTH FUNDS BE REGULATED?

I. INTRODUCTION

Before 2007, few had heard of sovereign wealth funds (SWFs). SWFs became visible during the subprime mortgage housing crisis that began in summer 2007, during which large U.S.-based financial institutions suffered huge losses and turned to foreign investors to ease the resulting credit crunch. In many cases, these investors are state-controlled.¹ According to an estimate by Morgan Stanley, SWFs invested about \$37 billion in U.S. financial institutions in 2007.² Although SWF infusions have alleviated the credit crunch and played a stabilizing role, SWFs have raised concerns due to their high-profile deals and increasing sizes. First, SWFs are generally opaque about investment criteria, management, and financial information, thus potentially presenting a systematic risk to market security.³ Second, because they are controlled by governments, SWFs may not focus on wealth maximization.⁴ Non-commercial considerations may threaten the

1. *When Nations Amass Dollars, the Fault Lies in Ourselves*, USA TODAY, Jan. 21, 2008, at 10A, available at <http://www.usatoday.com/printedition/news/20080121/edit21.art.htm>.

2. See Anders Aslund, *The Truth About Sovereign Wealth Funds*, FOREIGN POLICY, Dec. 2007, http://www.foreignpolicy.com/story/cms.php?story_id=4056; see also *China Fund Grabs Morgan Stanley Stake*, THE SIDNEY MORNING HERALD, Dec. 20, 2008, available at <http://business.smh.com.au/china-fund-grabs-morgan-stanley-stake/20071220-1i6p.html> (stating in December 2007, the China Investment Corporation invested \$5 billion in Morgan Stanley, soon after the financial firm announced it was writing off \$9.4 billion of loss in mortgage investments); *Citi to Sell \$7.5 Billion of Equity Units to the Abu Dhabi Investment Authority*, REUTERS, Nov. 26, 2007, <http://www.reuters.com/article/mergersNews/idUSN2643967220071127> (discussing that in November 2007, the Abu Dhabi Investment Authority (ADIA), the world's largest state-owned fund, purchased a 4.9% stake in Citigroup for \$7.5 billion); Marine Cole, *Hybrids Let Foreign Investors Skirt Fed's 9.9% Wall*, FIN. WEEK, Jan. 21, 2008, available at <http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080121/REG/9599056/1028>; Thomas Heath, *Government of Abu Dhabi Buys Stake in Carlyle*, WASHINGTON POST, Sept. 21, 2007, § Financial, at D01 (stating in September 2007, Dubai's Mubadala Development Company invested \$1.35 billion for a 7.5% stake in the Carlyle Group, a private-equity firm); *Merrill Lynch Will Sell Stake to Temasek Holdings*, REUTERS, Dec. 25, 2007, <http://www.cnbc.com/id/22395384/> (Merrill Lynch announced that Singapore's Temasek would buy \$4.4 billion worth of Merrill stock with an option to buy \$600 million more by March 2008); Yalman Onaran, *Citigroup, Merrill Receive \$21 Billion from Investors*, REUTERS, Jan. 15, 2007, <http://www.bloomberg.com/apps/news?pid=20601087&sid=anjGWhqi0PSE&refer=home> (discussing that in January, 2008, sovereign funds from Abu Dhabi, Kuwait, Singapore, and South Korea provided a \$21 billion infusion of capital to Citigroup and Merrill Lynch. The funds owners were Tokyo-based Mizuho Financial Group Inc., the Korean Investment Corp., the Kuwait Investment Authority, the Government of Singapore Investment Corp. and Saudi Prince Alwaleed bin Talal).

3. See generally EDWIN TRUMAN, A SCOREBOARD FOR SOVEREIGN WEALTH FUNDS (Peterson Inst. for Int'l Econ. 2007) [hereinafter TRUMAN, A SCOREBOARD].

4. EDWIN TRUMAN, SOVEREIGN WEALTH FUNDS: THE NEED FOR GREATER TRANSPARENCY AND ACCOUNTABILITY 4-6 (Peterson Inst. for Int'l Econ. 2007) [hereinafter TRUMAN, SOVEREIGN WEALTH FUNDS].

national security of host countries.⁵ Given these concerns, there have been calls for greater scrutiny of SWF activities.

The United States has modified the Foreign Investment and National Security Act (FINSAs) to strengthen interagency review of foreign investment.⁶ France and Germany have avowed that they will not allow acquisitions from state-controlled investors to take place in their territories.⁷ Some economists and policy makers, however, see restrictions on SWFs as protectionist responses and are concerned about the negative effects of protectionism.⁸ They stress the benefits of foreign capital, such as lowering interest rates and promoting employment and innovation.⁹

There is a delicate balance between the protection of national security and an open investment policy. This note argues that FINSAs, a unilateral U.S. regulation of foreign investment with an emphasis on SWFs, is unnecessary and may even be harmful to the U.S. capital markets and overall economy. In coordination with other countries, especially the European countries into which SWF capital has increasingly flowed, the U.S. should instead further its efforts for increased SWF transparency. In addition, the U.S. should maintain and refine its present regulation of foreign ownership in sensitive industries such as energy and telecommunications.

Part II of this note describes the history of SWFs and their current development. Part III addresses concerns and benefits relating to SWFs. Part IV reviews U.S. policy and regulation of foreign investment. Part V argues for the establishment of a set of international guidelines that address SWF transparency. Part VI concludes by arguing that U.S. efforts to establish international guidelines for SWF activities will be in line with U.S. national interests and the open investment policy that the United States has traditionally advocated.

II. SWFs: DEVELOPMENT AND INVESTMENT APPROACHES

An SWF is a government investment vehicle funded by foreign exchange assets that are managed separately from a country's official

5. *Id.*

6. Ed Mullane & Bhavna Kaul, *Sovereign Wealth Funds Could be Impacted by Upcoming FINSAs Regulations*, FIN. TIMES, Feb. 4, 2008, available at http://www.ft.com/cms/s/2/d33cd7fd34b-11dc-b861-0000779fd2ac,dwp_uuid=e8477cc4-c820-11db-b0dc-000b5df10621.html.

7. Carter Dougherty, *Europe Looks to Control State-run Investors; Officials are wary of Intentions of China and Russia*, INT'L HERALD TRIB., July 14, 2007, § News, at 1; see also *Sarkozy Attacks Wealth Funds on Eve of Mideast Trip*, REUTERS, Jan. 12, 2008, <http://www.reuters.com/article/oilRpt/idUSL1220023020080112>.

8. *Asset-backed Insecurity*, THE ECONOMIST, Jan. 19, 2008, available at http://www.economist.com/opinion/displaystory.cfm?story_id=10533428.

9. *Id.* See also Jonathan C. Stagg, *Scrutinizing Foreign Investment: How Much Congressional Involvement is Too Much*, 93 IOWA L. REV. 325, 331 (2007).

reserves.¹⁰ In addition to high foreign currency exposures, SWFs feature other key elements, including a high-risk tolerance, long investment horizons, and a lack of explicit liabilities.¹¹

Although the term was recently coined, SWFs are by no means a new phenomenon. The first fund, Kuwait Investment Board, was established in 1953.¹² Early sovereign funds generally had moderate goals. For example, the Kuwait fund was created as a means to stabilize its economy from volatile oil prices,¹³ and Kiribati's Revenue Equalization Reserve Fund was formed in 1956 to manage profits from phosphate mining.¹⁴ However, the landscape of SWFs has changed. As SWFs have grown rapidly in recent years, countries' currency reserve cushions intended for economic stabilization have exceeded their immediate needs.¹⁵ Accordingly, SWF owners have begun engaging in riskier, yet potentially higher-yielding, investments.¹⁶

A. RECENT DEVELOPMENT OF SWFS

The 1970s and 1990s saw the two major waves of SWF formation. In the 1970s, in response to the oil crisis caused by the Arab oil embargo, Middle East and American countries established funds to mitigate oil shock.¹⁷ In the 1990s, more sovereign funds were formed, following Norway's Government Pension Fund - Global, which was launched in 1990 to preserve wealth for future generations of Norwegians.¹⁸ This wave continues today. In the past eight years, funds have been established by China, Iran, Russia, Qatar, and the United Arab Emirates.¹⁹ In December 2007, Saudi Arabia announced plans to establish an SWF that is likely to be

10. DEP'T OF THE TREASURY, REPORT TO CONGRESS ON INT'L ECONOMIC AND EXCHANGE RATE POLICIES (2007), <http://www.treas.gov/offices/international-affairs/economic-exchange-rates/>.

11. STEPHEN JEN, CURRENCIES: THE DEFINITION OF A SOVEREIGN WEALTH FUND, MORGAN STANLEY GLOBAL RES. Oct. 25, 2007, available at <http://sovereignwealthfunds.files.wordpress.com/2008/01/the-definition-of-a-sovereign-wealth-fund-morgan-stanley-october-2007.pdf>.

12. See generally Martin Weiss, *Sovereign Wealth Funds: Background and Policy Issues*, CRS REPORT FOR CONGRESS (RL34336; Jan. 28, 2008) (discussing how the Kuwait Investment Board was later acquired by the Kuwait Investment Authority, a separate fund founded in 1960).

13. *Id.*

14. *Id.*

15. David J. Lynch, *Foreign Governments Seek Higher Returns; Cash-rich Nations' Secretive Investment Funds May Hurt Treasuries, Trigger Backlash*, USA TODAY, June 21, 2007, § Money, at 1B.

