Misplaced Fears Put to Rest: Financial Crisis Reveals the True Motives of Sovereign Wealth Funds

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"Do we want the [C]ommunists to own the banks, or the terrorists? I'll take any of it, I guess, because we're so desperate."

—Jim Cramer, CNBC Financial Analyst[1]

"Fortunately there are more than 200 countries in the world. And fortunately there are many countries who are happy with us."

—Gao Xiqing, President of China Investment Group[2]

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1. Peter S. Goodman & Louise Story, *Overseas Investors Buy Aggressively in U.S.*, N.Y. TIMES, Jan. 20, 2008, at A1.

2. Stephen Schwarzman, *Reject Sovereign Wealth Funds at Your Peril*, FIN. TIMES, June 20, 2008, http://www.ft.com/cms/s/0/405b8888-3dff-11dd-b1bd-0000779fdac,dwp-uuid=b03d580a-4ff0-11dc-a6b0-0000779fd2ac.html.

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I. INTRODUCTION

Few issues have generated more headlines and debate in recent months than sovereign wealth funds (SWFs or funds). On one hand, these state-owned investment vehicles are hailed for their ability to inject cash quickly into starving equity markets. On the other hand, SWFs are chided for their lack of transparency and their ability to pursue political aims, rather than strict financial ones, in global equity markets. Somewhat oddly, most pundits, politicians, and academics assume the worst and propose increasing domestic barriers and vetting procedures for SWF investments.[3] But these assumptions are not the result of empirical study. Rather, these fears stem from what SWFs *could* do in a market that is relatively stable. As SWF activity grew at the turn of the twenty-first century, Western leaders called for an international effort to assuage some of the fears created by large SWF holdings in major domestic financial firms. The end product was the Generally Agreed Principles and Practices (GAPP), a code of best practices designed to alleviate the host countries' fears by promoting normative behavior among the funds.[4]

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3. *See* Ronald J. Gilson & Curtis J. Milhaupt, *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 60 STAN. L. REV. 1345, 1360-61 (2008); *see also* Edwin M. Truman, *Sovereign Wealth Funds: The Need for Greater Transparency and Accountability* (Peterson Inst. for Int'l Econ., Policy Brief No. PB07-6, 2007), *available at* http://www.iie.com/publications/pb/pb07-6.pdf; Evan Bayh, *Time for Sovereign Wealth Rules*, WALL ST. J., Feb. 13, 2008, at A26, *available at* http://online.wsj.com/article/0,,SB120286960358864245,00.html.

4. Int'l Working Group of Sovereign Wealth Funds, Sovereign Wealth Funds: Generally Accepted Principles and Practices (GAPP) (Oct. 2008), *available at* http://www.imf.org/external/np/pp/eng/2008/022908.pdf.

But the international regime did not entirely assuage the fears held by SWF critics.[5] The nonbinding nature of GAPP, coupled with a growing sense of urgency to regulate these nonprivate investors, led some critics to propose ways of "hardening" the soft law nature of GAPP.[6] This Comment adds what is missing from the SWF debate: an examination of SWF activity, and the subsequent GAPP, based on empirical observation. Ironically, the current financial crisis provides an excellent laboratory to test the investment aims of SWFs in Western financial markets. Starting in the early stages of the crisis, SWFs were keen to invest in what they correctly viewed as vulnerable institutions in great need of cash injections.[7] But when some of Wall Street's most storied firms succumbed to insolvency, driven largely by subprime mortgage-backed securities, SWFs were some of the hardest hit institutional investors.[8] As losses mounted, SWFs did just what any other investor would do—they sold off riskier liabilities and invested in more conservative financial instruments.[9]

The exodus of SWF dollars from Western financial markets created an enormous conundrum for policymakers in host countries: either pursue a course that hardens GAPP but risks further searing off SWF investments or accept GAPP in its soft form and hope SWF investments return. Much of this decision depends on whether policymakers view SWFs as politically motivated entities with malicious ends or as legitimate investment vehicles searching for higher returns. This Comment seeks to analyze SWF behavior in the context of the financial crisis. It concludes by advocating the pursuit of a course that avoids hardening GAPP. Based on empirical observations of how SWFs reacted to losses in holdings and vulnerabilities of large financial services firms, this Comment further concludes that SWFs demonstrated purely financial motives and thus should not be subject to additional barriers to investment. Moreover, the regulation of SWFs raises certain international issues that are better addressed via nonbinding international means.

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5. Aaditya Mattoo & Arvind Subramanian, *Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization* 1 (Peterson Inst. for Int'l Econ., Working Paper No. WP08-2, 2008), *available at* http://www.iie.com/publications/interstitial.cfm?ResearchID=871.

6. *See id.*

7. *See* Goodman & Story, *supra* note 1.

8. *From Torrent to Trickle*, ECONOMIST, Jan. 24, 2009, at 78, *available at* http://www.economist.com/displaystory.cfm?story_id=12998177.

9. *See id.* at 79.

Before making behavioral observations, it is important to focus on the two main issues facing U.S. policymakers in regard to SWF investment. First, there is the political problem of needing to appear up to the task of protecting U.S. citizens from foreign government-owned entities, while at the same time avoiding the label of acting as a protectionist. Second, there is the legal problem of whether to pursue a course that hardens GAPP or one that preserves its soft law status.

This Comment focuses on the second issue—whether to pursue soft or hard law solutions to GAPP—and concludes that hard law should be avoided. Part II defines SWFs and tracks their rise to prominence in the global economy. Part III discusses some of the fears SWFs engender and the domestic measures taken, as well as proposed measures to reduce these perceived fears. Part IV discusses the role of SWFs in the financial crisis and their reactions to large losses. Part V charts the international response to SWFs and analyzes its strengths and weaknesses. Part VI examines hard and soft law solutions to GAPP, and Part VII concludes that a soft law approach is appropriate in light of SWF behavior during the financial crisis.

