"Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?"

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Chairman Schumer, Vice-Chair Maloney, Ranking Member Saxton and Members of the Committee, good afternoon. Thank you very much for holding this important and timely hearing.

During the Clinton Administration I was fortunate to hold several positions that brought me into frequent contact with issues of inward investment into the United States: I was the US Ambassador to the European Union, Under Secretary of Commerce for International Trade, Under Secretary of State for Economic, Business and Agricultural Affairs, and then Deputy Secretary of the Treasury. Since my government service I have been the chair of the International Practice Group at Covington and Burling, LLP where I have engaged in this issue from the private sector.

I am honored to participate in the Committee's discussions and hope that my experience and contributions will be helpful to the Committee's deliberations.

The question posed in the title the Committee has given this hearing, whether Sovereign Wealth Funds (SWFs) strengthen or imperil the US economy, is the critical question in the SWF debate. Permit me to say at the outset that the challenges provided by the some $3 trillion in SWFs , from China and Russia to the Gulf States and Saudi Arabia, are as much a reflection of our own economic problems as they are about SWFs

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themselves. Their remarkable growth and decisions to broaden their portfolio beyond the investments of their central banks in Treasury bills, is a reflection of our growing dependence on expensive foreign oil and our massive current account deficit. This Committee and the Congress, and all of us, should be spending as much time and energy on dealing with these structural economic problems as on the consequences of those problems. In effect, SWFs are recycling U.S. petro-dollars and our appetite for products from China and Emerging Markets.

In addition, I am a strong believer in the importance of the free flow of capital around the world, and of the value of foreign direct investment (FDI) in creating jobs in the United States, and adding creativity and innovation to our economy. There is a difference, for sure, between private foreign investment and that of SWFs and their close cousins, State Owned Enterprises (SOEs). But even there, the distinction is not always as clear as it may seem. Many European companies, for example, have some government ownership through "golden shares". Moreover, many European governments are trying to create "national champions" to better compete in the global marketplace. We need to be very careful that in dealing with SWFs, we do nothing to deter the free flow of international capital.

I strongly believe that SWFs do bolster the US economy, and that on balance they are a significant net plus for the U.S. economy. If we take off the "welcome sign", they will invest their growing wealth elsewhere in the world. At the same time, there are legitimate concerns about SWFs that need to be addressed. These heavily revolve around the need for "transparency" and good governance. This, in my opinion, does not mean that they must divulge their holdings and investments, but rather that they should be transparent in their governance, in their relationships to their governments, in their processes, in their goals, and in determining whether they obtain subsidized government financing on individual deals-- which would create an unfair advantage over U.S. or foreign corporations who must rely on the private credit markets for competing for the same acquisitions. We have a legitimate interest in assuring that SWFs have a purely commercial, not a political or national security, interest in their investments in the U.S.

Beyond transparency, there certainly are a limited number of matters in which national security risks are implicated by SWFs and SOEs acquisition. But in a globalized world economy, in which the U.S. does not have a monopoly on products, it is important that national security not be defined so broadly that it is used as a broad basis to deter foreign investment.

I urge Congress not to seek legislation or to pressure regulators to impose heavy regulations on SWFs at this stage. The reason for this is that Congress has wisely provided the Executive Branch -- in the form of last year's bipartisan Foreign Investment and National Security Act (FINSA) -- the means to deal with genuine national security threats from SWFs and SOEs. In my opinion we already have the legislative tools necessary to effectively address any national security concerns raised by SWF investments, and we should give the CFIUS process the time to work through SWF/SOE investments on a case by case basis.

Moreover, it is critically important that Congress not take unilateral action. It is vital that we try to develop multilateral principles. Europe, for example, has similar concerns with SWFs/SOEs; for instance, Russia's Gazprom has expressed interest in acquiring energy assets in Europe. The Bush Administration has wisely agreed to support this multilateral approach. The IMF is now working directly with all the major SWFs on developing a set of "best practices", which they hope to have completed by April. The OECD is doing the same exercise with host countries, and their report will be ready in roughly the same time frame. Moreover, the Government Accounting Office is examining SWFs and their report will be an important touchstone. We should allow these activities to play out, and, for example, see how the SWFs react to the IMF effort to develop a set of principles focused on transparency.