16. *Id.*

17. See *Gas Fever: Happiness Is a Full Tank*, TIME MAG., Feb. 18, 1974. See also TRUMAN, A SCOREBOARD, *supra* note 3.

18. Weiss, *supra* note 12.

19. *Id.* See also TRUMAN, A SCOREBOARD, *supra* note 3.

the world's largest.²⁰ The proposed Saudi fund would dwarf the world's presently largest SWF, the Abu Dhabi Investment Authority and Corporation (ADIA).²¹

Not only have SWFs increased in numbers, their value has grown rapidly in recent years. The value of Norway's Government Pension Fund – Global grew 28% in 2006, resulting in current holdings exceeding \$300 billion.²² The value of the portfolio for Singapore's Temasek Holdings rose 35% to \$108 billion in assets.²³ The Kuwait Investment Authority grew 30% to reach over \$200 billion in holdings.²⁴ The growth rate for Russia's Stabilization Fund was 96%.²⁵ The fund had over \$140 billion in assets in 2007.²⁶ The ADIA has achieved a 20% rate of return for many years and rarely considers deals less than \$100 million.²⁷ Although China's \$3 billion investment in the Blackstone Group has lost more than half its value,²⁸ China's \$1.5 trillion in foreign reserves is growing at a rate of more than \$20 billion a month.²⁹

The Federal Reserve Bank of New York estimates that SWFs have a combined \$2.5 trillion at their disposal, larger than the combined assets of all hedge funds and private equity funds.³⁰ Morgan Stanley projects that SWFs will grow to \$12 trillion by 2015.³¹ Funds derived from oil and gas export revenues constitute approximately two-thirds of the total assets held by SWFs, with the rest consisting of funds primarily controlled by Asian surplus exporters.³² Table 1 provides a list of the major SWFs in the world.

20. Henny Sender & David Wighton, *Saudis Plan Huge Sovereign Wealth Fund*, FIN. TIMES, Dec. 21, 2007, available at http://us.ft.com/ftgateway/superpage.ft?news_id=fto122120071455059553.

21. *Id.*

22. See *Investments—World Grows More Wary of Sovereign Wealth Funds*, ASIAMONEY, Nov. 28, 2007, available at <http://www.asiamoney.com/Article/2055809/Channel/18816/INVESTMENTS-World-grows-more-wary-of-sovereign-wealth-funds.html> [hereinafter *Investments*].

23. *Id.*

24. *Id.*

25. *Id.*

26. TRUMAN, A SCOREBOARD, *supra* note 3.

27. Henny Sender, *Live at Apollo (Management): Plan to Cash In, Limit Scrutiny*, WALL ST. J., July 17, 2007 at C1.

28. Michael Flaherty, *Sovereign Wealth Funds are Shying Away from Wall Street Firms*, INT'L HERALD TRIB., Mar. 18, 2008, § Finance, at 12.

29. For further detail, see the monthly data on the website of China's State Administration of Foreign Exchange (SAFE), <http://www.safe.gov.cn>.

30. George F. Will, *Investors We Need Not Fear*, WASHINGTON POST, Feb. 3, 2008, at B07, available at <http://www.washingtonpost.com/wp-dyn/content/article/2008/02/01/AR2008020102662.html>.

31. Stephen Jen, *Currencies: How Big Can Sovereign Wealth Funds be by 2015*, MORGAN STANLEY GLOBAL RES., May 3, 2007. See also *Investments*, *supra* note 22 (Gerard Lyons, chief economist at Standard Chartered, estimates that SWFs will grow six-fold in the next decade, a potential total of \$13.2 trillion).

32. Jen, *supra* note 31.

Table 1³³
World's Largest SWFs

Country	Funds	Size (\$ billions)	Year Established
United Arab Emirates	Abu Dhabi Investment Authority and Corporation (ADIA)	500–875	1976
	Mubadala Development Company	10	2002
	Isithmar	4	2003
Norway	Government Pension Fund – Global	329	1990
Singapore	Government of Singapore Investment Corporation (GIC)	100–330	1981
	Temasek Holdings	108	1974
Kuwait	Kuwait Investment Authority	213	1960
China	China Investment Corporation, Ltd. (CIC)	200	2007
Russia	Stabilization Fund for the Russian Federation	141	2004
Qatar	Qatar Investment Authority	50	2005
Australia	Future Fund	49	2006
Algeria	Revenue Regulations Fund	43	2000
United States	Alaska Permanent Fund	40	1976
Brunei	Brunei Investment Agency	30	1983
Korea	Korea Investment Corporation	20	2005
Kazakhstan	National Oil Fund	19	2000
Malaysia	Khazanah Nasional	18	1993
Venezuela	National Development Fund	15	2005
	Macroeconomic Stabilization Fund	1	1998
Canada	Alberta Heritage Savings Trust Fund	15	1976
Chile	Economic and Social Stabilization Fund	10	2006
New Zealand	Superannuation Fund	10	2001
Iran	Oil Stabilization Fund	9	2000

B. REASONS FOR SWF GROWTH AND CHANGES IN SWF INVESTMENT APPROACHES

The recent growth of SWFs can be attributed to several factors. First, it is a consequence of the rapid increase of commodity prices and large trade surpluses in emerging markets.³⁴ The recent commodity price boom has swelled the asset holdings of commodity-exporting countries.³⁵ The value

33. TRUMAN, A SCOREBOARD, *supra* note 3. See also Belinda Cao, *China's \$200 Billion Sovereign Fund Begins Operations*, BLOOMBERG, Sept. 29, 2007, <http://www.bloomberg.com/apps/news?pid=20601080&sid=aPeGXnGYN9g4> (last visited Apr. 9, 2009).

34. Weiss, *supra* note 12.

35. *Id.*

of oil and gas exports from the Middle East was about \$650 billion in 2007 and is expected to rise in coming years.³⁶ Worldwide government revenues from oil and gas are estimated at \$510 billion for 2007 and will keep increasing.³⁷ Considering these revenues to be temporary, Middle East countries have avoided using them for domestic expenditures, which may cause serious economic problems such as inflation. Instead, they have invested the excess commodity-export income in SWFs.³⁸ The savings thus serve as a financial stabilizer if commodity prices decline and depress tax revenue.³⁹ Because they serve immediate needs, funds intended for financial stabilization tend to be conservative in their investment decisions, focusing on fixed income rather than equity investment.⁴⁰

Although many oil funds are predominantly oriented towards stabilization, as the assets of funds reach a level beyond stabilization needs, the objective of saving wealth across generations takes priority.⁴¹ Consequently, savings funds are utilized to transform public assets, such as oil and other natural resources that are subject to fluctuating commodity prices, into a diversified and conceivably stable global portfolio, thereby protecting the income stream for future generations. As compared to stabilization funds, savings funds are characterized as having longer investment horizons and more aggressive investment strategies.⁴² Savings funds are invested in a broader range of assets, including longer-term government bonds, agency and asset-backed securities, corporate bonds, equities, commodities, real estate, derivatives, private equity, hedge funds, and foreign direct investment.⁴³

A second factor behind the growth of SWFs is the long-standing trade surpluses of Asian emerging market countries with the United States and other Western countries, resulting in huge foreign currency reserves.⁴⁴ Following the 1998 Asian financial crisis, many Asian economies began accumulating large amounts of reserves to provide adequate insurance against future currency fluctuations.⁴⁵ Given the goal of these currency

36. AASIM M. HUSAIN, RIDING THE CREST OF THE OIL BOOM, IMF MIDDLE EAST AND CENTRAL ASIA DEPARTMENT (Oct. 30, 2007), <http://www.imf.org/external/pubs/ft/survey/so/2007/CAR1030A.htm>; see also INTERNATIONAL MONETARY FUND, REGIONAL ECONOMIC OUTLOOK: MIDDLE EAST AND CENTRAL ASIA, Oct. 2008.

37. *Id.*

38. *Sovereign Wealth Funds: Stumbling Blocks or Stepping Stones to Financial Globalization*, FRBSF ECONOMIC LETTER, Dec. 14, 2007, <http://www.frbsf.org/publications/economics/letter/2007/el2007-38.html>.

39. *Id.*

40. Rachel Ziemba, *Responses to Sovereign Wealth Funds: Are 'Draconian' Measures on the Way?*, RGE MONITOR, Nov. 2007, available at http://www.rgemonitor.com/economonitor-monitor/220669/responses_to_sovereign_wealth_funds_are_draconian_measures_on_the_way.