II. SOVEREIGN WEALTH FUNDS

A. *Sovereign Wealth Funds Defined*

SWFs do not have a common definition, but they can broadly be characterized as government-owned investment funds that look abroad for returns.[10] Specifically, SWFs invest a government's surplus abroad and then bear the losses or reap the gains of those investments.[11] The United States Department of the Treasury (Treasury) defines SWFs as "government investment vehicles funded by foreign exchange assets, which manage those assets separately from official reserves."[12]

B. *How Sovereign Wealth Funds Operate*

More important than rigidly defining SWFs is understanding how SWFs function and how they influence the global economy. Overall, SWFs are beneficial to the global economy because they recycle trade surpluses from the global South to equity investments in the global

10. *See* INT'L MONETARY FUND [IMF], SOVEREIGN WEALTH FUNDS—A WORK AGENDA 4 (Feb. 29, 2008), *available at* http://www.imf.org/external/np/pp/eng/2008/022908.pdf.

11. *See id.*

12. *Under Secretary of the Treasury for International Affairs David H. McCormick: Testimony Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2007) (statement of David M. McCormick), *available at* http://www.treas.gov/press/releases/hp681.htm.

North.[13] Most SWFs are fuelled by trade surpluses rooted in the export of either cheap consumer goods or oil and are driven by exchange rate policies.[14] The Abu Dhabi Investment Authority (ADIA) is the largest SWF and is largely representative of those financed by profits from oil exports.[15] The ADIA plays a vital role in Abu Dhabi's economic health by diversifying state revenues so that its wealth is not overly reliant upon exporting nonrenewables.[16] Other funds, like the China Investment Corporation (CIC), which manages over $200 billion, is fuelled by trade surpluses from exports.[17] The aim of the CIC is to reduce the potentially negative impact large trade surpluses can have on domestic markets via inflation, while at the same time seeking higher returns on state investments than those offered by conservative financial investments like government treasury bills.[18]

While the ADIA and CIC are prototypical of most SWFs, the purpose of each SWF can be as unique as the country from which it originates. The International Monetary Fund (IMF) loosely fits SWFs into five categories: stabilization funds, which aim to provide insurance against commodity price shocks; savings funds, which ensure that future generations have public services; reserve investment corporations, which simply seek higher returns on government investments; development funds; and contingent pension reserve funds.[19]

In sum, SWFs reinvest trade surpluses from commodity and noncommodity export sales in developing countries back into Western economies by purchasing shares in publicly and privately held corporations. In doing so, SWF investments are encouraged by many because of their ability to increase efficiency in global asset allocation; however, they are also discouraged by many because of the potential for abuse that can arise when governments own private investments.[20]

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13. *See* Gilson & Milhaupt, *supra* note 3, at 1-3.
14. IMF, *supra* note 10, at 4.
15. Gerard Lyons, *State Capitalism: The Rise of Sovereign Wealth Funds*, 14 L. & BUS. REV. AM. 179, 184 (2007).
16. IMF, *supra* note 10, at 4 (discussing how SWFs protect oil economies from commodity price swings).
17. Lyons, *supra* note 15, at 188.
18. Edward F. Greene & Brian A. Yeager, *Sovereign Wealth Funds—A Measured Assessment*, *in* EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION IN EUROPE: A CONTRAST IN E.U. & U.S. PROVISIONS 427-28 (PLI Corp. Law & Practice, Course Handbook Series No. B-01712, 2009).
19. IMF, *supra* note 10, at 5.
20. Vidhi Chhaochharia & Luc Laeven, *Sovereign Wealth Funds: Their Investment Strategies and Performance* 1 (Centre for Econ. Policy Research, Discussion Paper No. 6959, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1308030.

C. The Rise to Prominence

It is perhaps easiest to understand the controversy behind SWF investments by tracking their rise to prominence. Initially, SWFs were modest investors whose size and substance garnered little attention.[21] But as the global economy grew in the second half of the twentieth century, so too did the trade surpluses of developing nations rich with natural resources or cheap labor markets. Two events accelerated this phenomenon. First, the precipitous rise of oil prices—peaking at $147.27 per barrel in 2008[22]—left the coffers of many Gulf States flush with petrodollars.[23] These profits were quickly channeled into SWFs in order to stave off inflation in local economies.[24] Second, China and other Asian nations capitalized on large pools of cheap labor to become the world's manufacturing shop. Fed by the United States' current account deficit and devaluation of the Chinese Renminbi,[25] China alone boasts an estimated $1.4 trillion trade surplus.[26]

In short, the SWF phenomenon and debate is a by-product of enhanced global trade in the second half of the twentieth century and the accompanying movement of cash from developed countries to developing countries. The attention SWFs garner will likely wax and wane with the price of oil, the profitability of Asian exportation, and trends in global demand.

A report by Morgan Stanley estimated that all SWFs held $2.5 trillion in assets in 2007, a number that exceeded the amount held by hedge funds at the time and was projected to grow to $12 trillion by 2015.[27] As long as capital moves across borders, SWFs will continue to play a large role in the global economy.

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21. *See* Peter Heyward, *Sovereign Wealth Fund Investments in US Financial Institutions: Too Much or Not Enough?*, BANKING & FIN. SERVICES POL'Y REP., May 2008, at 19, 19. SWFs trace their beginnings to the mid-twentieth century. *Id.* One of the first SWFs was the Revenue Equalization Reserve Fund, established in 1956 by Kiribati to invest revenues from phosphate deposits. *Id.*

22. *Oil Hits New High on Iran Fears*, BBC, July 11, 2008, http://news.bbc.co.uk/2/hi/business/7501939.stm. The price of oil was hovering steadily around $145 per barrel, but briefly rose to $147.27 per barrel. *Id.*

23. Greene & Yeager, *supra* note 18, at 431.

24. *Id.*

25. *See* Mattoo & Subramanian, *supra* note 5, at 3.

26. Lyons, *supra* note 15, at 188.

27. Steven R. Weisman, *A Fear of Foreign Investments*, N.Y. TIMES, Aug. 21, 2007, at C5 (discussing a report by Morgan Stanley that projects SWF growth).

III. PROBLEMS AND PROPOSALS

A. *The Ensuing Concerns*

As SWFs grew to an enormous size around the turn of the twenty-first century, growing concerns mounted over the fact that substantial portions of equity in large multinational firms were held by foreign governments.[28] The essence of this scrutiny revolved around one complicated question: do SWFs invest for political or financial reasons?[29] The fear was that politically motivated investments could negatively affect one or more of three distinct areas: national security, financial stability, and corporate governance. To understand domestic responses to SWFs, their shortcomings, and the influence each had on GAPP, a brief outline of each perceived threat is necessary.

