The Regulatory Framework for Sovereign Investments

Testimony
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Chairman Dodd, Senator Shelby, and Members of the Committee:

Thank you for inviting me to speak before today's hearing on the regulatory framework applicable to foreign government investment in the U.S. economy and financial sector.

I should state at the outset that, as Chairman Cox, Secretary Paulson, and others have noted on many occasions, the United States welcomes foreign investment. I know that is a view widely shared and supported by members of this Committee as well. You have asked me to speak to the particular issues that arise not from foreign investment, but from foreign government investment in the United States, from the standpoint of the Securities and Exchange Commission. There are some important differences between the two.

A bit of history to begin. As others have noted, government ownership of investment funds and businesses is not new, but the scale on which today's sovereign wealth funds and sovereign businesses are operating is new – as is their remarkable growth over the past few years. Today, sovereign wealth funds hold, by some estimates, more than $2.5 trillion in assets. That is more than all the world's hedge funds combined. And sovereign business is challenging in size even the very largest privately owned companies: witness PetroChina's for a time eclipsing ExxonMobil as the world's largest company by market value. It is typical of today's publicly held state-owned enterprises in that PetroChina has offered just 12% of its shares to the public, according to regulatory filings.

There are important differences between sovereign businesses and sovereign wealth funds, as well. Unlike the case of sovereign wealth funds, whose portfolio investment may be purely passive, a sovereign business is controlled by the government whose assets comprise a majority of its ownership. Any analysis of foreign government investment in the U.S. economy and financial sector, therefore, should include consideration not only of sovereign wealth funds, but also of the equally significant and potentially even more thorny issues surrounding sovereign businesses, whose minority interests are owned in part by U.S. investors, because both trends are manifestations of a serious blurring of the distinction between the role of the market and the role of the state.

What should be of even greater interest than the current status of these forms of state ownership is the projected growth of sovereign ownership in global public markets. One investment bank has forecasted, for example, that sovereign wealth funds will increase five-fold by the middle of the next decade. That could make these funds, collectively and perhaps individually, the largest shareholders in many of the world's biggest companies that are today privately owned. At the same time, because of the growth in sovereign business, many more of the world's biggest public companies could be directly controlled by governments.

The reasons behind the rapid growth of state-controlled investment funds and state controlled businesses are still being debated among academics and policymakers. The superficial reasons are clear enough: rapid economic growth in some developing markets, large trade surpluses with the United States, and rising oil prices have generated U.S. dollar surpluses in East Asia, the Middle East, Norway, and Russia. But the fact of rapid economic growth and the influx of dollars alone does not ameliorate potential concerns regarding the fact that governments, rather than private market actors, have the power to control the investing of this newfound wealth and may not have the same, market-sensitive set of incentives that characterize the private sector.

To note, over the past few decades, many of the command economies of the past have embraced market-based economics, at least in some areas. Greater international trade that has resulted from this liberalization could have been expected to give rise to greater wealth in private hands, and a proliferation of market participants. But instead, in many cases, a chief effect of broader trade has been growth in government-held foreign exchange reserves. Sovereign wealth funds have emerged as a way for governments, rather than individuals and privately owned firms, to invest the foreign exchange that has been generated by expanded trade. The growth in sovereign business may also be attributed, at least in part, to the effects of liberalization in nations which had a very circumscribed private sector in the past. These nations are embracing part of the free enterprise model – securities exchanges and public capital raising – while hanging on to state control.

Sovereign wealth funds consisting of foreign exchange reserves have always tended to invest abroad, since their capital was based on a foreign currency. What is new, in addition to the increase in the amount of their capital, is their emphasis on investing in companies around the world, rather than just investing in foreign government bonds. In this sense, they are now competing with other diversified investment vehicles, including mutual funds, pension funds, and hedge funds in the United States.