41. See *Sovereign Wealth Funds*, *supra* note 38.

42. *Id.*

43. *Id.*

44. Weiss, *supra* note 12.

45. See *Asset-backed Insecurity*, *supra* note 8.

reserves, they were invested conservatively. For example, China initially invested much of its reserves in U.S. government treasury bills, which offered little risk but low rates of return on the investment.⁴⁶ As the foreign reserves grew beyond Asian countries' immediate needs, however, their risk tolerance increased, and the countries holding large reserves began diversifying portfolios and seeking riskier yet potentially higher-yielding investments.⁴⁷ Finally, in addition to trade surpluses, foreign currency reserves of countries like China also result from their attempts to limit the appreciation of their own currency against the dollar.⁴⁸

C. SWF GOALS & TRANSPARENCY

SWF owners claim to have different goals for their funds. The CIC was created to "improve the rate of return on China's . . . foreign exchange reserves and to soak up some of the nation's excess financial liquidity."⁴⁹ The Norwegian government says its fund is an instrument for ensuring that a reasonable portion of the country's petroleum wealth benefits future generations.⁵⁰ A country may have multiple SWFs and multiple goals for the funds. The United Arab Emirates created the ADIA, its primary fund, to invest surplus cash in assets that provide steady returns over the long run; its newer fund, Mubadala Development, however, has pursued direct investment projects targeted at higher returns.⁵¹

SWFs also differ in management and levels of transparency. Norway's and Qatar's funds are directly managed through the central bank or the finance ministry, while the United Arab Emirate's funds are incorporated as private companies with some degree of independence.⁵² However, funds' management structure does not necessarily speak of their transparency level. The funds of Norway, New Zealand, Alaska, and Canada are highly transparent in their investment criteria and financial accounting. They conventionally invest in a wide range of investments, including bonds,

46. Joe McDonald, *China to Create Firm to Invest Its \$1 Trillion in Reserves*, ASSOCIATED PRESS, Mar. 10, 2007, available at <http://www.globalresearch.ca/index.php?context=va&aid=5039>.

47. Lynch, *supra* note 15.

48. Wayne M. Morrison & Marc Labonte, *China's Currency: Economic Issues and Options for U.S. Trade Policy*, CRS REPORT FOR CONGRESS (RL32165; Jan. 9, 2008).

49. Michael F. Martin, *China's Sovereign Wealth Funds*, CRS REPORT FOR CONGRESS (RL34337; Jan. 22, 2008).

50. See, e.g., *Transparency and Trust: Keys to the Norwegian Pension Fund*, Norway the Official Site in the United States, <http://www.norway.org/policy/gpf/norwegian+pension+fund+global.htm>.

51. Weiss, *supra* note 12, at 7.

52. Jim Hamilton's World of Securities Regulation, SEC and European Commission Seek More Transparency for Sovereign Wealth Funds, <http://jimhamiltonblog.blogspot.com/search?q=SEC+and+European+Commission+Seek+More+Transparency+for+Sovereign+Wealth+Funds> (Dec. 25, 2007, 16:15 EST).

equities, commodities, and foreign direct investment.⁵³ Malaysia's SWF and Singapore's Temasek Holdings, while also transparent, pursue more strategic holdings, targeting industries that are of sovereign interest.⁵⁴ Funds controlled by the United Arab Emirates, Qatar, Kuwait, and China are among those that disclose the least information about their activities and are most likely to consider sovereign interests in their investing activities.⁵⁵

III. SWFs: CONCERNS AND BENEFITS

Because SWFs have become increasingly active as market participants, they will likely affect financial markets in a systematic manner. SWFs thus draw attention from financial analysts and policymakers, who have assessed the benefits and possible detriments of SWFs. This part begins with a list of concerns about sovereign funds, followed by an evaluation of them. It concludes by analyzing the benefits that SWFs have brought and will likely bring to the U.S. and global economies.

A. CONCERNS ABOUT SWF ACTIVITIES

1. Lack of Transparency

SWF transparency can be measured in terms of the level of disclosure of the following factors: size of the fund, types of investment, earnings, holders of investment mandates, auditing, geographic location, investment instruments, and currency composition of investments.⁵⁶ Among the funds that have shown a high level of transparency are the funds of Norway and New Zealand.⁵⁷ In contrast, those owned by the United Arab Emirates, Qatar, Kuwait, and China are less transparent.⁵⁸

SWF transparency is important for a few key reasons. First, limited disclosure of SWFs makes it difficult to determine whether funds are pursuing non-commercial interests, which has created fear of SWF activities.⁵⁹ Second, the lack of disclosure also makes it difficult to assess governance of the funds by obscuring mismanagement and governance irregularities within the funds.⁶⁰ This problem is of particular concern as many SWFs are established in countries that lack the underpinnings for good corporate governance. Some policymakers consider that, in these countries, sizable failures in management and corruption by fund managers are possible, and that the problem may be worsened because of limited

53. See *Sovereign Wealth Funds*, *supra* note 38.

54. Weiss, *supra* note 12.

55. TRUMAN, A SCOREBOARD, *supra* note 3.

56. *Id.*

57. *Id.*

58. *Id.*

59. Weiss, *supra* note 12.

60. *Id.*

disclosure under which the risk of the funds cannot be monitored as necessary.⁶¹

2. Strategic Holdings

The rise of SWFs has triggered concern over “state capitalism.”⁶² By investing heavily in U.S. companies, foreign governments can use SWFs to seize control of companies in sensitive sectors to promote their own political agenda and threaten U.S. national security.⁶³ Strategic areas include financial services, defense, energy, and telecommunications.⁶⁴

According to Dealogic, a financial data provider, SWFs invested \$37.9 billion in U.S. financial institutions in 2007, 63% of total SWF activity.⁶⁵ Investment in financial services offers potential access to technology and expertise unavailable abroad that can be transferred home.⁶⁶ There are misgivings about sovereign stakes in U.S. banks given Asian countries’ interest in developing their domestic financial markets.⁶⁷ Alex Pollock of the American Enterprise Institute stated in 2008 that SWFs were “arms of the state,” and that “out-flow of insider knowledge” due to foreign stakes in U.S. banks should be taken seriously.⁶⁸

Defense is another area of investment raising national security concerns. In early 2006, Dubai Ports World, a company controlled by the government of Dubai, attempted to acquire Peninsular & Oriental Steam Navigation Co., a U.K.-based company running global operations in more than a dozen ports, including six U.S. port facilities.⁶⁹ The attempt caused debates over whether U.S. national security was threatened by the transaction, and Dubai Ports World, under U.S. pressure, agreed to spin off the American assets to a purely American company.⁷⁰

Acquisitions of large holdings in energy are considered another potential threat to national security. In 2005, China National Offshore Oil Cooperation attempted to purchase the U.S. energy company Unocal, which triggered substantial congressional debates, including debates concerning

61. *Id.*

62. *Id.*

63. Andrew Ross Sorkin, *What Money Can Buy: Influence*, N.Y. TIMES, Jan. 22, 2008, available at <http://www.nytimes.com/2008/01/22/business/22sorkin.html?dlbk>.

64. Richard Portes, *Sovereign Wealth Funds*, VOXEU, Oct. 17, 2007, available at <http://www.voxeu.org/index.php?q=node/636>. See also David Rothnie, *Sovereign Wealth Spending on Banks Exceeds \$50bn*, FIN. NEWS ONLINE, Jan. 14, 2008, <http://www.financialnews-us.com/?page=ushome&contentid=2449561453>.

65. Rothnie, *supra* note 64.

66. See *Investments*, *supra* note 22.

67. Cole, *supra* note 2.

68. Mullane & Kaul, *supra* note 6.

69. See Greg Hitt, *Lawmakers Keep Up Pressure on Dubai Ports Firm*, WALL ST. J., Mar. 16, 2006, at A4.

70. Mullane & Kaul, *supra* note 6.

China's possible intention to secure access to natural resources, causing China to abandon the deal.⁷¹

Telecommunication is also an area raising national security issues. Foreign ownership in telecommunications is regarded as a threat to the dilution of culturally significant content in broadcasting.⁷²

3. Threat to Market Stability

SWF activities have sparked concerns that large foreign holdings of U.S. securities increase the risk of a financial crisis as a result of potential large-scale liquidation or portfolio adjustments for economic or non-economic reasons.⁷³ Some believe that if a withdrawal of foreign funds occurs during a period when the domestic economy is growing slowly, the impact of such withdrawal will be damaging.⁷⁴ The Federal Reserve typically reduces interest rates to stimulate the economy. However, if outflows of needed capital occurred in an economic recession, it would force the Federal Reserve to raise interest rates to attract capital inflows.⁷⁵ Elevated rates would lead some companies to reduce borrowing and investing. They would also discourage household consumption, especially of interest-sensitive products such as housing and automobiles.⁷⁶ Over the long run, persistently lower levels of investment and consumption would impact the growth rate of the economy.⁷⁷

Another concern relating to market security is the uncertain risk of hybrid instruments that have been used in SWFs.⁷⁸ A hybrid instrument generally refers to a financial vehicle that blends characteristics of debt and equity markets.⁷⁹ An example of a hybrid instrument is a convertible bond.⁸⁰ For the purpose of the Bank Holding Company Act (the Act),⁸¹ a hybrid instrument is classified as debt.⁸² Since investment in debt generally does not give a lender voting rights or control over a company, the controlling ownership threshold applied to a foreign investor's equity

71. Edmund L. Andrews, *A Furor Was Built on Many Grudges*, N.Y. TIMES, Aug. 3, 2005, available at <http://www.nytimes.com/2005/08/03/business/03react.html>.

72. JEFFREY ROBERTSON, FOREIGN OWNERSHIP IN THE TELECOMMUNICATIONS SECTOR, PARLIAMENT OF AUSTRALIA <http://www.aph.gov.au/Library/pubs/RN/2004-05/05rn34.htm>.