1. National Security

One concern is that national security interests are put in jeopardy by allowing foreign governments to own or control companies engaged in sensitive industries or oversight of limited natural resources.[30] The argument is that by owning controlling shares in such companies, the foreign government could increase its military capacity by expropriating technology, the expropriation of which the U.S. government prohibits to certain countries.[31] Similarly, a foreign government could threaten U.S. national security by controlling reserves of natural resources necessary for military operations.[32]

Illustrative of the fear of foreign ownership of sensitive property is the 2006 case of Dubai Ports World, where an Emirate port security company was prevented from winning a contract for U.S. shipping facilities.[33] An example of the concern surrounding foreign government ownership of natural resources is the botched attempt by the China National Offshore Oil Corporation to acquire the American energy giant UNOCAL in 2005.[34] Congress prohibited the deal from going through because opponents of the takeover argued that the United States would be compromising a strategically sensitive sector of its economy.[35] While these examples involve foreign government-owned companies—not

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28. *See* Bayh, *supra* note 3; *see also* Truman, *supra* note 3, at 1.
29. *See* Truman, *supra* note 3, at 1.
30. *See* Heyward, *supra* note 21, at 20.
31. *Id.*
32. *Id.*
33. Truman, *supra* note 3.
34. *Id.*
35. *Id.*

SWFs—they reveal the anxiety many Americans have for increasing amounts of foreign government activity in areas that have historically been the object of U.S. firms.

More important is the fact that most SWF investments are passive—that is, they do not seek out controlling shares.[36] Nevertheless, host countries have taken a number of precautions to guard against the influx of foreign investment.

2. Financial Instability

Another, and seemingly more plausible, fear is that SWFs can destabilize global currency and bond markets by abruptly moving investments from one market or sector to another or by selling them outright.[37] In theory, the sudden sale of an SWF's shares would cause other shareholders to follow suit out of the fear that the SWF is privy to information not available to other shareholders.[38] The resulting uncertainty in that corporation or sector would then spread throughout the financial system. Unlike possible threats to national security, financial stability concerns are not industry-specific and are difficult to safeguard against. However, these fears are misguided because there have been no such instances of SWFs selling shares to intentionally or unintentionally cause market turmoil.

3. Corporate Governance

A third concern is that an SWF may use its vote to direct a company to act in ways beneficial to the SWF's home country and detrimental to the company.[39] For instance, one commentator posits that SWFs can direct a company to build factories in its home state in order to boost its economy through jobs, taxes, and diversity.[40] Also, an SWF could invest in a company to receive relatively low-priced goods at the expense of other shareholders.[41] Furthermore, and related to the fear of market instability, an SWF could use its large stake as a bargaining chip with the

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36. *See* Paul Rose, *Sovereign Wealth Funds: Active or Passive Investors?*, 118 YALE L.J. POCKET PART 104 (2008).

37. Bart de Meester, *International Legal Aspects of Sovereign Wealth Funds: Reconciling International Economic Law and the Law of State Immunities with a New Role of the State* 9 (Inst. for Int'l Law, Working Paper Series Version 18, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1308542.

38. *Id.*

39. Paul Rose, *Sovereigns as Shareholders*, 87 N.C. L. REV. 83, 93-94 (2008).

40. *Id.* at 94.

41. *Id.*

host government.[42] For example, an Arab fund could threaten to use its shares maliciously if the United States did not adopt a certain stance regarding Israel or failed to give tax breaks to its firm.[43]

One last corporate governance concern is raised by strict capitalists who fear that any political influence on matters of corporate governance will result in goods being allocated in a manner that is not the most economically efficient.[44] These purists hold that resource allocation is best determined by individuals seeking economic returns, not governments that may have social or political aims.[45]

The source of each concern is very different. For national security concerns, the type of *industry* in which the SWF investment takes place is a cause of anxiety. For financial stability concerns, the *amount* of capital invested is at issue. Regarding corporate governance, SWFs' ability to affect *decision making* is a source of frustration. Because the nature of each concern is different, it has been difficult for one single host-country institution to vet SWF activity properly.

B. Domestic Safeguards Against Foreign Investment

To mitigate the fears created by SWF activity, Western countries have responded by creating domestic institutions to review and monitor SWF transactions. In the United States, the front line against any foreign investment is the Committee on Foreign Investments in the United States (CFIUS).[46] The Exon-Florio Amendment of 1988 provides a formal wealth fund-acquisition review procedure, where the president may block an acquisition that poses a threat to national security if "credible evidence" exists that the acquisition genuinely poses such a threat.[47] The latest addition to the U.S. regulatory framework is the Foreign Investment and National Security Act of 2007, which requires the CFIUS to determine whether an acquiring interest is a foreign government, and upon such a finding to investigate whether the acquisition poses a risk to

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42. *Id.*

43. *See* Steven R. Weisman, *Overseas Funds Resist Calls for a Code of Conduct*, N.Y. TIMES, Feb. 9, 2008, at C3.

44. Greene & Yeager, *supra* note 18, at 435.

45. *See id.*

46. *See* 22 U.S.C. § 3101 (2006) ("[T]he United States Government is presently authorized to collect limited amounts of information on United States investment abroad and foreign investment in the United States."). CFIUS was created by executive order and later codified as the International Investment and Trade in Services Survey Act of 1976, 22 U.S.C. §§ 3101-3108 (2006).