Sovereign wealth fund investment in the U.S. capital market – like cross-border investment generally – potentially offers benefits. Through their competition for investments in the United States, sovereign wealth funds can help offer U.S. companies a lower cost of capital and a more liquid market for their securities than might otherwise be available. But those same benefits would likely accrue to U.S. companies and markets if the foreign investment were privately directed, rather than government directed. And so it is necessary to inquire into the special consequences that ensue when it is not just a foreign individual or entity but a foreign sovereign doing the investing – or in the case of sovereign business, a foreign sovereign which is outright owning and controlling companies in the public markets.

A sovereign investor or controlling person behind a business raises a number of potential concerns for regulators and other market participants. Because the fund manager or business owner is a government, it may have different and more complex incentives than those that normally drive private sector marketplace participants to make decisions. Sovereign wealth funds, and sovereign businesses, may therefore have a distorting effect on market. If government-controlled companies and investment funds increasingly direct the investment of business and capital, what will be the effect on the pricing of assets and the allocation of resources?

The SEC's mandate is focused on investor protection, maintaining fair and orderly markets, and promoting capital formation. Accordingly, the SEC has in place several rules that require disclosure of certain sovereign wealth fund activities and sovereign business activities that could raise many of the concerns we hear in our own and other markets. None of these disclosure requirements was designed with sovereign wealth funds or sovereign businesses in mind, but they are nonetheless of value in this context to the extent that many of the concerns that sovereign investing raises are similar to concerns about other types of investment.

For example, the SEC requires through Form 3 under Section 16(a) of the Securities Exchange Act ("Exchange Act") that an issuer's officers and directors, as well as any beneficial owner holding 10% or more of an issuer's equity securities, disclose their ownership interest. If one of these persons or entities buys or sells securities in the issuer, this change in ownership interest must be disclosed through a Form 4 filing within two business days.

Among other things, this disclosure requirement is designed to provide the market with information about the purchase and sale of issuer securities by individuals and entities who may be in a privileged position with regard to important information about the company. This could include both sovereign wealth funds and governments or government officials who own securities in a public company. Trading on the basis of material non-public information, of course, is prohibited by the Commission's Rule 10b-5 under Section 10(b) of the Exchange Act. Nonetheless, Forms 3 and 4 strengthen the integrity of our markets by providing information about the investments of insiders and large shareholders – including sovereign wealth funds – in the companies they run or may have control over.

Likewise, the SEC requires beneficial owners of more than 5% of an issuer's equity securities to file Form 13D under Section 13(d) of the Exchange Act. This disclosure must be made within 10 days of the purchase and is designed, among other things, to disclose possible takeover attempts of an issuer. Form 13D also requires the beneficial owner of the securities to disclose the source and amount of funds being used to purchase the shares, and announce whether the purpose of the purchase is to acquire control as well as any plans or proposals with regard to future actions by the purchaser.

In some cases, investors who do not intend to control or influence control of the issuer may file Form 13G instead. This disclosure is often used by institutional investors such as mutual funds and state pension funds, but is also available to sovereign wealth funds that are passive, albeit sizable, investors in a public company.

Finally, the SEC requires institutional investment managers who exercise investment discretion over $100 million or more of U.S. exchange-traded equity securities to file a Form

13F. The form requires a manager to disclose the name of each reportable issuer in the manager's portfolio as of the end of each calendar quarter, as well as the number of shares and the market value. It also provides some information about the manager's voting authority. Entities that may not be registered with the SEC – such as managers of pension funds, endowments, and domestic and offshore hedge funds – often are required to file Form 13F. The same reporting standard applies to sovereign wealth funds.

These and other examples make the point that SEC rules that apply to investors in the U.S. capital market also apply to sovereign wealth funds and sovereign businesses. That said, laws and regulations can be rendered meaningless without an effective enforcement mechanism. One of the significant concerns about sovereign wealth funds and sovereign businesses is not that they are foreign, but that their managers are sovereign. While request for cross-border enforcement assistance might be readily honored by a foreign government with respect to private actors in the market, help may not be as forthcoming if the subject of the request is the government itself.