73. JAMES K. JACKSON, U.S. CONGRESSIONAL RESEARCH SERVICE, FOREIGN OWNERSHIP OF U.S. FINANCIAL ASSETS: IMPLICATIONS OF A WITHDRAWAL (RL34319; Jan. 14, 2008).

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

78. Cole, *supra* note 2.

79. What Does Hybrid Security Mean?, Investopedia, a Forbes Digital Company, <http://www.investopedia.com/terms/h/hybridsecurity.asp>.

80. *Id.*

81. 12 U.S.C. § 1841 (2006).

82. Cole, *supra* note 2.

holding under the Act does not apply to its investment in debt.⁸³ Accordingly, as long as SWF investments represent less than ten percent of the bank or bank holding company's voting shares, they will escape scrutiny under the Act even though SWFs also hold hybrids.⁸⁴ Some have expressed concern that sovereign funds may try to boost their stake in U.S. companies by investing in the form of hybrids.⁸⁵

4. Conflicts of Interest

Conflicts of interest are also a concern for SWFs. They commonly arise when a government is both the regulator and the regulated.⁸⁶ Christopher Cox, former chairman of the U.S. Securities and Exchange Commission (SEC), has raised concern over conflicts of interest in SWFs.⁸⁷ According to Cox, because foreign governments control SWFs, SWFs may not be fully cooperative in the SEC's investigation of cases where a government-backed issuer is suspected of violating U.S. securities laws, which may jeopardize investors' interests and the SEC's mission of protecting investor and market integrity.⁸⁸

B. CONCERNS ABOUT SWFs ARE UNTENABLE

Foreign investments have existed in the U.S. market for a long time,⁸⁹ but there is no empirical data showing that they are or have been used to engage in market manipulation or to serve as a political vehicle to force the United States to compromise its national security.⁹⁰ Although the historical record may not determine the future course of SWF activities, it potentially demonstrates the true nature of the funds. Also, other than for commercial reasons, it is difficult to imagine what types of events could trigger a withdrawal of SWFs from U.S. financial markets.⁹¹ Further, even if they

83. *Id.*

84. *Id.* See also 12 U.S.C. § 1841(a)(2) (2006). The Act requires any company to obtain approval from the Federal Reserve before making a direct or indirect investment in a U.S. bank or bank holding company if the investment meets certain thresholds. In particular, the Act defines that the control interest is acquired when: (1) ownership or control of 25 percent or more of any class of voting securities of the bank or bank holding company, (2) control of the election of a majority of the board of directors of the bank or bank holding company, or (3) the ability to exercise a controlling influence over the management or policies of the bank or bank holding company.

85. Cole, *supra* note 2.

86. Christopher Cox, Former Chairman, Sec. & Exch. Comm'n, Speech by SEC Chairman: The Rise of Sovereign Business, Gauer Distinguished Lecture in Law and Policy at the American Enterprise Institute Legal Center for the Public Interest (Dec. 5, 2007), available at <http://www.sec.gov/news/speech/2007/spch120507cc.htm>.

87. *Id.*

88. *Id.*

89. James Surowiecki, *Sovereign Wealth World*, THE NEW YORKER, Nov. 26, 2007, available at http://www.newyorker.com/talk/financial/2007/11/26/071126ta_talk_surowiecki.

90. See *Asset-backed Insecurity*, *supra* note 8.

91. Jackson, *supra* note 73.

continue growing at the current rates, SWFs will remain a small portion of the world economy, and can hardly disrupt it in a significant manner.⁹² In today's globally interdependent market, collective manipulation of large funds, such as a sudden withdrawal of the funds from the U.S. market, is more likely to harm foreign investors than to harm the U.S. economy as a whole.⁹³ Other mechanisms help prevent SWF mischief, including market competition,⁹⁴ the passivity of SWFs,⁹⁵ and SWF owners' increased awareness of financial practices. Therefore, many concerns and speculations about SWF harm are unfounded.

1. SWFs Constitute a Small Portion of the World Economy

Although they grow rapidly, with an estimated \$2.5 trillion in total assets, SWFs are worth "much less than the \$16 trillion, \$18 trillion and \$22 trillion managed by insurance companies, pension funds and mutual funds, respectively."⁹⁶ In fact, total SWF assets make up only 2% of the world's \$165 trillion in traded securities.⁹⁷ Even if SWFs maintain their growth rate and reach \$12 trillion by 2015, the funds will still account for less than 3% of global traded securities.⁹⁸

The following statistics also illuminate the size of SWF assets. First, combined SWF assets are a small fraction of the \$14 trillion U.S. economy.⁹⁹ Second, the U.S. economy is larger than the next four largest economies combined—those of Japan, Germany, Britain and China.¹⁰⁰ Finally, Russia's economy is about the size of New York's and Arizona's combined, and India's economy is about half the size of California's.¹⁰¹

2. Collective Maneuvering of Funds Will Harm Foreign Investors Themselves

If foreign investors with large holdings attempt to collectively maneuver their funds to threaten U.S. markets, they will likely either liquidate U.S. Treasury securities rapidly, or shift the composition of their portfolios.¹⁰² These activities, however, will be more likely to cause damage to the investors themselves than to the U.S. economy because of the

92. Will, *supra* note 30.

93. Adam Davidson, *Morning Edition: U.S. Watches Nervously as Oil-Rich Nations Invest*, (Nat'l Public Radio broadcast, Nov. 30, 2007).

94. Surowiecki, *supra* note 88.

95. Cole, *supra* note 2.

96. Will, *supra* note 30.

97. See *Asset-backed Insecurity*, *supra* note 8.

98. *Id.*

99. Will, *supra* note 30.

100. *Id.*

101. *Id.*

102. Jackson, *supra* note 73.

interdependent nature of the global market and the market's capability for self-adjustment.¹⁰³

If foreign investors attempt to liquidate their U.S. securities rapidly, they will likely experience a severe loss for two reasons. First, their attempt to sell quickly will create a huge supply of securities in the market, which will reduce their gains from liquidation.¹⁰⁴ Second, their attempt to transform their dollar holdings into other currencies will create large demand for other currencies, which will drive up their investment outlays.¹⁰⁵ Given these losses, foreign investors seem unlikely to engage in coordinated large-scale liquidation.

Further, the impact of such liquidation on the U.S. economy will likely be minimal because other investors will arbitrage these transactions for their benefit.¹⁰⁶ In the face of a large-scale liquidation of dollar-denominated assets, new investors may well consider these assets undervalued and, accordingly, liquidate or leverage their now higher-priced foreign securities and use the proceeds to acquire dollar-denominated assets, thereby replacing those selling U.S. securities.¹⁰⁷ Given the dynamic nature of capital markets and the instant communication of information, the adverse effects on the U.S. economy due to such a large-scale liquidation, including the reduced price of Treasury securities and increased interest rates, should be "short-lived."¹⁰⁸

Another strategy that foreign investors could take, with an aim to adversely affect the U.S. markets, is a shift in the make-up of their portfolios.¹⁰⁹ Yet, the adjustment of portfolio composition is by no means a new phenomenon—investors have always engaged in it while reassessing their investment risks and regulators' policies.¹¹⁰ If foreign investors seek to diversify the composition of their portfolios among dollar-denominated assets, the exchange value of the dollar will not be affected because the total demand for dollar-denominated assets will remain constant.¹¹¹ If foreign investors shift their large holdings away from U.S. securities to other currency-denominated assets, the shift of supply and demand in the securities market will settle at prices that will be close to those that existed prior to the original shift by foreign investors.¹¹² U.S. multinational firms will take advantage of the shift made by foreign investors, using higher-valued foreign currency to repatriate part of the profits of their foreign

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

108. Jackson, *supra* note 73.

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

affiliates, thereby boosting the balance sheet of their U.S. headquarters and strengthening investments within the United States.¹¹³

In the “context of mutual dependence, [b]lowing somebody else up does you at least as much financial damage.”¹¹⁴ Because an interdependent relationship exists among the global market participants and the market has strong capability for self-adjustment, a large-scale maneuver of funds by foreign investors will likely not produce as much damage to the U.S. economy as it will to foreign investors themselves. Consequently, foreign investors are likely to refrain from such self-damaging business activities.

3. Investing with Non-commercial Incentives is Self-defeating

Among the concerns about SWFs is the possibility that they will be invested with non-commercial motives. However, “[r]unning a business non-commercially is a recipe for huge losses rather than world domination,”¹¹⁵ and will be avoided by any rational investor. Free markets and competition have the capability to correct distorted motives.¹¹⁶ An example helps illustrate this point: if a country experienced bad publicity for its defective products and had its SWF buy an American toy company to let the company sell toys made in the SWF country, the company would lose customers quickly to its competitors.¹¹⁷ Therefore, even if foreign investors invested with governmental instead of commercial interests, the market would likely respond accordingly by driving the investor out of the market. “Free markets don’t require that everyone try to maximize profits; they just need competition, so that if a company makes bad decisions someone else can come in and take advantage.”¹¹⁸ Accordingly, investing with non-commercial intentions is not a rational choice for investors, including SWF owners. As long as competition is present in the market, a company that acts out of non-commercial motives will act at its own peril. SWF owners should be aware of this and refrain from investing non-commercially.