47. 50 U.S.C. app. § 2170 (2006).

national security.[48] In making this determination, CFIUS must consider the transaction's potential effects on "critical infrastructure" and "critical technologies."[49]

C. Proposals To Heighten Security

Despite the current framework, the recent increase of SWF activity has prompted proposals to heighten the scrutiny applied to SWF investments.[50] Most of these propositions are aimed at reducing the decision-making capacity of the SWFs. For example, some critics have called for SWF voting rights to be suspended.[51] This proposal posits that because a shareholder's influence is represented through its shares, the best way to prevent strategic behavior is to suspend the voting rights attached to those shares.[52] Other proposals involve requiring SWFs to use external asset managers to manage their funds and to disclose their votes.[53] Still others call for taxing SWFs into oblivion.[54]

As suggested above, calls for heightened scrutiny are grounded largely on unfounded fears. Critics have yet to provide a concrete example of foreign investment funds pursuing nonfinancial ends. Nonetheless, the specter of SWFs investing for strategic nonfinancial reasons still exists, but now on a larger scale. Given the opacity of SWFs—information regarding investment objectives, asset allocation, and fund performance is often not made public—little knowledge can be gained from looking at a particular fund's composition.[55]

In summation, the years following the turn of the twenty-first century witnessed a strange relationship of distrust, mutual need, and uncertainty between SWFs from the developing world and financial regulators in the developed world. As the trade reserves of commodity- and export-rich nations grew, Western financial firms became an attractive vehicle to increase returns and diversify investments. Financial firms did not resist, nor did the governments of many host nations. But politicos in Washington and their European counterparts began to grow

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48. Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (2007) (codified at 50 U.S.C.A. app. § 2061 note (West Supp. 2009)).

49. *Id.*

50. *See* Bayh, *supra* note 3.

51. *See* Gilson & Milhaupt, *supra* note 3, at 1362-65.

52. *Id.* at 1364.

53. Rose, *supra* note 39, at 136.

54. *See* Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. 440, 503 (2009).

55. *See* EDWIN TRUMAN, A SCOREBOARD FOR SOVEREIGN WEALTH FUNDS 4 (2007), http://www.iie.com/publications/papers/truman1007swf.pdf (last visited Oct. 27, 2009).

skeptical when foreign investment reached unprecedented levels. What was missing from the SWF dilemma was an environment where these fears could be tested.

IV. SOVEREIGN WEALTH FUNDS IN ACTION

A. The Financial Crisis: SWFs as First Responders

Credit markets are often referred to as the lifeblood of an economy. Without lending, economies cannot grow and companies cannot prosper. For robust lending, financial firms must consistently receive new investments. The financial crisis has provided a fertile environment to test SWF behavior because stock prices have been low, regulators and firms have been hungry for investment, and oil and export rich countries have been flush with cash.

When U.S. financial firms sought to capitalize on rising home prices and risky lending practices by "securitizing" subprime mortgages, few questions were asked regarding the prudence of such practices.[56] When housing prices fell in 2007, the assets underlying these mortgage-backed securities—the houses themselves—did not equal in value the combined sales price necessary to make the lender whole.[57] Consequently, these losses, coupled with financial firms' use of leveraging—the risky practice of borrowing funds to make investments that will hopefully have higher returns than the interest on the loans—put the financial services firms in "cardiac arrest."[58]

Slumping stock prices and other danger signs were making U.S. investors wary of pumping more cash into starved financial firms. Without new investments to mitigate the subprime losses, financial firms were unable to post profits. As losses mounted, stock prices fell further. Eager to capitalize on what appeared to be low-hanging fruit, SWFs injected billions of dollars—much more than they would typically spend—to rescue some of Wall Street's biggest firms.[59] Citigroup saw investments of $7.5 billion from the ADIA, and $6.88 billion from the

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56. Martin N. Baily et al., *The Origins of the Financial Crisis* 7-8 (Brookings Institution, Working Paper No. 3, 2008), *available at* http://www.brookings.edu/papers/2008/11_orgins_crisis_baily_litan.aspx.

57. *Id.* at 8.

58. Simon Johnson, The Economic Crisis and the Crisis in Economics (Jan. 7, 2009) (revised version of a speech, on file with Peterson Inst. for Int'l Econ.), *available at* http://www.iie.com/publications/papers/paper.cfm?ResearchID=1090.

59. Roula Khalaf, *Sovereign Wealth Funds Do Not Have All the Answers*, FIN. TIMES, Sept. 30, 2008, at 17, *available at* http://www.ft.com/cms/s/0/aa9e7d9e-8e37-11dd-8089-0000779fd18c.html?nclick_check=1.

Government of Singapore Investment Corporation.[60] Morgan Stanley benefited from a $5 billion cash injection from CIC.[61] Merrill Lynch received $4.4 billion from Temasek and another $4 billion from Kuwait and South Korea.[62] The early stages of the financial crisis were a mutually advantageous love fest for SWFs and Western firms. Countries like China worried about inflation from large currency reserves and tried to "get as much money out the door as possible, as quickly as possible."[63] Other, petrol-driven funds wanted to take advantage of the surge in oil prices.[64] The cheap U.S. stocks and rich foreign investors culminated in a spending spree. These actions led the zany market analyst Jim Cramer to quip: "Do we want the [C]ommunists to own the banks, or the terrorists? I'll take any of it, I guess, because we're so desperate."[65]

But the cash injections were not enough. The risk associated with mortgage-backed securities was well masked by the practice of "bundling" securities: taking good loans and mixing them with bad loans. The toxic subprime assets permeated throughout the entire global economy.[66] Furthermore, the performance of credit rating agencies, the private firms responsible for rating risky investments so that investors may steer clear, continuously gave subprime mortgage backed securities and CDOs triple-A ratings, the gold standard of investments. Henry Waxman, Chairman of the Committee on Government Oversight and Reform, characterized the performance of the three rating giants as a "colossal failure."[67] Risky lending practices, financial voodoo, and shoddy credit ratings resulted in the current financial crisis.

B. SWF Holdings Take a Massive Hit

When the global financial crisis appeared to be a mere hiccup, SWFs held over $3 trillion in securities in American financial firms.[68] In

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60. Sovereign Wealth Fund Inst., Subprime Report—Cash Infusion (Apr. 2008), *available at* http://www.swfinstitute.org/research/subprimereport.php.

61. *Id.*

62. *Id.*

63. Henry Sender, *Sovereign Funds Cool on Rescue Finance*, FIN. TIMES, Nov. 9, 2008, http://www.ft.com/cms/s/0/2e76-ae8a-11dd-1621-000077b07658.html?nclick_check=1.

64. Simeon Kerr, *Gulf Funds 'Looking' To Invest in US*, FIN. TIMES, Oct. 29, 2008, http://www.ft.com/cms/s/0/fdb1d65e-a55a-11dd-b4f5-000077b07658.html.

