What Banks Need To Know About the Coming Debate Over CFIUS, Foreign Direct Investment, and Sovereign Wealth Funds

THOMAS E. CROCKER

The author reviews recent developments relating to Foreign Direct Investment and Sovereign Wealth Funds of interest to U.S. banks.

Exactly two years after the Dubai Ports World controversy exploded into public view, today a new confluence of forces is coming together to place foreign direct investment issues back on Page One. These developments include the sudden growth of sovereign wealth funds ("SWFs"); the weakening U.S. dollar; the surge in foreign investment in the United States; recent changes in the law governing review of foreign direct investments in the United States; Congress's continued assertion of at least implicit political veto power over private sector investment decisions despite the new law; and, more broadly, the prospect of a looming debate on these issues in this presidential election year.

What really underlies this complex mosaic and what does it mean for the United States?

Thomas E. Crocker is co-chair of the International Trade & Regulatory Group at Alston & Bird LLP. He represented DP World (popularly but inaccurately known as "Dubai Ports World," which term is nonetheless used in this article) in its CFIUS and legislative dealings in connection with its acquisition of the U.S. port operations of P&O Steam Navigation Company Limited. Mr. Crocker can be reached at thomas.crocker@alston.com.

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

First, a word of background about the investment review process in the United States. In 1988 Congress enacted the Exon-Florio Amendment to the Defense Production Act of 1950 in reaction to concerns about the sharp rise in the 1980s of foreign — mainly Japanese — investment in the United States. The amendment, named after its original sponsors, Senator James Exon (D-NE) and Representative James Florio (D-NJ), authorizes the president to suspend or prohibit an acquisition, merger or takeover of a "U.S. person" by a "foreign person" that threatens to impair the "national security" of the United States. Neither the Exon-Florio Amendment nor its implementing regulations define "national security."

The Committee on Foreign Investment in the United States ("CFIUS") is the interagency committee chaired by the Department of the Treasury that reviews foreign acquisitions under the Exon-Florio Amendment. CFIUS is exclusively an Executive Branch committee and includes members from eight departments, including State, Homeland Security, Defense and Commerce, as well as representatives of other agencies appointed by the president. Normally acquisitions are notified to CFIUS on a voluntary basis by the transactional parties. CFIUS conducts its reviews on a strictly confidential basis to avoid politicizing its decisions or discouraging foreign investment. CFIUS has traditionally prided itself on maintaining an objective, apolitical review process.

CFIUS's practice of implementing the Exon-Florio Amendment has in the past focused on relatively narrow concepts of "national security" while maintaining the longstanding U.S. policy of encouraging foreign investment. Reviews by CFIUS traditionally dealt with defense contractors or sole sources of supply in critical industries, such as semiconductors or aircraft manufacturing. Since September 11, 2001, however, there has been a tendency to construe "national security" more broadly. Nonetheless, CFIUS reviews only a small percentage of foreign investments. For example, in 2006 there were approximately 10,000 mergers and acquisitions in the U.S., of which some 1,730 were cross-border. Only 113 — or 6.5 percent — came before CFIUS. None was blocked by CFIUS.

The Exon-Florio Amendment is an unusual statute in that it gives the president broad authority to block or even unwind a private sector transac-

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

tion. The president's decision is not subject to review by courts, and no action by Congress is required. However, as demonstrated by the Dubai Ports World case in 2006, Congress was able to annul a final and legally binding decision by CFIUS.

DUBAI PORTS WORLD

The Dubai Ports World case was a critical inflection point in both the policy and process for reviewing foreign direct investment in the United States. When Dubai Ports World filed its notification with CFIUS in late 2005 to acquire the U.S. port assets of the Peninsular and Oriental Steam Navigation Company Limited as a minor part of a global acquisition of P&O, it literally parachuted into a political storm. For some months previously, Congress had been jostling with the Executive Branch over the proper role for the two branches of government in reviewing foreign direct investments. Congress was taking an increasingly assertive approach to the Executive Branch's handling of CFIUS reviews. Issues included CFIUS's purported failure to respond to Congressional inquiries concerning the review process, which heightened Congress's distrust of the adequacy of the process; CFIUS's reluctance to brief Congress on particular transactions because of confidentiality concerns; and a perception by some in Congress that the White House exercised a "hands off" approach toward security reviews, which further contributed to Congressional concern that the process failed to weigh legitimate security concerns. Even before the Dubai Ports World matter, these criticisms had resulted in several reports by the Government Accountability Office ("GAO"), as well as in preliminary Congressional hearings to lay the groundwork for legislation to reform the CFIUS process.