4. Dangers of Hybrid Securities are Overstated

U.S. banks have raised much capital from SWFs in the form of hybrid securities.¹¹⁹ Because hybrids are classified as debt instead of equity, there is concern that sovereign funds can increase their stake without hitting the

113. *Id.*

114. Davidson, *supra* note 92.

115. See *Asset-backed Insecurity*, *supra* note 8.

116. See Davidson, *supra* note 92; Surowiecki, *supra* note 88.

117. Surowiecki, *supra* note 88.

118. *Id.*

119. Cole, *supra* note 2.

controlling ownership threshold under the Bank Holding Company Act.¹²⁰ However, the danger is overstated because hybrid securities do not have the voting rights that straight equity has.¹²¹ Further, sovereign funds have chosen not to take board seats, thereby keeping their investments passive.¹²²

Arguably, foreign investors could gain some influence over a bank if it were to become insolvent, because hybrid securities, although subordinated debt, would nevertheless give investors some claim on a bank's assets. However, no one, including issuers and investors, would want the bank to go bankrupt. The claim at liquidation only gives investors limited influence, if any.¹²³

5. Concern over the Outflow of Financial Knowledge is Unnecessary

Another concern over SWF activities arises from the ambition of SWF holders to develop their own financial markets. For example, China and Singapore have expressed their interest in using investments in overseas financial institutions to acquire money-management knowledge to help develop their domestic capital markets.¹²⁴ Such an agenda is "benign," however.¹²⁵ It is inevitable that an investor with large holdings will gain financial knowledge. Indeed, it is difficult to imagine that a market participant with money at stake will be indifferent toward financial knowledge. U.S. financial and legal systems have actually encouraged investors' research to gain market information and sophistication.¹²⁶ The federal securities laws are derived from one simple and straightforward concept: disclosure.¹²⁷ All investors, whether large institutions or private individuals, should have access to information about an investment prior to buying it and while holding it.¹²⁸

Further, it does not seem possible to preclude foreign investors from seeking various paths to financial knowledge. In addition to learning from investing, knowledge can be obtained by other ways, such as the flow of human capital. The CIC, for example, has attempted to recruit financial

120. *Id.* (stating foreign investors that own more than 9.9% of a U.S. bank must demonstrate that they forgo control of the institution in order to avoid greater scrutiny).

121. *Id.*

122. *Id.*

123. *Id.*

124. Weiss, *supra* note 12.

125. *Id.*

126. Press Release, *FINRA Investor Education Foundation Funds Research to Improve Disclosure of Financial Product Information*, Financial Industry Regulatory Authority, <http://www.finra.org/Newsroom/NewsReleases/2007/P037228>.

127. Lori J. Schock, *Speech by SEC Staff: Feedback from Individual Investors on Disclosure* (Jan. 19, 2007), <http://www.sec.gov/news/speech/2007/spch011907ljs.htm>.

128. *Id.*

talent from around the globe since it was founded in 2007.¹²⁹ The CIC is now in negotiations with many experts, including Alan Greenspan, in the hope that these experts will help the CIC determine global investment strategies and policies.¹³⁰ Finally, an effort to learn good financial practices should be a good sign that foreign investors are focused on the bottom line—maximizing returns on their investments.

Given the instant flow of information enabled by advanced technology and the free movement of human capital, learning from investments in overseas financial institutions is unavoidable in a global market. Moreover, gaining financial knowledge should help foreign investors appreciate the importance of complying with financial rules, which will give them a foundation to become responsible and credible market participants. Obtaining financial knowledge will also help foreign investors find common terms in which they can effectively communicate with other market participants. This is extremely important because addressing SWF concerns requires not only an effort from countries receiving SWF investments, but also input from the foreign investors holding SWFs. Consequently, concern over the outflow of financial knowledge is unnecessary.

C. SWFs BENEFIT U.S. AND GLOBAL ECONOMIES

Although recent SWF activities have raised a variety of concerns, including their possible function as an instrument to achieve sovereign rather than commercial goals and possible large-scale withdrawal of funds from U.S. market, the concerns are clearly overstated. In fact, a review of the history of foreign investment shows that SWFs should bring benefits to U.S. and global economies.

1. Foreign Investments Benefit the General Economy

Foreign investment is a vital force for creating employment and innovation.¹³¹ Foreign-owned companies employ approximately one in twenty American workers.¹³² These jobs on average pay thirty percent higher than the national median for their respective industries.¹³³ Foreign investment also benefits the U.S. economy by increasing real estate value, preserving agricultural land, and promoting venture capital.¹³⁴ It led to

129. Zhong tou song chu gan lan zhi, ni pin Gelinsipan ren gu wen [China Investment Corporation Inviting Greenspan as its Advisor], CHINA REV. NEWS, <http://gb.chinareviewnews.com/doc/1005/3/7/0/100537034.html?coluid=10&kindid=253&docid=100537034&mdate=0107120134>.

130. *Id.*

131. Stagg, *supra* note 9.

132. *The Don't Invest in America Act*, WALL ST. J., July 19, 2006, at A12.

133. *Id.*

134. See Robert Shearer, *The Exon-Florio Amendment: Protectionist Legislation Susceptible to Abuse*, 30 HOUS. L. REV. 1729, 1751 (1993).

exportation of goods worth over \$150 billion in 2003, helping combat the U.S. trade deficit.¹³⁵ It is also an important factor to which economists attribute vigorous U.S. economic growth.¹³⁶ In Canada, parliamentary data has shown that foreign investment restrictions effectively impede innovation and expansion of the Canadian economy.¹³⁷ As a result, the Canadian government has commenced proceedings to lift restrictions on foreign investment.¹³⁸

In the United States, capital inflows lower interest rates and increase access to capital for American enterprise.¹³⁹ Without such capital, U.S. consumers would have to pay higher rates for home mortgages and car loans than when the capital is available.¹⁴⁰ These foreign capital inflows thus allow consumer expenditures to exceed the country's current level of output of goods and services.¹⁴¹ Absent such capital, businesses would have to finance purchases at high rates, which would increase business costs, pushing up prices and affecting consumers' standard of living.¹⁴² Presently, foreign investment is critical because the United States faces both a historically "high national budget deficit and historically low levels of public savings."¹⁴³ Consequently, foreign capital benefits the economy and is needed in this country.

2. SWFs Play a Bridging-gap Role in U.S. Capital Markets

In an open market, capital flows to where it can be used most efficiently.¹⁴⁴ This argument is corroborated by an economic analysis of Federal Reserve data during the years from 1996 and 2006. The analysis shows the interplay among household (individual) savings, the extent of deficit or surplus of governments, and foreign capital flows.¹⁴⁵ When there was a lack of household savings and a government surplus, investment was filled with large capital inflows.¹⁴⁶ In contrast, when there were sufficient domestic sources of funds, foreign capital fell and flowed out of the country.¹⁴⁷ Thus, foreign capital rises as a response to the lack of domestic sources of funds, thereby bridging the gap between the supply and demand for credit within the U.S. market. Capital inflows increased sharply from

135. Stagg, *supra* note 9, at 331.

136. *Id.*

137. Robertson, *supra* note 72.

138. *Id.*

139. See *Asset-backed Insecurity*, *supra* note 8.

140. Shearer, *supra* note 133, at 1751.

141. *Id.*

142. *Id.*

143. Weiss, *supra* note 12.

144. Jackson, *supra* note 73.

145. *Id.*

146. *Id.*

147. *Id.*

2000 to 2006, as the United States experienced historically large household dissaving and historically large governmental deficits in nominal terms.¹⁴⁸ Accordingly, SWFs flowed to the U.S. market as a response to the credit crunch, and the gap-bridging role it plays will support the country's continuing economic development.¹⁴⁹

3. SWFs Should Be a Stabilizing Force in Riskier Markets

Empirical data show that SWFs tend to be stabilizers, rather than disrupters.¹⁵⁰ Because SWFs are used to save for future generations or to stabilize domestic economies, they typically have a long-term horizon, avoiding rapid liquidations during market volatility.¹⁵¹ Moreover, SWFs tend not to be highly leveraged, which makes them a strong force for stability.¹⁵² As SWF assets are increasingly allocated to riskier securities,¹⁵³ they should be a stabilizing force for riskier financial markets.¹⁵⁴ In its December 2007 Financial Stability Review, the European Central Bank wrote:

[SWFs] contribute to the broadening of the long-term investor base for risky assets, such as equities, corporate bonds, emerging market assets, private equity and real estate. In this regard, such funds could become a more stable investor base for risky assets in certain markets. In addition, provided that the investments of such funds are driven entirely by risk and return considerations, SWFs may contribute to a more efficient allocation and diversification of risk at the global level.¹⁵⁵

The stabilizing role of foreign capital can be seen by a comparative analysis of the U.S. economy during two time periods: November 1982 through December 2007, and 1945 through 1982.¹⁵⁶ In the former period, large overseas capital was available and the economy was in recession only 4.6 percent of the time.¹⁵⁷ In contrast, during the latter time frame, foreign capital was generally unavailable, and recession accounted for 22.4 percent

148. *Id.*

149. *Id.*

150. See *Asset-backed Insecurity*, *supra* note 8.

151. Mullane & Kaul, *supra* note 6. See also Jen, *supra* note 11.

152. Mullane & Kaul, *supra* note 6.

153. See Steffen Kern, *Sovereign Wealth Funds-State Investments on the Rise*, DEUTSCHE BANK RES., Sept. 10, 2007 (discussing that Deutsche Bank estimates a total of over \$1 trillion from SWFs will flow into global equity markets and \$1.5 trillion into global debt markets over the next five years); Alex Patelis, *The Overflowing Bathtub, the Running Tap and SWFs*, MERRILL LYNCH ECON. ANALYSIS, Oct. 6, 2007 (on the more aggressive assumption, Merrill Lynch projects that \$3.1 to \$6 trillion will be invested in riskier assets by SWFs in the next five years).