The Benefits and Concerns of the "New" Sovereign Wealth Funds

The benefits of foreign investment into the US are well known. Such investments support economic growth and job creation; they help keep domestic industry competitive; they grease the wheels of the international economy by helping to right financial imbalances; and, as we have seen since last summer as SWFs began investing heavily in the US financial industry, foreign investments can be ready sources of assistance to distressed sectors, in this case bolstering the US economy while providing a needed vote of confidence in the US financial system at a difficult time.

Moreover, we know that SWFs are not recent innovations The first versions beginning in the 1950s and 60s with states as diverse as Kuwait, Kiribati and Norway establishing national investment vehicles, many of which have long invested in the US. SWFs have a strong record of making long-term investments, with a generally passive involvement in the management of the companies in which they invest.

Most SWF and SOE investments raise no national security risks.

For instance, the acquisition of Barney's, the U.S. retailer, by Dubai, hardly impacts on national security. CFIUS approved the sale of IBM's PC division to Lenovo (which our firm handled), which is partly owned by the Chinese government. Further, SWFs' recent investments in U.S. and European financial institutions have been for small stakes, well under 10%, with no board seats or management voice. It is important to recognize that the control test -- which can trigger CFIUS review -- is not a mechanical test of 10% voting shares. There are a variety of factors to consider, such as whether the SWF/SOE has the right to appoint members of the board of directors; the right to appoint or veto members of management; the right to approve the corporate budget; the right to approve of new investments and divestitures. Generally, SWFs/SOEs have not insisted on this level of control.

Even if a SWF or SOE transaction presents some risk to national security, CFIUS has proven well-equipped to analyze the risk and negotiate appropriate measures to

mitigate that risk. If, for some reason, CFIUS determines that the risk cannot be satisfactorily mitigated, the President has the power to block the transaction.

There are some different factors at work in the recent emergence of SWFs. The amount of money under SWF management is greater than it has ever been. Fueled in some cases by high commodity prices (as is the case for the Persian Gulf, Russian and Norwegian funds) and in others by trade surpluses "unequalled as a percentage of the global economy since the beginning of the 20th century" (as for East Asian SWFs) SWFs are thought to control as much as $3 trillion in assets -- greater than the global stock of assets invested in either hedge funds or private equity. Even so, SWFs account for no more than 1.3 percent of the world's financial assets.

And, the number of SWFs are increasing, with some new entries representing perhaps the biggest challenges for US regulatory review. There are now more than 40 major SWFs, with as many as a dozen established since 2005. Given the size and number of the new players in the SWF world, some measure of anxiety was expected and prudent.

The timing of the emergence of SWFs also sharpened fears. The 2008 presidential campaign has begun, memories of two highly-politicized bids by foreign government owned companies for key US assets were still raw (CNOOC's bid for Unocal was in 2005, the Dubai Ports World controversy erupted in 2006), and news of SWFs came just as Congress was completing its legislative overhaul of the US investment screening mechanism -- the Committee on Foreign Investment in the United States (CFIUS) codified in FINSA -- a task that was precipitated by the CNOOC/Dubai Ports World events but took on new urgency once SWFs appeared.

Governance and Transparency – The Critical SWF Reforms

If there has been an underlying theme for most of the concerns verbalized about SWFs it the assertion that these funds, as a whole, are nontransparent, and consequently policymakers cannot be sure what drives the funds' investments, divestments, and other behaviors. It is asserted that that SWFs may be political or intelligence-gathering tools out to harm the United States, rather than profit maximizers. And, it is disquiet emanating from this alleged feature of SWFs that has led many of those otherwise positively disposed towards free capital movements -- including Treasury Department officials, capital markets regulators, and some in the think tank community -- to question whether some regulation is needed. Senior government officials from Robert Kimmitt and Clay Lowery at Treasury to Chris Cox, the Chairman of the SEC, to experts like Ted Truman at the Peterson Institute, have raised a number of legitimate concerns:

-- whether the governments subsidize individual transactions;
-- the potential for imprudent investments to increase risks for market stability;;
-- whether they have a political agenda, such as Gazprom has exhibited in Ukraine, Georgia and elsewhere;
--whether there is a risk of insider trading;

--whether there is a risk for corruption, if government officials are directly involved from countries with a record of corrupt activities.;
--whether there is a risk of leakage of sensitive technology to countries which are not allies of the U.S.