In addition to this institutional jockeying with politicized overtones, the Dubai Ports World case offered up a ready-made argument for Congressional Democrats that the Bush Administration was lax on national security. Fueled by a high octane mix of massive media coverage and Democratic outrage, the Congressional Republicans found themselves outflanked and, with the exception of a handful of senior Senators, joined in the melee to demand an unwinding of the legally approved and consummated transaction. The

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

Dubai Ports World controversy is perhaps best summarized by the comments of a very senior and respected Democratic Congressman, who, after listening patiently and attentively to Dubai Ports World's arguments in favor of allowing the acquisition to proceed, stated "You may have the facts on your side, but it just doesn't matter. This transaction is not acceptable to the 'biscuit and gravy' crowd."

In the two years since those words were uttered, a lot has happened on the macro level which would give the "biscuit and gravy" crowd cause for concern.

THE BRAVE NEW WORLD

Parag Khanna's provocative article "Waving Goodbye to Hegemony," which appeared in the January 27, 2008 issue of *The New York Times Magazine*, paints a sweeping picture of the giant — but little understood — shifts in global economic and political power that have occurred in the last few years. Khanna's thesis is that the post-Cold War "peace dividend" was never converted into a global order under American leadership and that now, rather than bestriding the globe, "we are competing — and losing — in a geopolitical marketplace alongside the world's other superpowers: the European Union and China." In addition to the "Big Three" of the U.S., EU and China, there is, in Khanna's view, a range of "Second World" countries which are the swing states that will determine which of the superpowers has the upper hand for the next generation of geopolitics. These countries do not rank in the First World tier of the global economy or in its Third World periphery. They include such countries as Russia, Turkey, India, South Africa, Brazil, the former Soviet "Stans," Saudi Arabia, Iran and Malaysia, among others. In Khanna's view, these Second World countries are essentially up for grabs. The United States can no longer boast that "They are with us" or "He's our SOB." Most of them tell the U.S. they are its friend while "busily courting all sides."

Lest there be any question of the economic clout of these players, if China is included they hold a majority of the world's foreign exchange reserves and savings, and their spending power makes them the global economy's most important new consumer markets and thus engines of global eco-

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

nomic growth. IPOs from Brazil, Russia, India and China accounted for 39 percent of the volume raised globally in 2007, just one indicator of the Second World countries' rising importance in corporate finance. As Khanna observes, they do not replace the United States but are not dependent on it either — the so-called "decoupling" theory. Perhaps most tellingly, Khanna states that "When Tata of India is vying to buy Jaguar, you know the landscape of power has changed."

What is significant about this global shift is that foreign direct investment in the United States by China and precisely this band of Second World countries is rapidly increasing and potentially freighted with political and national security concerns.

Concomitant with these global shifts and interacting with them has been the weakening U.S. dollar, which makes the U.S. a bargain basement for investments by these countries (at the same time, the dollar is under assault as the international currency of choice for transactions as Iran and other Middle Eastern oil exporters move to denominate their transactions in Euros). The year 2006 saw capital inflows into the U.S. of over $183 billion and the overall value of foreign direct investment in the United States exceeding $2 trillion. Of course, foreign direct investment is neither new nor necessarily detrimental. For example, Dutch capital helped finance U.S. growth as early as the administration of George Washington, and Scottish trusts were crucial in financing the 19th century U.S. railroad boom. U.S. affiliates of foreign companies spend more than $350 billion annually on salaries and pay an average salary that is more than 30 percent higher than the average paid by U.S. companies. Over 30 percent of these jobs are in manufacturing, compared with less than 10 percent of all U.S. jobs. Foreign firms also reinvested $71 billion, or 52 percent of their income, into the U.S. in 2006. Foreign companies spent over $31 billion on research and development in the United States in 2005 — approximately 13 percent of all U.S. R&D outlays.

However, beginning with Dubai Ports World and accelerating with the recent spate of high visibility bailouts of marquee U.S. financial institutions (for example, in January, the governments of Singapore, Kuwait and South Korea provided much of a $21 billion lifeline to Citigroup and Merrill Lynch, with more to come), political questions have begun to gnaw at the fabric of the foreign investment process. Notwithstanding the

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

Administration's support for foreign investment (reaffirmed in a January 23 Executive Order) and the well-documented benefits that such investment brings, a 2006 poll by the Pew Research Center for the People and the Press found that 53 percent of Americans believe foreign ownership of U.S. companies is "bad for America." These trends and attitudes provide a potentially volatile mix which could make foreign direct investment a political issue in this presidential election year.