154. Will, *supra* note 30.

155. EUROPEAN CENTRAL BANK, FINANCIAL STABILITY REVIEW Dec. 2007, <http://www.ecb.int/pub/pdf/other/financialstabilityreview200712en.pdf>.

156. Will, *supra* note 30.

157. *Id.*

of the time.¹⁵⁸ Consequently, the inflow of foreign funds has played a role in stabilizing the economy. Because SWFs help stabilize the investor base for riskier markets across national borders, they are likely to contribute to a more rational allocation of risk at the global level.¹⁵⁹ As a result, the debate continues as to whether SWFs can be used as part of the efforts to tackle the current financial crisis.¹⁶⁰

IV. U.S. RESPONSES TO SWF INVESTMENTS AND REGULATIONS

Opinions about SWFs within the United States are split. While there has been fear that SWFs are going to buy up America and threaten U.S. national security,¹⁶¹ many economists take the view that “money is naturally going to gravitate toward dollar-based assets because of the strength of our economy.”¹⁶² The strengths of the U.S. economy include a well-developed financial system, large market size, strong per-capita buying power, advanced transportation and communication facilities,¹⁶³ as well as a favorable regulatory scheme, overall economic stability, and political stability with regard to trade policy.¹⁶⁴ These factors have contributed to the rise in foreign investment.¹⁶⁵

A. U.S. POLICY AND REGULATIONS WITH REGARD TO FOREIGN INVESTMENT

U.S. government leaders have traditionally advocated an open foreign-investment policy.¹⁶⁶ President Reagan is particularly credited for shaping modern U.S. policy in this area. After the end of the Cold War, with the resulting global environment amenable to international trade, President Reagan encouraged foreign investment in the United States by highlighting the benefits the country provides to foreign investors.¹⁶⁷ This policy led to an unprecedented level of foreign capital imported into the United States

158. *Id.*

159. *Id.*

160. Jim Moran, *Paving the Way for Sovereign Wealth*, NAT’L J., Dec. 10, 2008, http://www.nationaljournal.com/njonline/no_20081210_7663.php.

161. Steven R. Weisman, *Concern about Sovereign Wealth Funds Spreads to Washington*, INT’L HERALD TRIB., Aug. 20, 2007. See also David R. Francis, *Will Sovereign Wealth Funds Rule the World?*, THE CHRISTIAN SCI. MONITOR, Nov. 26, 2007, at 16, available at <http://www.csmonitor.com/2007/1126/p16s01-wmgn.html> (SWFs are “huge, scarily big”); Surowiecki, *supra* note 88.

162. Weisman, *supra* note 160.

163. Stagg, *supra* note 9, at 330–31.

164. Michael Petrusic, *Recent Development, Oil and the National Security: CNOOC’s Failed Bid to Purchase Unocal*, 84 N.C.L. REV. 1373, 1387 (2006).

165. Stagg, *supra* note 9, at 330–31.

166. Shearer, *supra* note 133, at 1746–47.

167. *Id.* at 1747.

and vigorous domestic economic growth.¹⁶⁸ The United States won “the global race for capital.”¹⁶⁹ As a result of its liberal policy toward foreign investment, the United States led a modern revolution toward globalization and the free movement of capital, promoting its status as the leader in advancing democratic and capitalist ideologies.¹⁷⁰ The United States continues to encourage other nations to reduce investment barriers through participation in multilateral negotiations such as the Uruguay Round of trade negotiations and the North American Free Trade Agreement (NAFTA).¹⁷¹

Because of its policies favoring open investment, U.S. regulation of foreign investment was relaxed except in extreme cases.¹⁷² The Committee on Foreign Investment in the United States (CFIUS)¹⁷³ characterizes U.S. policy toward foreign investment as follows:

The United States has traditionally welcomed Foreign Direct Investment (FDI) and provided foreign investors fair, equitable and nondiscriminatory treatment with few limited exceptions designed to protect national security. [U.S. regulations with regard to foreign investment are] . . . implemented within the context of this open investment policy.¹⁷⁴

In 1977, the first statute to regulate foreign investment, the International Economic Emergency Powers Act, was passed.¹⁷⁵ The statute authorized the president to block transactions involving property of hostile governments or their citizens.¹⁷⁶ However, presidents were reluctant to invoke it because doing so would be close to “a declaration of hostilities against the government of the acquirer company.”¹⁷⁷

168. Christopher R. Fenton, *U.S. Policy Towards Foreign Direct Investment Post-September 11: Exon-Florio in the Age of Transnational Security*, 41 COLUM. J. TRANSNAT'L L. 195, 197 (2002).

169. See *The Don't Invest in America Act*, *supra* note 131.

170. Fenton, *supra* note 167, at 196.

171. Shearer, *supra* note 133, at 1748.

172. Stagg, *supra* note 9, at 338.

173. U.S. Dep't of Treasury, Committee on Foreign Investments in the United States, <http://www.ustreas.gov/offices/international-affairs/exon-florio/>. The CFIUS, an inter-agency committee chaired by the secretary of the Treasury, is designated by the president to implement the Exon-Florio provision, investigating foreign-investment transactions that raise national security concerns. CFIUS was originally established by Executive Order 11858 in 1975 mainly to monitor and evaluate the impact of foreign investment in the United States. In 1988, the president, pursuant to Executive Order 12661, delegated to CFIUS his responsibilities under Section 721. Specifically, E.O. 12661 designated CFIUS to receive notices of foreign acquisitions of U.S. companies, to determine whether a particular acquisition has national security issues sufficient to warrant an investigation and to undertake an investigation, if necessary, under the Exon-Florio provision. This order also provides for CFIUS to submit a report and recommendation to the president at the conclusion of an investigation. For CFIUS review procedure in implementing the Exon-Florio provision, see next section. See *id.*

174. *Id.*

175. Stagg, *supra* note 9.

176. See 50 U.S.C. §§ 1701(a), 1702(a)(1)(B) (2000).

177. Fenton, *supra* note 167, at 203.

In 1988, the Exon-Florio provision of the Omnibus Trade and Competitiveness Act was passed as a response to the attempted acquisition of Fairchild Semiconductor Corporation, an American company, by the Fujitsu Corporation, a Japanese company.¹⁷⁸ U.S. government officials viewed the deal as threatening national security because they believed that Japanese companies intended to dominate the world semiconductor market.¹⁷⁹ The Exon-Florio provision allowed the president to block transactions or divest foreign interests in U.S. companies that constituted threats to national security.¹⁸⁰

In 1993, Congress expanded the Exon-Florio provision through the National Defense Authorization Act, known as the Byrd Amendment.¹⁸¹ Under the Byrd Amendment, the factors to be considered by CFIUS in determining whether a proposed transaction by a foreign entity is legitimate emphasize the national security implications of the foreign acquisitions.¹⁸² The Byrd Amendment makes investigation of transactions by executive branches and offices mandatory when two conditions are met: when (1) the acquirer is “controlled by or acting on behalf of a foreign government,” and (2) the acquisition “could result in control of a person engaged in interstate commerce in the United States that could affect the national security of the United States.”¹⁸³

The CFIUS regulations have triggered critiques because the definitions of key terms in the regulations are ambiguous.¹⁸⁴ First, the definition of “control” is not a bright line rule like the majority ownership standard;¹⁸⁵

178. Shearer, *supra* note 133, at 1730.

179. *Id.*

180. See 50 App. U.S.C.A. § 2170(d)(1) & (3).

181. National Defense Authorization Act for Fiscal Year 1993, Pub. L. No. 102-484, § 837(a), 106 Stat. 2315, 2463 (1993).

182. According to 50 U.S.C.A. app. § 2170(f)(8):

For purposes of this section, the President or the President’s designee may, taking into account the requirements of national security, consider: (1) domestic production needed for projected national defense requirements, (2) the capability and capacity of domestic industries to meet national defense requirements, including the availability of human resources, products, technology, materials, and other supplies and services, (3) the control of domestic industries and commercial activity by foreign citizens as it affects the capability and capacity of the United States to meet the requirements of national security, (4) the potential effects of the proposed or pending transaction on sales of military goods, equipment, or technology to any country . . .

See 50 U.S.C.A. app. § 2170(f)(8).

183. National Defense Authorization Act for Fiscal Year 1993 Pub. L. No. 102-484, §837(a)(2), 106 Stat. 2315, 2463 (1993).

184. See Christopher F. Corr, *A Survey of the United States Controls on Foreign Investment and Operations: How Much Is Enough?*, 9 AM. U. J. INT’L L. & POL’Y 417, 429–30 (1994).