Tellingly, SWFs have followed these debates and concerns and appear to have made recent investments with political sensitivities in mind. As I mentioned, the recent SWF investments in the financial sector have explicitly and invariably been non-controlling minority investments, have not included any board seats for the SWFs or powers to control management, budgets, or new acquisitions or divestitures, and have generally been below 10% voting shares.

Further, some SWFs have already responded to calls for greater openness.

I hope that SWFs will take steps to be more transparent. Even in the short run, increasing transparency produces benefits not just for the host states, but for the SWFs themselves. Real transparency promises to ease the acceptance of SWF investments as host states come to understand SWFs' investment strategies and management structures, and can be assured that commercial rather than political interests control investments, and that SWFs do not receive unfair subsidies that may make competitive bidding with private entities difficult. Finally, SWFs will very likely come to understand that adopting some measures of transparency and other robust regulation for themselves is the best way to avoid more heavy-handed regulation from both the US and other investment recipients.

Across the Atlantic, Joaquin Almunia, the EU Commissioner for Economic and Monetary Affairs, has explicitly suggested such a *quid pro quo*, stating that there were "good reasons" to ask funds about their investment strategies and holdings, and if they do not provide such information "we can find good reasons to 'react' in some cases, where these funds try to invest…in strategic sector[s] or…specific industries."

Unilateral Rules May Harm the U.S.

My contention that SWF-specific legislation is not needed at this juncture comes not just from my hope that over time many SWFs will become more transparent of their own accord. Rather the imposition of unilateral rules on US investment for SWFs may harm the competitive position of our economy. After all the United States is only one of many markets in which SWFs can choose to invest. As former Secretary of State Colin Powell noted, "capital is a coward," and unilateral rules in the US that are not matched by similar regulations in other potential host states may adversely impact our ability to attract FDI and consequently may diminish our competitiveness. It is worth remembering that the majority of SWF money that has been invested into the US is actually recycled US dollars resulting from our oil dependence (for the Middle Eastern funds) and mass current account deficit (for the East Asian funds). It seems far better to have this money recycled here, than to be moved elsewhere.

The Way Ahead – Multilateral Discussions and the "New" CFIUS

The necessity for a global solution that evens the playing field between potential recipients of investments provides one of the guideposts to the most effective future direction for US policy on the SWF issue. Fortunately such a multilateral approach is underway. Last fall, the Treasury Department, along with finance ministries from the rest of G8 and those of several states owning leading SWFs asked the International Monetary Fund and the Organization for Economic Cooperation and Development to begin working on best practices.

The IMF process, which is focused on best practices for the SWFs themselves, is due to issue its recommendations in April. Though the IMF will likely touch on several aspects of reform, it seems evident that a central focus of the guidelines will be on enhancing SWF transparency in order to increase the number of SWFs that publish annual accounts and provide outsiders some insight into governance and investment strategies. In a hopeful sign, some SWFs are closely assisting the IMF efforts.

Working alongside the IMF, the OECD's Investment Committee has begun working on best practices for host countries, and in particular the processes of host country review of SWF investments. The OECD report is due in March. The OECD's primary concern is that some recipient states may overreact to SWFs and erect needless procedural barriers to SWF investments which may chill wider FDI flows. Though still being drafted, the OECD rules will likely borrow from best practices in some of its members, including the US CFIUS process.