65. Goodman & Story, *supra* note 1.

66. Baily et al., *supra* note 56, at 7.

67. Jann Swanson, *Ratings Agencies Hit for Role in Financial Crisis*, MORTGAGE NEWS DAILY, Oct. 23, 2008, http://www.mortgagenewsdaily.com/10232008_Ratings_Agencies_.asp.

68. *Sovereign Wealth Funds*, FIN. TIMES, Dec. 7, 2008, www.ft.com (follow "Lex" hyperlink; then search "sovereign wealth funds").

December 2008, that number was down to $2.3 trillion.[69] Likely the hardest hit was Singapore's Temasek, which lost no less than $2 billion on investments made in Merrill Lynch alone.[70] The Gulf fund ADIA invested $7.5 billion in Citigroup in November 2007, only to see Citi's share price fall from $34.60 to $3.50.[71] Citi's losses also hit the Kuwaiti Investment Authority (KIA), which suffered a $270 million loss in Citigroup in September 2008.[72] China's CIC lost nearly $6 billion for its holdings in Morgan Stanley and Blackstone.[73] Fears of future losses were accelerated when the United States Treasury let Lehman Brothers fail.[74]

C. From Scare to Scarce

In 2008, the full gravity of the financial crisis began to manifest. Many financial firms were damaged badly, some beyond repair. SWFs ebbed the flow of liquid injections that were once the finance industry's saving grace.[75] A common destination for SWF monies became their domestic markets.[76] For instance, the Kuwaiti Investment Authority bought a share in the country's national telecommunications company.[77] It also bailed out its domestic bourse.[78] The Qatar Investment Authority committed $5.3 billion to its banks.[79] Simultaneously, other funds are starting to hoard cash. Abu Dhabi's fund is now experiencing its highest level of cash, 10% to 20% of its holdings.[80] Likewise, the Kuwait Investment Authority has increased its cash position, with its director

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69. *Id.*

70. Saskia Scholtes & Greg Farrell, *Temasek Counts Cost of Paper Losses on Merrill Investment*, FIN. TIMES, Jan. 7, 2009, www.ft.com (search "Temasek Counts Cost of Paper Losses").

71. Andrew England, *Sovereign Wealth Funds Lose Their Gloss*, FIN. TIMES, Jan. 28, 2009, www.ft.com (search "Sovereign Wealth Funds Lose Their Gloss").

72. *Id.*

73. *China's Sovereign Wealth Fund Loses $6 Billion*, FIN. EXPRESS, Dec. 4, 2008, http://www.financialexpress.com/news/chinas-sovereign-wealth-fund-loses-6-billion/393850/.

74. Alan S. Blinder, *Six Errors on the Path to the Financial Crisis*, N.Y. TIMES, Jan. 24, 2009, at BU7. Blinder refers to the decision to allow Lehman to fail a "colossal error" and characterizes it as an "offering to the moral-hazard gods." *Id.*

75. Heather Timmons & Keith Bradsher, *To Avoid Risk and Diversify, Sovereign Funds Move on from Banks*, N.Y. TIMES, Sept. 19, 2008, at C4.

76. *Id.*

77. *Id.*

78. *See* Robin Wigglesworth, *Kuwait Seeks To Reassure Investors*, FIN. TIMES, Nov. 19, 2008, http://www.ft.com/cms/s/0/91883248-b5c7-11dd-ab71-0000779fd18c,dwp_uuid=b03d580a-4ff0-11dc-a6b0-0000779fd2ac.html?nclick_check=1.

79. Landon Thomas Jr., *Sovereign Funds Now Prefer Hoarding Cash To Rescuing U.S. Financial Firms*, N.Y. TIMES, Oct. 14, 2008, at B7.

80. *Id.*

telling New York bankers that it is no longer interested in buying distressed financial companies.[81]

SWFs are still interested in investments abroad, just not in commercial banks. For instance, Abu Dhabi's investment fund purchased the Manchester City soccer team,[82] a Dubai fund is considering investing in British property developer Minerva,[83] and Saudi funds are looking into agricultural investments in Pakistan.[84] The president of China's CIC captured the SWF collective sentiment when he said: "Fortunately there are more than 200 countries in the world. And fortunately there are many countries who are happy with us."[85] In other words, SWFs did not take kindly to calls for heightened scrutiny at a time when they were suffering huge losses in the U.S. financial market. Furthermore, if they continue to dump funds into ailing American firms, they fear they will be viewed as a source of "dumb money."[86]

SWFs are also returning to the failsafe investment of government treasury bills.[87] To be sure, these investments are welcomed by a federal government engaged in bail outs and deficit spending. But long-term, private-sector investment is also needed. Sensing the turning tide, U.S. policymakers have been more open to facilitating SWF investment.[88] In remarks aimed at countering SWF critics, Deputy Treasury Secretary Robert Kimmitt took note and said, "It is our responsibility to make sure we have an open investment climate."[89] Translation: dial down the anti-SWF rhetoric and assure foreign governments that measures like the Troubled Assets Relief Program (TARP) will make the U.S. financial services industry an attractive place for foreign investors.[90]

The critical lesson from the ongoing financial crisis is that SWFs act like any rational, financially motivated investor. When share prices went down, they increased holdings, expecting the market to recover. When it became uncertain whether these financial firms would ever recover, SWFs diverted new investments into other sectors of the global economy or into traditional, conservative financial instruments. The ironic part of the SWF financial crisis saga has been the consistent calls

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81. *Id.*
82. Timmons & Bradsher, *supra* note 75.
83. *Id.*
84. *Id.*
85. Schwarzman, *supra* note 2.
86. Gillian Tett, *Insight: Western Banks Face SWF Backlash*, FIN. TIMES, Feb. 7, 2008, http://www.ft.com/cms/s/7bfc8ee8-d5b1-11dc-8b56.
87. *See* Kerr, *supra* note 64.
88. *Id.*
89. *Id.*
90. *See id.*

to increase domestic security against foreign investment in the face of demonstrated financial motivations. However, a multilateral response to the SWF dilemma has shifted the focus from domestic safeguards to international law.