Governments that control sovereign wealth funds and sovereign businesses, because they are governments, can in some cases control certain economic events, and they may have information advantages over private market participants. Governments routinely are privy to certain types of information that most private investors are not. What if the fund obtains information through its status as a government entity?

In addition to questions of market efficiency, transparency, enforcement, and information disparity, sovereign businesses and sovereign wealth funds raise other issues as well. One is the increased opportunity for political corruption. When individuals with government power also possess enormous commercial power and exercise control over large amounts of investable assets, the risk of misuse of those assets, and of their conversion for personal gain, rises markedly.

The SEC is not without tools, however, when it comes to enforcement. If the SEC were to pursue wrongdoing by a sovereign wealth fund or a sovereign business, and the jurisdiction in which it is based did not cooperate in our investigation, our Commission's response would be firm. And even in the face of a lack of cooperation from the country in which the foreign actor is based, we know from experience that market manipulation, insider trading, and other illegal activities that take place in the American market often leave sufficient evidence that the SEC can proceed with an enforcement action against the offender.

Nor does the fact that a fund or a business is owned by a foreign government shield it from liability under U.S. federal securities laws. It is a well-established principle of American jurisprudence and international law that sovereign immunity does not extend to a state's commercial activities in another jurisdiction. And while SEC enforcement cases involving a foreign person or entity are, all things being equal, somewhat more complicated than those with no cross-border nexus, SEC staff have a strong track record investigating such cases and working closely with our foreign counterparts in collecting evidence abroad.

Just this past year, the SEC sent more than 550 requests for assistance to foreign regulators, and we received more than 450 in return. The SEC expects this number to grow, as cross-border securities activity grows, and as it becomes easier for investors to move assets across borders. To cite just one example, this past year, approximately 34% of the insider trading cases brought by the SEC's Division of Enforcement involved the SEC's Office of International Affairs seeking assistance from the SEC's foreign counterparts.

Furthermore, the ability to provide this type of cross-border regulator-to-regulator cooperation in enforcement investigations is now an international expectation. In 2002, in the wake of the attack of September 11, the International Organization of Securities Commissions created the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, which is a multilateral arrangement through which the MOU's signatories agree to share enforcement-related information. Today, this arrangement has 47 signatories, with another 15 publicly committed to obtaining the legislation they need to provide this information to others. Furthermore, in 2005, IOSCO's membership agreed that by 2010 the ability to sign on to this MOU would become a criterion for continued membership in the organization. Most of the governments that have sovereign wealth funds that invest in the United States are members of IOSCO, and many have already signed on to the MOU.

Shared international support for fair and transparent markets is also driving cooperation on the development of best practices for sovereign wealth funds. The International Monetary Fund currently is developing a set of voluntary best practices for sovereign wealth funds. And the European Commission has proposed a common EU approach for a code of conduct for sovereign wealth funds. Although discussions are ongoing, it is contemplated that sovereign wealth funds would disclose such things as:

- The investment positions and asset allocations, particularly where they have majority ownership;
- The exercise of ownership rights;
- The use of leverage;
- The size and source of their resources; and
- A disclosure of their home country's regulation and oversight that governs the sovereign wealth fund.

These international developments are encouraging. The United States is already ahead of the curve on this subject – in our country, these disclosures are already mandatory for any sovereign wealth funds of significant size.

Finally, if we were to prohibit sovereign wealth funds from investing in our market for fear they might introduce market distortions, there is a risk we might actually end up doing precisely this ourselves through the prohibition. A better approach might be to address the underlying issues of transparency, independent regulation, de-politicizing of investment decisions, and conflicts of interest.

I hope this brief overview of the issues surrounding foreign government investment in the U.S. economy and financial sector from the perspective of the Securities and Exchange Commission is helpful to you. I will be happy to answer your questions.