THE CHALLENGE OF SOVEREIGN WEALTH FUNDS

The spark that may ignite that flame is the seemingly rapid emergence of sovereign wealth funds ("SWFs"). According to Deputy Secretary of the Treasury Robert M. Kimmitt, there is no universally accepted definition of a SWF. However, at its most basic, in Treasury's view a SWF is a government investment vehicle funded by foreign exchange assets and which manages those assets separately from official reserves. It is distinct from other types of sovereign investments, such as international reserves (official foreign reserves that are controlled by finance ministries and central banks for financing international payment imbalances and short-term liquidity), public pension funds and state-owned enterprises. In fact, SWFs are neither new nor particularly novel. The Kuwait Investment Authority and its predecessors, for example, have existed since 1953. However, what is eye opening is the rapid increase in the number and asset size of SWFs in recent years. Globally the number of funds has doubled since 2000 (from 20 to almost 40 now), with over 10 established since 2005. SWFs currently manage total assets of approximately $1.9 to $2.9 trillion. Estimates suggest that that figure could grow to between $10 to $15 trillion by 2015. This figure is comparable to U.S. Gross Domestic Product, which currently stands at around $12 trillion. By some estimates, they currently are bigger than hedge funds and private equity funds combined but are far less than the $165 trillion in global traded securities.

According to a January 28 Congressional Research Service ("CRS") report, the following countries operate SWFs: United Arab Emirates, Norway, Singapore, Kuwait, Russia, China, Qatar, Australia, Algeria, the United States (Alaska), Burnei, South Korea, Kazakhstan, Malaysia,

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

Venezuela, Canada, Chile, New Zealand and Iran. Others, such as Libya and Nigeria, reportedly are in the process of establishing funds.

In the case of China, this growth has been fueled by that country's export earnings and in the case of Middle Eastern and certain other Second World countries by the rising price of oil. The fact that the China Investment Corporation, established last year with $200 billion at its disposal, put $3 billion into the U.S. private equity company Blackstone and the China Construction Bank invested $1 billion in Bear Stearns attracted attention.

The U.S. Treasury Department has sensibly analyzed SWFs in terms of their impact on financial stability and concluded that there is "much reason to be reassured." SWFs are in principle are long-term investors, are not highly leveraged and act as a force for financial stability. However, Treasury acknowledges that SWFs also raise a number of issues, including whether they perpetuate undesirable macroeconomic and financial policies; whether they represent "large, concentrated and often opaque positions" in financial markets; and whether they might give rise to legitimate national security concerns because of their control by foreign governments. Stated more succinctly by the CRS report, U.S. policy makers have two broad policy concerns about SWFs: (1) their lack of transparency and (2) their possible misuse for political goals. The CRS report ranked the existing SWFs by their transparency and investment approach. Not surprisingly, it ranked the large Chinese and Middle Eastern SWFs low on transparency and high on strategic, non-commercial investment approaches.

Given the attention that SWFs have begun to receive, it is perhaps inevitable that without careful political management a backlash could develop. German Chancellor Angela Merkel has already called for EU-wide investment screening to address "new elements" which distinguish SWFs from private funds. French President Nicolas Sarkozy has called for reciprocal openness to investments by EU countries. However, the potential for reaction is perhaps greatest in the United States, with its appetite for large capital infusions, anxieties about globalization and volatile mix of media and politics. Although CFIUS has not blocked any SWF investments so far, Congressional interest has begun to stir. At a February 13 hearing by the Joint Economic Committee, Senator Charles Schumer (D-NY), who played a prominent role in the Dubai Ports World matter, criticized the lack of

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

transparency of SWFs, ascribed their rise to economic "failures" by the Bush Administration and hinted at legislation to regulate them. At a minimum, further Congressional hearings are likely, and the leaders of the Senate Finance Committee recenty asked the Joint Committee on Taxation to evaluate current tax rules applicable to SWFs. Moreover, at the state level legislation has been introduced in California which would prohibit state employee pension funds from investing in private equity firms owned in whole or in part by SWFs.

INTERNATIONAL STANDARD SETTING

In an effort to head off a counterproductive reaction to SWFs, the U.S. Treasury last October tasked the Group of Seven (the U.S., U.K., Japan, Canada, Germany, France, and Italy) and leaders of eight SWF nations to put together voluntary codes of "best practices." In response, the International Monetary Fund is currently working on a code for SWFs, and the Organization for Economic Cooperation and Development is writing a code for recipients of SWF investments. The two institutions are expected to produce a preliminary set of guidelines in April. However, the codes are not likely to address directly the largest political issue surrounding the funds, namely whether they can be used for strategic, rather than commercial, purposes. Instead, the IMF is focusing on guidelines to help SWFs operate more professionally, like private investments funds. For example, there would be rules on establishing investment strategies and ensuring that decisions conform to those strategies. Other guidelines might look at the structure of SWFs, including oversight boards and committees to manage purchases and standards for disclosure of financial information. These voluntary guidelines fall short of regulating SWFs, and it is unlikely the IMF could impose tougher measures such as upper limits on SWF investments.

