FINANCIAL POINTS OF ENTRY.
SOVEREIGN WEALTH FUNDS: HIDDEN SECURITY THREAT OR SMART FINANCE?

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By

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ABSTRACT

Sovereign Wealth Funds, the investment funds of sovereign governments, gained momentum in recent years. There are questions as to what regulation should be in place regarding these funds at a domestic and international level. The controversy surrounds whether foreign governments could use SWFs as a form of power and effectively undermine U.S. security. This thesis seeks to examine 1) whether countries will use their SWFs as a form of power and if so, how; 2) whether SWFs are, stabilizing or destabilizing factors for the international economy; 3) the extent to which SWF activities are or can be made transparent. Are the U.S. and the international community ready for sovereign states to become major players in the global financial market?
The writing of this thesis is dedicated to my family
who encouraged me along the way.
Many thanks to Dr. Sims who helped me achieve this goal.

Thanks,
Lillian E. Lang
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Introduction

"True individual freedom cannot exist without economic security and independence. People who are hungry and out of a job are the stuff of which dictatorships are made."
- Franklin D. Roosevelt

In 2006, a corporation, owned by the government of the United Arab Emirates, (UAE) tried to acquire control of six ports in the United States. The corporation, Dubai Ports World, eventually withdrew their bid. The withdrawal was in response to accusations from members of Congress that the UAE had ties to Al Qaeda. The controversy, though over-inflated, was not all that surprising. The 9/11 Commission had reported financial ties between the UAE and Al Qaeda, the terrorist group that conducted the 9/11 attacks. More surprising was what happened afterward: as the U.S. economy lurched into a major recession in 2008, some of the same members of Congress who opposed the Dubai deal in 2006 backed the UAE’s use of its sovereign wealth fund to invest heavily in critical but vulnerable US financial institutions\(^1\) such as Citigroup.\(^2\) The American public hardly reacted at all. Suspicions regarding the links between Al Qaeda and the UAE seemed forgotten.

An incident such as the one with Citigroup suggests that there may be a disconnect between American security strategies and American financial policies. In certain elite circles, sovereign wealth funds (SWF) seem suspect. SWFs are, after all, the investment funds of governments. The governments that own these funds can be governments of a state or province like Alaska or of a nation like China. The funds are financed by a government's revenue, for instance from a natural resource like oil. That money is used to invest or buy shares in

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companies in order to turn a profit. Governments may use the profits they make to subsidize a project or a pension fund. SWFs are controlled by either a fund manager or directly by the government that owns the fund. Policymakers in Washington and members of the U.S. financial community have raised concerns in recent years over whether SWFs could be used to threaten American security. The controversy surrounds whether foreign governments could use SWFs as a form of power and effectively undermine U.S. security.

Sovereign wealth funds do not appear to be sparking concern or debate from the broader American public. One reason may be that most people do not know SWFs exist. Media coverage on this topic is concentrated in specialized publications such as the Wall Street Journal and Financial Times. Liberal, capitalist societies tend to assume that unrestricted financial flows are good for national security. Yet, given the vast sums involved and the critical financial institutions affected, should Americans view SWFs as something new and worrisome?

The rapid growth of SWFs in the last ten years sparked the current debate that surrounds the investment vehicles. SWFs are injecting billions of dollars into the world economy faster than ever before. In fact, it is estimated that SWFs hold $3 to $3.5 trillion dollars in pooled assets and that number is expected to more than double by 2015. The rise of SWFs gives some economists pause with regard to how the capital that the funds provide will affect the future of the global economy. If the investments of states continue to grow at a breakneck pace they could change the face of the global economy and capitalism. Are we ready for sovereign states to become major players in the global financial market?

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Three key issues permeate the SWF debate: 1) whether countries will use their SWFs as a form of power and if so, how; 2) whether SWFs are, stabilizing or destabilizing factors for the international economy; 3) the extent to which SWF activities are or can be made transparent. This paper will explore these key issues by examining the current literature on the topic and the specific circumstances under which these funds came to controversy. Part of the debate on SWFs stems from the concern over whether foreign governments could use their investment vehicles to affect critical areas of the U.S. economy. After examining the literature and history I will draw conclusions as to whether SWFs pose a threat to American security. Lastly, this paper seeks to explain why SWFs are not debated outside the congressional and economic arenas and have remained just a blip on the radar screen of the American public.

Background

Alberto Quadrio Curzio and Valeria Miceli divide the history of SWFs into four phases. The first phase began in 1953 and extended into the mid-1990's. They likely chose to have the first phase encompass forty years because up until 1995 there were only 16 SWFs in existence; now there are 53 SWFs. It was during this time that oil rich nations were developing investment strategies for the surpluses from oil, which had increased substantially during that