185. Steen Thomsen and Torben Pedersen, *Industry and Ownership Structure*, 18 INT’L REV. L. & ECON. 385, 391. The majority ownership is ownership of a sufficient number of a corporation’s

instead, CFIUS looks to the functional abilities of an acquirer to exercise control.¹⁸⁶ The regulations provide that there is no control when voting securities are held “solely for the purpose of passive investment,” which means that the acquirer “does not plan or intend to exercise control”¹⁸⁷ The definition seems to be circular. The Exon-Florio provision has also been criticized because “national security” is not defined under the statute; rather, executive departments and offices have broad authority to determine on a case-by-case basis whether a transaction poses a threat to national security.¹⁸⁸ Because the national security standard is “a broad, vague generality” subject to “numerous inconsistent interpretations,”¹⁸⁹ fear has arisen that foreign investors will seek other markets with less ambiguous regulatory standards.¹⁹⁰

However, presidential action under the provision has been minimal. In the period between 1988 and 1999, the president investigated only seventeen of more than 1,200 companies that volunteered for review.¹⁹¹ Of those investigated, seven withdrew their offers, and the president declined to pursue nine of the remaining ten cases.¹⁹² Until recently, CFIUS, with executive-authorized power to investigate foreign investment, applied a fairly narrow interpretation of the Exon-Florio provision.¹⁹³ In applying the statute, CFIUS seems to have focused on balancing multilayered policy considerations, “seek[ing] to serve U.S. investment policy through thorough reviews that protect national security while maintaining the credibility of our open investment policy and preserving the confidence of foreign investors here and of U.S. investors abroad that they will not be subject to retaliatory discrimination.”¹⁹⁴

voting shares to control company policy. This may be more than 50% or less, if the other shares are widely dispersed and not actively vote. *Id.*

186. See 31 C.F.R. § 800.204. See also Gilson, Ronald J. and Milhaupt, Curtis J., *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism*, Feb. 18, 2008, Columbia Law and Economics Working Paper No. 328, <http://ssrn.com/abstract=1095023>. The proposed regulations defined control functionally, in terms of the ability of the acquirer to make certain important decisions about the acquired company, such as whether to dissolve the entity, or to relocate or close production or research and development facilities. A number of commenters complained that this standard is too nebulous, and advocated the adoption of a bright line control test based on a particular percentage of stock ownership and/or the composition of the board of directors. Given the national security purposes underlying section 721, the CFIUS believes it would be inappropriate to adopt such bright line tests, which would make it relatively easy to structure transactions to circumvent the statute. See *id.*

187. See 31 C.F.R. § 800.223, 31 C.F.R. §800.302(b).

188. Corr, *supra* note 183.

189. Shearer, *supra* note 133, at 1741–42.

190. Corr, *supra* note 183, at 421.

191. Fenton, *supra* note 167, at 210.

192. *Id.*

193. *Id.* at 211.

194. U.S. Department of Treasury, *supra* note 172.

In addition to Exon-Florio, which targets foreign investments that implicate national security, other laws are in place that restrict the percentage of foreign ownership in sensitive sectors, which include aviation, defense, banking, electric and gas, mineral leases and resources, power generation and utility services, real estate, and communications and broadcasting.¹⁹⁵ Under the Bank Holding Act, for example, foreign investors must own less than twenty-five percent of a U.S. bank to avoid increased scrutiny.¹⁹⁶ Aside from setting limits for the percentage of foreign ownership, statutes also look to the nationality of the owners or the management, in order to determine whether a U.S. subsidiary is used by foreign investors for their investment.¹⁹⁷

B. NEW DEVELOPMENT: FINSA

FINSA, a recent amendment to Exon-Florio, greatly affects SWF investment in the United States.¹⁹⁸ Its enactment was a consequence of substantial controversy surrounding the attempted acquisition of six major U.S. shipping ports by Dubai Ports World in 2006.¹⁹⁹ The planned transaction generated intense political debates and heightened interest in national security issues arising from foreign acquisitions of U.S.-based entities.²⁰⁰ In July 2007, Congress passed FINSA, aimed at reforming the Exon-Florio review process for foreign investment in U.S. entities.²⁰¹ While retaining the basic components of the CFIUS review procedures, FINSA mandates more rigorous procedures, including expanding the definition of industries that fall under the category to be reviewed by CFIUS, increasing post-closing scrutiny for previously reviewed and cleared transactions, and enhancing the executive and Congressional involvement in the scrutiny of overseas investments, especially that made by a foreign government. As a result, foreign entities investing in the United States are challenged by tougher regulatory treatment.

FINSA makes clear that foreign investments subject to national security review go well beyond those in the traditional defense sectors to include investments in “critical infrastructure.”²⁰² Under FINSA, critical infrastructure is defined expansively as any “systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security.”²⁰³ The definition of critical infrastructure permits more

195. Corr, *supra* note 183.

196. See discussion, *supra* note 83.

197. See Corr, *supra* note 183.

198. Foreign Investment and Nationality Security Act of 2007, PL 110-49, 121 Stat. 246.

199. See *The Don't Invest in America Act*, *supra* note 131.

200. *Id.*

201. Mullane & Kaul, *supra* note 6.

202. 50 U.S.C.A. app. § 2170(b)(2)(B)(i)(III).

203. 50 U.S.C.A. app. § 2170(a)(6).

industries to be included for CFIUS review, such as energy assets. Although the statute does not define energy assets, its legislative history implies that Congress expects CFIUS to interpret this term broadly to include electrical generating, transmission and distribution facilities, gas storage, transmission, and distribution facilities.²⁰⁴ The scope of national security is also expanded to include matters of homeland security.²⁰⁵

FINSA provides explicit statutory authority for CFIUS to “negotiate, enter into or impose, and enforce any agreement or condition with any party to the covered transaction in order to mitigate any threat to the national security of the United States that arises as a result of the covered transaction.”²⁰⁶ Accordingly, CFIUS is statutorily empowered with the authority to require changes to a deal via a “mitigation agreement” in exchange for CFIUS approval. Further, CFIUS has the power to designate a lead agency to negotiate mitigation agreements.²⁰⁷ FINSA requires the lead agency to report periodically to CFIUS on the parties’ compliance with the agreed conditions and to report any material change in connection with a transaction.²⁰⁸

FINSA also requires greater scrutiny by CFIUS far beyond the business transaction itself. Under FINSA, where a foreign government-owned entity is involved, CFIUS must consider whether the foreign government is in compliance with U.S. and multilateral counter-terrorism, non-proliferation and export control regimes.²⁰⁹ As a result, factors that are not necessarily related to the transaction in question come under CFIUS scrutiny, which increases the uncertainty of doing business.

Congressional involvement in overseas investment is also enhanced by a mechanism established under FINSA where member agencies must meet in a commission and ask questions probing the risks associated with a transaction, both in terms of the threat to national security posed by the foreign investor, and the vulnerabilities of the asset or entity that is being acquired.²¹⁰ These member agencies include: Homeland Security, Commerce, Defense, State, the Attorney General, Energy (a new addition), and the Treasury, whose secretary sits as the chair.²¹¹ The secretary of Labor and the Director of National Intelligence act as non-voting

204. Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates, *President Signs Legislation Reforming U.S. National Security Reviews of Foreign Investments in U.S. Companies*, Wash., D.C., July 26, 2007, at n.1, www.skadden.com/content%5CPublications%5CPublications1292_0.pdf.

205. Mullane & Kaul, *supra* note 6.

206. 50 U.S.C.A. app. § 2170(l)(1)(A) (2009).

207. 50 U.S.C.A. app. § 2170(k)(5); *see also* Mullane & Kaul, *supra* note 6.

208. 50 U.S.C.A. app. § 2170(k)(5); *see also* Mullane & Kaul, *supra* note 6.

209. 50 U.S.C.A. app. § 2170(f)(9).

210. 50 U.S.C.A. app. § 2170(g); *see also* Mullane & Kaul, *supra* note 6.

211. 50 U.S.C.A. app. § 2170(k)(2)–(3).

members.²¹² FINSA also grants the president the discretion to appoint additional representatives from other executive agencies and offices.²¹³ Further, following the conclusion of a CFIUS review, CFIUS must provide Congress with notice of the transaction, the actions taken, briefings, and certifications by CFIUS officials.²¹⁴ As a result, FINSA significantly strengthens Congressional oversight of the review process. Such transaction-by-transaction Congressional involvement also raises the risk of political mischief.

Finally, FINSA removes the safe harbor rule, which protected a previously reviewed and cleared transaction from post-closing scrutiny by CFIUS.²¹⁵ Post-closing scrutiny, which can result in asset divestitures or potential unwinding, can be invoked upon a finding of intentional omission or misrepresentation in the original notification to CFIUS, or the party's material breach of a mitigation agreement.²¹⁶

FINSA represents a unilateral U.S. action to deal with concerns over SWFs. Because of FINSA, foreign investors can expect an increased risk of delays, as well as political and bureaucratic inference in the proposed business transaction. Foreign investors will weigh the increased regulatory costs in making investment decisions, and will likely shy away from the U.S. market because of the regulatory uncertainty and political fights that ensue for larger SWF investments. This will likely affect the competitiveness of the United States in attracting capital. Therefore, strict enforcement of the statute is worthwhile only when the risks of SWFs outweigh their benefits and when there are no alternative ways to mitigate SWF risks.

V. INTERNATIONAL BEST PRACTICE IS POSSIBLE

In tackling the perceived risks posed by SWFs, the establishment of international standards for SWF activities provides an attractive alternative to U.S. unilateral action. The elements that have been suggested for international standards include transparency, governance, and reciprocity.²¹⁷ A set of international codes that stress these elements offers a promising way to increase the accountability of SWF activities.²¹⁸

212. 50 U.S.C.A. app. § 2170(k)(2).