THE FINSA FIX

Against this background of Congressional/Executive Branch powers maneuvering, the Dubai Ports World controversy, global economic shifts and

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

the rise of SWFs, last July President Bush signed into law the Foreign Investment and National Security Act of 2007 ("FINSA"), which requires added scrutiny and higher level clearance for transactions which involve foreign government control. Treasury hailed FINSA as "well balanced," and most industry observers would agree. Indeed, many of the changes made by FINSA had already been implemented and put into practice by CFIUS in the immediate wake of the Dubai Ports World controversy. FINSA is perhaps more remarkable for what it does not include than what it does. Specifically, it does not include a requirement that CFIUS breach confidentiality by notifying Congress of pending transactions, it does not incorporate "economic security" criteria, it does not authorize Congress to force an investigation or override presidential approval of particular transactions, it does not require notification of CFIUS reviews to state governors and it does not remove the Department of the Treasury from the chairmanship of CFIUS — all proposals that Congress had under consideration. Of these, the most important is that FINSA maintains CFIUS confidentiality.

However, there should be no illusion that the CFIUS process is as apolitical as it once was. FINSA enhanced Congress's oversight role, and CFIUS now informs Congress about completed reviews. Moreover, FINSA makes clear that "national security" under the Exon-Florio Amendment includes the broad concept of "critical infrastructure" and that that term in turn includes "major energy assets." The expansive definition of "critical infrastructure" — "systems and assets … so vital to the United States that [their] incapacity or destruction … would have a debilitating effect on national security" — could open the range of transactions subject to CFIUS review to virtually anything and could serve as an entry point for Congress to voice concerns about particular transactions. At a minimum, FINSA is likely to solidify the recent wave of defensive CFIUS filings that acquirors have been making.

Of equal importance, the practice developed over the last two years by acquirors of seeking informal blessings from key members of Congress to transactions prior to their notification to CFIUS is likely to continue and accelerate, particularly in the case of investments made by SWFs from China or the Second World. Nowhere has this practice been more apparent than in the recent wave of SWF investments in floundering U.S. financial institutions — almost to the point of instituting an unwritten set of investment cri-

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

teria not found in FINSA or the Exon-Florio Amendment. Thus, passive stakes with no Board memberships or equity investments of less than 10 percent have emerged as the touchstone for the Congressional seal of approval. For example, Senator Schumer, who led the charge against Dubai Ports World, recently dismissed the 2006 ports case as "an anomaly" and has blessed large infusions of cash by SWFs into Citigroup, Bear Stearns and other U.S. financial institutions.

SO WHAT DOES THE FUTURE HOLD?

Proposed regulations implementing FINSA are shortly due to be issued for public comment. These regulations may provide refinement on FINSA's broad definitions as well as on the parameters of passive investments.

Separately, the Department of the Treasury, under point man Kimmitt, deserves high marks for having stepped out smartly to try to establish a constructive framework for the coming debate on SWFs, not only by tasking the IMF and OECD to produce voluntary guidelines but also by engaging in outreach and discussions with SWFs and market participants in order to analyze and better understand the risks and benefits associated with SWFs. Kimmitt has articulated a set of common sense principles for countries receiving SWF investments and for SWFs themselves. For recipient countries, these principles include avoiding protectionism; affirming fair and transparent investment frameworks; respecting investor decisions; and treating foreign and domestic investors equally. Importantly, reciprocity on investment is not on this list, despite the fact that many SWF countries are far from open to foreign investment, because it is nonetheless in the U.S. national interest to be open to their investments. For SWFs, the principles include investing commercially rather than politically; implementing institutional integrity through transparency of investment policies and strong risk management systems, governance structures and control; competing fairly with the private sector; promoting international financial stability; and respecting host country regulatory and disclosure rules. In late March, Treasury reached agreement on those principles for SWF investments with Singapore and Abu Dhabi.

As Congress sets about its educational process through hearings and

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

studies, it is to be hoped that the legislative branch will respond in kind to the dispassionate and analytical example set by Treasury. While individual members of Congress will no doubt continue to keep their finger on the pulse of particular cases brought before CFIUS, Congress might well resist the temptation to politicize particular acquisitions as it goes about its legitimate business of fostering a national consensus on foreign investment by SWFs. Because many of the controversial SWFs come from China or Second World countries which do business with U.S.-embargoed countries like Iran and because many of these home countries have endemic problems with corruption or lack of reciprocity in investment policies, consistent dispassionate analysis may be all the more difficult to maintain.

Published in the May 2008 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.