V. A MULTILATERAL RESPONSE

A. *International Call to Action*

Before the severity of the financial crisis was known, there was dissatisfaction with CFIUS's ability to promote transparency in SWFs.[91] To address this issue, the Bush administration and other Western nations began pressuring the IMF and the World Bank to study the behavior of SWFs and devise a voluntary code of conduct.[92] These sentiments were echoed by the world's leading finance ministers in a communiqué issued during a meeting of finance ministers from G7 countries.[93] The statement did not name specific countries, nor did it specifically call for countries to suppress political motivations when investing.[94] It simply called for a "code of best practices."[95] Surprisingly, the communiqué was initially met with hesitation from the World Bank.[96] Its president, Robert Zoellick, described the investment strategy of SWFs as a "question of national judgment."[97]

But the IMF took heed of the request and began drafting a code.[98] Leaders of SWFs were anxious about the proposal, which they viewed as unnecessary in light of the purely commercial response of their funds to the crisis.[99] The result was the Generally Accepted Principles and Practices (GAPP), or "Santiago Principles" (in reference to the location of the drafting in Chile).[100]

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91. Steven R. Weisman, *Rules Urged To Govern Investing by Nations*, N.Y. TIMES, Oct. 20, 2007, at C1.
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.*
96. *Id.*
97. *Id.*
98. Weisman, *supra* note 43.
99. *Id.*
100. *See* GAPP, *supra* note 4. Signatories to the GAPP include: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, and the United States. *Id.* at 28. The OECD, Oman, Saudi Arabia, Vietnam, and the World Bank are permanent observers. *Id.*

B. Examination of the GAPP

Transparency and accountability are the primary sources of SWF criticism. Because the money that funds investments is public—from taxes and currency reserves—there is no body of shareholders to which the directors are accountable. Likewise, because many governments from the oil and export rich nations are not considered democratic by Western standards, the decision makers within the fund are not held to the same standards of transparency as Western investment funds. Regarding the transparency and accountability of corporate governance structures, the GAPP does not attempt to impose a "one-size-fits-all" structure for the SWFs.[101] Rather, it vaguely lays out guideposts in keeping with its function as a code of "best practices."[102] For instance, GAPP 6 encourages a framework that establishes "a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence."[103] Furthermore, GAPP 14 and 18.2 address the use of investment managers and third parties and encourage the funds to disclose this information and work with them on "economic and financial grounds."[104] Also important is the requirement in GAPP 20 that funds do not use privileged information or inappropriate influence when competing with private entities.[105]

To assuage the risk of financial instability caused by quickly exiting the market, GAPP provides some reassurances. GAPP 3 speaks somewhat directly to this fear and instructs SWFs that where their "activities have significant direct domestic macroeconomic implications" the funds should coordinate "with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies."[106] GAPP 4 adds to this obligation by stating that funds should have "publicly disclosed policies" regarding "funding, withdrawal, and spending operations."[107]

While the primary response to national security concerns rests in domestic institutions like CFIUS, GAPP does provide some guidance on this issue. GAPP 19 provides that investment decisions should aim to maximize returns "in a manner consistent with its investment policy, and

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101. Rose, *supra* note 39, at 138.
102. GAPP, *supra* note 4, at 1.
103. *Id.* at 7.
104. *Id.* at 8.
105. *Id.*
106. *Id.* at 7.
107. *Id.*

based on economic and financial grounds."[108] Further, GAPP 19.1 requires an SWF to clearly identify any investment decision that is not based on "economic and financial considerations."[109]

C. GAPP's "Weakness"

The GAPP objectives outline a governance structure and require disclosures that will improve the way information is shared between the funds and the host countries. However, GAPP makes clear that implementation is entirely voluntary and "subject to the home country laws, regulations, requirements and obligations."[110] Thus, the GAPP is "soft law" or nonbinding international law.

Such a perceived "weakness" could be cause for alarm given SWFs' early rise to prominence in U.S. financial markets. Critics argue that the voluntary nature of GAPP renders it toothless and thus incapable of addressing the three concerns outlined above. But soft law can have its advantages. This Comment argues that the flexible, nonbinding nature of this international solution—pejoratively termed a "weakness"—is a characteristic that should be embraced.

VI. SOFT SOLUTIONS FOR A HARD PROBLEM

A. A Nonbinding Code: Where Do We Go from Here?

In the past decade, the global economy has seen an enormous amount of government-controlled capital flow from the developing world to the United States and Western Europe.[111] Responses to political and financial challenges from these investment flows have been primarily domestic. The passage of GAPP marked a new, multilateral era initiated by the capital exporting countries. The question now becomes, in light of the financial crisis, what do host countries do to mitigate the possible shortcomings of GAPP's voluntary nature? Some scholars argue that the United States should spearhead an effort to "harden" GAPP by merging the code of best practices into the WTO framework.[112] Others recognize the shortcomings of GAPP's soft law nature, but consider it a positive development in the effort to regulate SWFs.[113] This Comment examines both approaches and argues that a soft law response is appropriate in

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108. *Id.* at 8.
109. *Id.*
110. *Id.* at 7 (emphasis omitted).
111. *See* discussion *supra* Part II.C.
112. Mattoo & Subramanian, *supra* note 5, at 16.
113. Rose, *supra* note 39, at 147.

light of SWF behavior in the financial crisis and the uncertainty inherent in the current global economy.