The CFIUS process, newly vested with enhanced transparency and predictability, provides the other guidepost for effective domestic response to SWFs. Though as this Committee knows the CFIUS regulations are due to be released in April, even before the rules are finalized it is clear that FINSA's improvements on CFIUS are significant and important. Its enhancements include a greater clarity for foreign investors, a result of new transparency regarding the factors CFIUS considers in moving a transaction from a 30-day review to a 45-day investigations, alongside the requirements that CFIUS issue public guidance on the types of transactions that have been reviewed and that have raised national security concerns. Moreover, the law's provision for a "lead agency or agencies" for the government entity with greatest equities in a transaction promises to instill discipline in CFIUS and lead to more routinized review processes. Finally, the law requires the involvement of senior-level officials in major CFIUS actions including with respect to certifications provided to Congress and decisions not to investigate transactions involving foreign government ownership.

We should rely on the wisdom of FINSA and take solace from the CFIUS process and its recent ability to quickly clear transactions – such as the sale of IBM's personal computer business to Lenovo. That the review processes were transparent and efficient, simultaneously promoting both open investment and national security, suggests that the current tools -- set to be improved further after the release of the CFIUS regulations -- can effectively address SWF investments.

I counsel Congress to withhold judgment on the necessity for further legislation until both the CFIUS regulations are published and can be assessed in practice, and the IMF and OECD have delivered their reports.

History, Transparency and Nuance – The Key to Effective Regulation of SWFs

If the past is prologue, history does not suggest that most SWFs will engage in politically-motivated investments. SWFs have been long-term, stable and passive investors. Though they may be less risk averse than central banks solely investing in T-Bills, most SWFs are run with profit in mind. Quickly unwinding positions, or investing for political as opposed to financial gain, could be as damaging to SWFs (if not more so) as to host countries. Most SWFs have been mandated to secure healthy returns and many have received political and public rebuke at home for unsuccessful investments. Further, SWFs are aware of the growing political sensitivities regarding their investments and most would be loathe to upset host governments for fear of wearing out their welcome.

Even if history and the structure of SWFs suggest that we have little to fear, the current approach adopted by the Bush Administration should be lauded. Unilateral, protectionist regulations have not been contemplated, neither has the Administration raised the potential for imposing reciprocity as a test for SWF investments. In some quarters this has been a commonly suggested response to the SWF influx and asks the reasonable question why the United States should allow unfettered access to its assets to state-backed SWFs when those states to not allow commensurate access to their assets. A successor of mine as Deputy Treasury Secretary, Robert Kimmitt, made the Administration's rejection of reciprocity clear in his recent *Foreign Affairs* piece: raising reciprocity as a barrier to SWFs "is not on the list" of policy proposals. He argues correctly that the benefits the United States receives from foreign investment are irrespective of whether or not other countries provide US investors similar rights.

Indeed, instead of unilateral restrictions, constructive deliberation on a multilateral basis is critical so as to ease *bona fide* concerns regarding investors' intentions and fund transparency, while ensuring that host states remain open to receiving the benefits SWF investments can bring – benefits that include both domestic financial stability in distressed sectors and wider global stability as the world's major economies become ever more interdependent.

To that end, transparency coupled with nuance are key. Clearly there should be some limits to SWF acquisitions. However, these prohibitions should be clear, narrowly focused and few and far between. Broad prohibitions are not needed, and with nuanced review that takes into account the transparency of a particular investor and the magnitude of specific investments (differentiating between controlling and passive stakes), there is little reason that our aim of protecting national security cannot be consistent with opening up the vast majority of the American economy to SWF funds. Relying on the CFIUS process makes *per se* rules even less needed, given that appropriate protections can be negotiated on a case-by-case basis, ranging from insisting that investors establish an

arm's length proxy relationship to handle sensitive investments, to striking nuanced mitigation agreements of the kind the Government has forged with scores of foreign investors.

It is my view that a chorus of support for moderated, thoughtful reaction to SWFs must be developed now, before SWFs become a political third-rail and the United States loses out in attracting both needed funds and in retaining the mantle of the world's most dynamic economy.

Thank you. I will gladly respond to any questions.

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