213. 50 U.S.C.A. app. § 2170(k)(6).

214. 50 U.S.C.A. app. § 2170(b)(3).

215. 50 U.S.C.A. app. § 2170(b)(1)(D)(ii)–(iii) (2009).

216. *Id.*

217. TRUMAN, SOVEREIGN WEALTH FUNDS, *supra* note 4. See also Philipp M. Hilderbrand, *The Challenge of Sovereign Wealth Funds*, VOX, Jan. 21, 2008, <http://www.voxeu.org/index.php?q=node/881>.

218. *Id.* See also Edwin M. Truman, *Sovereign Wealth Fund Acquisitions and Other Foreign Government Investments in the United States: Assessing the Economic and National Security Implications*, Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S.

Because Norway's fund is universally considered to be transparent and publicly accountable, it may become a model for other SWFs.²¹⁹ Norway's fund features detailed and regular disclosure about SWF activities, accounting and auditing information.²²⁰ The fund is also considered an accountable investor with non-strategic holdings and "clear lines of responsibility between political authorities and the operational management."²²¹ In addition, the fund restricts its ownership to five percent of shares in any company in which it invests.²²²

In October 2007, the final G7 statement, while supporting the argument that the world economies "can benefit from openness to SWF investment flows," urged that best practices be identified for SWFs in the areas of institutional structure, risk management, transparency and accountability.²²³ The G7 meeting further asked the International Monetary Fund (IMF), World Bank, and the Organization for Economic Co-operation and Development (OECD) to examine this area.²²⁴ To prevent financial protectionism, the IMF also emphasized principles of nondiscrimination, transparency, and predictability among recipients of SWFs.²²⁵ OECD has produced guidelines building upon these principles.²²⁶

Secretary of the Treasury Henry Paulson, on behalf of the U.S., stated in the International Monetary and Finance Committee of the IMF that the United States values a multilateral approach that maintains open investment policies while seeking "[b]est practices [that] would provide multilateral guidance to new funds on how to make sound decisions, how to structure themselves, mitigate any potential systemic risk, and help demonstrate to critics that SWFs can be constructive, responsible participants in the international financial system."²²⁷

So far, SWF owners have responded favorably to the IMF's request for more disclosure. They are aware of the tensions their activities have raised, and are "unlikely to exacerbate matters with aggressive acquisitions."²²⁸ For example, China and Singapore have expressed their willingness to comply

Senate (Nov. 14, 2007), <http://www.petersoninstitute.org/publications/papers/truman1107.pdf> [hereinafter Truman, Testimony].

219. See *Transparency and Trust*, *supra* note 50.

220. TRUMAN, A SCOREBOARD, *supra* note 3.

221. See *Transparency and Trust*, *supra* note 50.

222. *Id.*

223. Treasury Dep't, Press Release, Statement of G-7 Finance Ministers and Central Bank Governors, Oct. 19, 2007, <http://treas.gov/press/releases/hp625.htm>.

224. *Id.*

225. *Id.*

226. OECD, *OECD Guidance on Sovereign Wealth Funds*, http://www.oecd.org/document/19/0,3343,en_2649_34887_41807059_1_1_1_1,00.html.

227. Henry M. Paulson, Jr., Secretary of the U.S. Treasury, Statement before the Int'l Monetary and Fin. Comm., Int'l Monetary Fund (Oct. 20, 2007), <http://www.imf.org/external/am/2007/imfc/statement/eng/usa.pdf>.

228. Surowiecki, *supra* note 88.

with best practices and increase transparency efforts.²²⁹ In November 2007, the CIC disclosed that a third of its \$200 billion in assets would be used to buy foreign assets and that the other two-thirds would be invested domestically.²³⁰ The CIC further disclosed that it would invest mostly in portfolios rather than individual companies and that it had no intention of gaining controlling interests in any companies.²³¹ China maintains that the CIC will prove to be a responsible corporate citizen, not investing in industries that damage the environment, waste energy or produce tobacco.²³² Nor will it buy into overseas airlines, telecommunications or oil firms.²³³ In terms of management, China says that the CIC will have its own corporate governance structure, without governmental interference.²³⁴ Lou Jiwei, Chairman of the CIC, has argued that if any country receiving investments has misgivings, China “may choose to leave” or look elsewhere.²³⁵ Yet not all SWFs share the same position. According to Tony Tan, Executive Director of Singapore’s GIC:

We believe there is a case for further disclosure on the part of sovereign wealth funds in the interest of transparency. Such disclosure can include clarity on the relationship between the funds and the respective governments, their investment objectives and general strategies, and their internal governance and risk management practices Any guidelines on sovereign wealth funds should encourage them to operate according to commercial principles with a long-term orientation, free from political motivations. Singapore will participate in formulating a set of principles and best practices for sovereign wealth funds.²³⁶

Transparency of SWF investment has emerged as an issue of paramount importance. Transparency requires substantial quantitative disclosure about investment strategies, outcomes, and the nature and location of actual investments.²³⁷ Transparency further dictates the activities of investment mechanisms to published, independent audits.²³⁸ Also, those concerned about unjustified barriers for SWF flow argue that a lack of transparency is a factor leading to protectionism and a tougher environment for SWF

229. Steven R. Weisman, *China Tries to Reassure U.S. About Its Investing Plans*, N. Y. TIMES, Feb. 1, 2008, available at <http://www.nytimes.com/2008/02/01/business/worldbusiness/01sovereign.html>. See also Weiss, *supra* note 12.

230. Keith Bradsher, *\$200 Billion to Invest, but in China*, N. Y. TIMES, Nov. 29, 2007, available at <http://www.nytimes.com/2007/11/29/business/worldbusiness/29yuan.html>.

231. Weisman, *supra* note 228.

232. *Id.*

233. Bradsher, *supra* note 229. See also Brad Setser, *China’s Sovereign Wealth Fund*, RGE MONITOR, Sept. 24, 2007, <http://blogs.cfr.org/setser/2007/09/24/china-s-sovereign-wealth-fund/>.

234. Weisman, *supra* note 228.

235. *Id.*

236. Weiss, *supra* note 12.

237. TRUMAN, SOVEREIGN WEALTH FUNDS, *supra* note 4, at 7.

238. *Id.*

investment.²³⁹ Therefore, a path that can counter suspicion and protectionism while meeting the requirements of transparency should be sought for SWFs. The international guidelines set by the IMF and OECD will likely contribute to this goal.

The mutual trust and confidence that transparency would establish should address many of the concerns SWF activities raise. First, an increased level of transparency will alleviate the negative impact of greater SWF investment by allowing financial markets to better monitor SWF activity and exercise market discipline.²⁴⁰ Second, it serves the interests of SWF holders in that transparency will help reduce the mysteries and misunderstandings surrounding SWFs, thereby reducing hostility towards the funds and resulting in more stable and predictable environment for SWF activities.²⁴¹

Although some observers are concerned that the IMF guidelines are voluntary and that there is no guarantee of compliance by nations holding SWFs, compliance should be expected because it serves the interests of nations receiving SWFs as well as those holding the funds. Moreover, most nations with SWFs are members of the IMF and are formally committed to a stable international monetary system.²⁴² Because mutual benefits will result from observing international best practices, such standards should be established and will likely be heeded. Compared to the unilateral, sweeping regulation of SWFs by the U.S., international standards emphasize cooperation and build confidence in the international community.

VI. CONCLUSIONS

SWFs have existed for more than half a century. They do not have a record of political or market mischief. Instead, their history shows that SWF investment spreads financial capital, helps the world economy adjust to imbalances, and gives countries stakes in each other's prosperity. Regardless, the increasing size and activism in markets of SWFs, together with their state-controlled nature, have raised suspicions about these funds' motives. If SWFs remain opaque, it is likely that a number of countries will increasingly oppose sovereign wealth acquisitions. That opposition will serve to restrict the investing activities and raise the investment risks for these funds. In response to the challenges posed by SWFs, the best option now available is to establish an internationally agreed upon standard to guide transparency and depress politically-driven investment decisions. The

239. Charlie McGreevey, European Commissioner for Internal Market and Services, The Importance of Open Markets, Speech before Council of British Chambers of Commerce in Continental Europe (COBCOE) (Jan. 10, 2008), <http://www.edubourse.com/finance/actualites.php?actu=35306>.

240. Weiss, *supra* note 12.

241. Truman, Testimony, *supra* note 217, at 9.

242. Weiss, *supra* note 12.

guidelines are not only necessary, but also viable, as both recipients and owners of SWFs see that their interests lie in building confidence.

Open investment policies bring about global prosperity. An open policy should be espoused without compromising national security and transparency. It need not lead to protectionist responses, however. Conflicts over one investment, such as Dubai Port World's acquisition of U.S. port facilities, should not be generalized to all SWFs. Such generalizations spark uncertainty, spilling over into the trade of goods and services and causing undue damage to the economy.²⁴³ This is especially dangerous during the current financial crisis. Instead of responding unilaterally with excessive regulations, the United States should play a leading role in the international community to establish a set of guidelines for SWF transparency.

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243. See *Asset-backed Insecurity*, *supra* note 8.

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