B. The Hard Law—Soft Law Continuum

To illuminate the differences between soft and hard law, it is helpful to place international laws on a continuum, with hard law at one end and soft law on the other.[114] Briefly, hard law can be defined as "legally binding obligations that are precise . . . and that delegate authority for interpreting and implementing the law."[115] The three key elements to hard law are obligation, precision, and delegation.[116] Soft law, simply put, exists when a legal agreement is weakened at one or more of these key elements.[117] International agreements are likely to fall anywhere on this spectrum and can have strong manifestations of some elements and weak manifestations of others.[118] The GAPP is firmly ensconced on the soft law end of the spectrum, as it embodies weak obligations,[119] precision,[120] and delegation.[121]

C. Hard Law Options: Institutionalizing the GAPP into the WTO Framework

Generally speaking, international actors should use hard legal commitments when both the benefits of compliance and the costs of opportunistic noncompliance are high.[122] The WTO is the ultimate multilateral hard law organ. It is strong along the three elements of obligation, precision, and delegation. It is not surprising, then, that several prominent voices have called for the WTO to subsume GAPP.[123]

The thrust of the argument in favor of having the WTO subsume GAPP is that the compliance and enforcement problems associated with nonbinding international law can be mitigated by adding an institutional framework.[124] For instance, institutions can resolve ambiguities or

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114. Kenneth W. Abbott & Duncan Snidal, *Hard and Soft Law in International Governance*, 54 INT'L ORG. 421-24 (2000).
115. *Id.* at 421.
116. *Id.* at 424.
117. *Id.* at 422.
118. *Id.* at 424-25.
119. In its own words, GAPP is "voluntary." *See* GAPP, *supra* note 4, at 7.
120. GAPP uses vague wording. *See* discussion *supra* Part V.B.
121. There is no enforcement mechanism named or envisioned in the GAPP. *See generally* GAPP, *supra* note 4.
122. *See* Abbott & Snidal, *supra* note 114, at 429.
123. *See* Mattoo & Subramanian, *supra* note 5, at 16.
124. *Id.*

indeterminate norms by making authoritative interpretations of texts.[125] Furthermore, institutions can help signatories overcome their inability to comply with the agreement by providing services like technical assistance.[126]

Aaditya Mattoo and Arvind Subramanian, two leading experts on international trade and finance, advocate for including SWF regulation in the WTO, specifically the General Agreement on Trade in Services (GATS).[127] They argue that GATS already provides a framework to regulate SWF investments as well as a dispute settlement mechanism.[128] The basic concept of GATS calls for countries to negotiate schedules of commitments—conditions placed on foreign investors in certain sectors of the economy—which control or outright prohibit investment in certain sectors.[129] While this proposal offers a plausible solution to the problems posed by SWFs, it places too much stock in the WTO's ability to take on such a challenge given its current state of gridlock.[130] Mattoo and Subramanian argue that the SWF issue can help revive the Doha Round by "rekindling the interest of a wide variety of groups."[131] However, there are major problems facing the WTO in the current Doha Round, and there are reasons why adding the SWF issue to the WTO framework is not likely to be as successful as the authors believe.

First, WTO trade negotiators are gridlocked on agricultural and other issues, with the main chasm found between those from the developing and developed worlds.[132] Disputes over agriculture, safeguard mechanisms, and a host of other issues are far more prescient than the SWF discord and would place it at the bottom of the priority list.[133] Mattoo and Subramanian argue that placing SWFs on the agenda will create an additional bargaining chip for the developed and developing countries to work with.[134] This author views their suggestion as overly optimistic, given the fact that several of the major players among the

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125. Dinah Shelton, *Law, Non-Law and the Problem of 'Soft Law,' in* COMMITMENT AND COMPLIANCE: THE ROLE OF NON-BINDING NORMS IN THE INTERNATIONAL LEGAL SYSTEM 1, 15 (Dinah Shelton ed., 2000).

126. *Id.* at 2.

127. Mattoo & Subramanian, *supra* note 5, at 16.

128. *Id.*

129. *Id.* at 17. Common examples of such industries where foreign countries are prohibited include telecommunications, radio, and television broadcast. *Id.*

130. *See* Jeffrey J. Schott, *A 5-Step Program for Doha Rehabilitation: Rational Expectations About the Doha Round Negotiations* (Peterson Inst. for Int'l Econ., Op-Ed. 2008), *available at* http://www.iic.com/publications10peds/print.cfm?ResearchID-976.

131. Mattoo & Subramanian, *supra* note 5, at 1.

132. Schott, *supra* note 130.

133. *See id.*

134. Mattoo & Subramanian, *supra* note 5, at 1.

developing countries (e.g., India and Brazil) do not have SWFs and thus have nothing to gain by adding the issue to the discussion. Moreover, Russia, a country with an SWF that is becoming increasingly significant, is not a member of the WTO. Further, the Gulf States, which make up two-thirds of the GAPP signatories, are not major producers of agriculture and thus would have little to gain by making concessions to their SWF governance. In sum, institutionalizing GAPP via GATS is not a reality because the relevant players do not have enough at stake in the current impasse facing the WTO. Furthermore, there are advantages to keeping the soft nature of GAPP.

D. Why Soft Law Is Appropriate for SWF Regulation

The general theory underlying the use of soft forms of legalization is that when contracting costs increase, incentives to use soft law also increase.[135] Contracting costs include costs to sovereignty and uncertainty, divergence of preferences among actors, and power differentials among the states.[136]

1. Sovereignty

Acquiescing to the authority of an external institution like the WTO entails a significant cost to a state's sovereignty. Such a surrender of power can limit the ability of the state to govern certain areas of domestic policy.[137] This is the case in the WTO, where domestic policies concerning subsidies, trade remedies, and other matters are created and enforced by the central governing organ. For SWFs, this would entail allowing an external agency to monitor its compliance with GAPP, as well as create new rules that will affect regulation. In order for an SWF country to justify such a curtailment of its sovereignty, there would need to be a reciprocal surrender of sovereignty from states that host SWFs. Domestic pressures are likely to view an unreciprocated surrender of sovereignty as impinging on the traditional relationship between a state and its citizens.[138] But any concession from the United States would likely come in the form of opening sectors of its economy currently closed to SWFs. Under GATT article XXI, the United States would be able to claim that keeping these sectors closed to foreign investment is

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135. *See* Abbott & Snidal, *supra* note 114, at 436.
136. *Id.*
137. *Id.* at 437.
138. *Id.*

"necessary for the protection of its essential security interests."[139] Thus, the hit on a SWF state's sovereignty would not be reciprocated by the host state and consequently will not foster the political will necessary for an SWF state to surrender some of its sovereignty. GAPP's voluntary nature avoids this problem by allowing SWF states to retain total sovereignty in implementing its provisions. Moreover, the United States can offer to give up some of its sovereignty—that is, open some currently closed sectors of its economy—in return for SWF states implementing certain provisions of GAPP.

2. Uncertainty

The rise of SWFs, their role in the financial crisis, and their subsequent retreat from the capital markets were not expected. Indeed, many international issues are so novel and complex that the challenges they pose and their possible solutions cannot be anticipated.[140] Soft law can be an attractive approach in this regard because it gives less weight to the binding nature of a state's commitments and thus more room to adapt to changing circumstances.[141]

In the current global economy, any number of unforeseen events can arise. Commodity markets like the oil market can rapidly decline in profitability, trading partners can erect barriers to imports, and wars or other domestic disturbances can put pressure on a government to spend its surpluses at home. For instance, GAPP 19 requires a fund to make decisions that "aim to maximize risk-adjusted financial returns" and are "based on economic and financial grounds."[142] Would a strict reading of this provision mean that should oil prices suddenly plummet, a Gulf SWF would be hindered from withdrawing funds from a well-performing investment? Would South Korea be stopped from withdrawing its funds to support a military campaign? If such an event were to affect an SWF state, a binding version of GAPP may hinder a fund's ability to exit the market quickly and spend its resources at home. Fortunately, GAPP's phraseology avoids binding language, which leaves the door open for SWFs to respond to unforeseen crises.[143]

In its current soft form, GAPP captures the easily recognizable issues facing host countries and takes steps to remedy them by promoting

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139. General Agreement on Tariffs and Trade, Oct. 30, 1947, art. XXI(b), 61 Stat. A-11, 55 U.N.T.S. 194 [hereinafter GATT].

140. *See* Abbott & Snidal, *supra* note 114, at 441.

141. *Id.*

142. GAPP, *supra* note 4, at 8.

143. *See id.* at 7-9.

normative behavior, while at the same time providing a framework that can adapt to unforeseen challenges.[144] If GAPP were hardened under the WTO, SWF countries would have to undergo negotiations, and then dispute settlement proceedings, before exiting the capital markets.[145] This cumbersome approach is not conducive to the urgent nature of many challenges in the global market.[146] Also, if harder forms are desired in some areas, such as clear disclosure of investment strategy, but not in others, they can be bargained for in a piecemeal manner through the soft law framework.[147]

3. Divergent Preferences

As noted above, soft law allows for flexibility in implementation, which enables states to better handle domestic pressures.[148] This aspect of soft law is not only important for a state's ability to respond to uncertainty, but is also crucial when a normative code like GAPP attempts to harmonize the practices of a diverse set of players.[149] For instance, the primary purpose of China's fund is to reduce the inflationary pressures of large reserves.[150] On the other hand, Gulf States seek to diversify their sources of national wealth.[151] These differences may mean Gulf States need to commit themselves in a way that makes exit from Western capital markets easy. Soft law is conducive to a situation in which multiple parties have divergent preferences because it allows states to implement commitments to their specific situations rather than attempting to accommodate multiple divergent preferences within a single text.[152] For instance, Gulf funds could give less weight to the vague language in GAPP 4, regarding clear policies on withdrawal, in order to counter swings in the commodities market.[153] If, however, GAPP were hardened, each party would be bound in the same manner, and the dispute settlement mechanism would ignore any one party's idiosyncrasies in order to promote consistency.

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144. Abbott & Snidal, *supra* note 114, at 444.
145. *See* Mattoo & Subramanian, *supra* note 5, at 16.
146. Abbott & Snidal, *supra* note 114, at 444.
147. *Id.* at 444-45.
148. *Id.* at 445.
149. *Id.*
150. *See* discussion *supra* note 15.
151. *See* discussion *supra* note 15.
152. Abbott & Snidal, *supra* note 114, at 445.
153. *See id.*

GAPP parties also diverge along current corporate governance practices.[154] Some parties to GAPP have transparent and accountable systems of corporate governance, like Norway; others, like China and Abu Dhabi, have little in the form of corporate governance that meets Western standards.[155] Soft law accommodates states with "different degrees of readiness" by avoiding rigid time frames and narrow language.[156]

VII. CONCLUSION

As stated previously, surging oil profits and trade surpluses propelled the accounts of many developing countries to new heights. These surpluses were recycled in the global economy by means of investments in Western financial firms. But these new investors were not always welcomed warmly. Some scholars, politicians, and pundits feared that SWFs were pursuing political ends with their investments. Acting on these fears, the United States erected the CFIUS regime to properly vet and reject any foreign investments that threaten national security. Currently, many critics of SWFs fear the existing framework is not enough and have called for heightened domestic safeguards. However, concerns about political motivations behind SWFs are not the product of empirical observation, but are borne from conjecture.

This Comment engages in an in-depth analysis of how SWFs responded to the financial crisis. Based on empirical observation, this Comment reveals a series of actions common to all SWFs that strongly suggest they are motivated by financial rather than political ends. SWFs invested heavily in the early stages of the financial crisis because they believed the cheap price of entry would pay off when distressed financial firms recovered from what was believed to be a slight recession. But when many financial firms did not recover, SWFs endured massive losses. When the full gravity of the financial crisis had finally sunk in, SWFs did what any other anxious investor would do—they got out. Thus, calls for heightened scrutiny of SWF activities appear counterintuitive in light of their clearly demonstrated financial motivations.

But there is more to the SWF debate. Simultaneous to the SWFs' rise to prominence in the financial crisis has been an international effort to promote normative behavior among SWF states. GAPP was intended

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154. Chhaochharia & Laeven, *supra* note 20, at 39.
155. *Id.*
156. Abbott & Snidal, *supra* note 114, at 445.

to be an alternative way to assuage the concerns of regulators in host states, but in actuality led to more discussion and debate. The primary criticism was GAPP's voluntary, nonbinding nature. However, this Comment has illustrated how the nonbinding nature of GAPP is actually a strength. First, for the same reasons domestic responses are not appropriate for regulating SWFs, a binding version of GAPP would also punish SWFs, after they put on a purely financial display during the crisis. Second, there are some advantages to a soft law response, namely, its ability to preserve sovereignty, to respond to uncertainty, and to accommodate divergent preferences. Ultimately, the SWF debate will continue to be shaped largely by the ebb and flow of international finance. What is important for SWF observers is to capture the critical developments—here, the financial crisis and GAPP—analyze them, and draw conclusions based on empirical observations, rather than on purely visceral fears.