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6 The total number of SWFs varies depending on source. Curzio and Miceli give 53 as the total count, while Edwin Truman counts 70 non pension SWFs. The SWF institute lists 50 on their website. If funds that invest primarily in domestic enterprises are included in the count along with pension funds then the count tends to be higher as in Truman's case. In addition, Truman lists some pre-1953 pension funds, which he determined should be classified as SWFs. The SWF institute only lists 50 SWFs but does not provide the criteria for inclusion on the list. Perhaps the institute only tracks the 50 largest I did not have access to their entire database. For the purposes of consistency I use Curzio and Miceli's counts as I am using their historical classification system for background.
time period. However, the first SWF was created almost sixty years ago when, in 1953, the country of Kuwait established the Kuwaiti Investment Authority (KIA).\textsuperscript{7} At the time, Kuwait had increased its production of oil in response to the nationalization of the Iranian oil industry and increased the tax on its oil, which is what other producers such as Saudi Arabia and Venezuela were doing at this time to increase revenue.\textsuperscript{8} The intention of the Kuwaiti government was to establish the fund in order take the excess money from the new oil tax and invest it because petroleum was a non-renewable resource.\textsuperscript{9} The second phase is defined from the late 1990's until 2004; in this period Asian countries dominated the establishment of SWFs due to trade imbalances and the the accumulation of extra currency. The third phase lasted from 2005 to 2008. The term "sovereign wealth fund" was coined by Andrew Razanov in a 2005 article he published in the Central Banking Journal.\textsuperscript{10} Curzio and Miceli describe this phase as one during which recipient countries became more wary of SWFs.\textsuperscript{11} The authors avoid putting this third period into context and do not mention the U.S. wars that were ongoing in Iraq and Afghanistan. The fourth and final phase lasted from 2007 to the present and encompasses the latest financial crisis. During the initial part of this time frame SWFs experienced losses and their activity lessened.\textsuperscript{12} Since the latter part of 2009 the funds seem to be recouping their losses and amassing more assets.\textsuperscript{13} The four phases are a helpful guideline to organize the activity of SWFs. The way the time line is divided points to the recent uptick in the creation of and use of

\begin{itemize}
  \item \textsuperscript{7} Ibid., 3.
  \item \textsuperscript{8} Jurgen Braunstein, "Sovereign Wealth Funds: The Emergence of State Owned Financial Power Brokers" (PhD diss., The Australian National University of Vienna, 2009) 12-13.
  \item \textsuperscript{9} Ibid.
  \item \textsuperscript{12} Ibid., 4.
  \item \textsuperscript{13} Ibid.
\end{itemize}
these investment vehicles by sovereign governments.

**Will foreign governments Use SWFs to threaten American interests?**

A main point of contention over the SWFs for Congress is whether or not these investment vehicles have the potential to be used as a form of power by a foreign government. Similar to the Dubai Ports World controversy it is the foreign political influence associated with SWFs that stoke the security debate. Groups in the policymaking communities, such as the U.S.-China Economic and Security Review Commission fear that these vehicles cannot be trusted because of the link to sovereign governments\(^\text{14}\). Since the 1988 legislation, two main security issues associated with SWFs continue to have implications for the U.S.: influence on decisions in critical industries, and economic espionage and warfare.

*Influence on Critical Business Decisions and Critical Economic Sectors*

The concerns regarding American security and the possible use of power that surround SWFs developed within the last five years. Two levels of power are important for this discussion: the ability to influence decisions at the business level and the ability to influence decisions at the nation-state level. The ability for SWFs to influence either level may be disconcerting; however the ability to exert dominance at the business level is probably more likely to occur than at the broad nation-state level. In private business, companies that are on the stock market are referred to as having "gone public." This simply means that any person within the public domain can purchase a piece of that company's worth or a share.\(^\text{15}\) If a person or

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\(^{15}\) Investopedia. Definition of "public."
entity purchases a large amount of shares that person or entity may acquire voting rights. Voting rights give a shareholder the ability to influence decisions such as who sits on a board of directors and matters of business policies. A SWF that invests in a major U.S. financial institution could vote against particular policy actions and board members that the foreign government opposes.

In 2008, under the auspices of the IMF, a set of principles were developed by several major players in the SWF community as a guide on issues such as voting rights. The Santiago Principles are not binding and consist of 24 "generally accepted principles" (GAPP). GAPP 21 discusses voting rights:

"SWFs view shareholder ownership as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights."

Principle 21 does not suggest that the voting rights of SWFs be restricted in any way but rather that a SWF should "protect its financial investments."

Voting rights might have implications for American security when a particular business that is backed by a SWF is a large force in a specific economic sector or is particularly sensitive.

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18 Ibid.
19 Ibid.
In addition, voting rights are feared because they open the door for governments that own the SWFs to manipulate a company based on strategic political motives; indeed, this is an area that some in Congress see as ripe for regulation.\(^\text{20}\) That said, Edwin Truman, senior fellow at the Peterson Institute for International Economics, makes the argument that since there may be no way to distinguish between the economic and political motives that a SWF may have as a shareholder there is no certain way to regulate voting rights. Truman goes as far as calling such an idea “foolish management” and also argues that, "...disenfranchising shareholders is inconsistent with most notions of shareholder democracy and its associated benefits in terms economic efficiency."\(^\text{21}\) Some SWFs could make a choice not to use their voting rights,\(^\text{22}\) acknowledging the sensitivity and possible conflict of interest. However, whether voting rights are permissible or not, they currently remain unregulated. Fundamentally speaking voting rights are a part of a liberal democratic capitalist system. If a foreign government were to use its right to vote for national security as opposed to business interests, a central business norm would be undermined.

Governments are also likely to care about the nature of the companies that attract SWF investments. Countries that find SWFs investing in companies directly related to national security may be more sensitive to control issues, such as voting rights, than others will be. For example, the energy sector of a country's economy is likely to have more national security implications than the textile industry. It was with this in mind that the U.S. federal government created the Committee on Foreign Investment in the United States (CFIUS). CFIUS is responsible for reviewing foreign investment in the U.S. in areas where national security

\(^\text{21}\) Ibid., 64.
\(^\text{22}\) Ibid., 137.
implications exist. CFIUS was created in response to increased investment by countries belonging to the Organization of Petroleum Exporting Countries (OPEC) following the oil crisis in the 1970's.\textsuperscript{23} CFIUS is a review body, headed by the US Treasury Secretary, which examines the implications of foreign investment.\textsuperscript{24} In 1988, in response to Japanese takeovers, Congress passed the Exon-Florio Amendment, which attempted to establish some criteria for reviewing proposed investments.\textsuperscript{25} While Congress attempted to define issues that should be raised to CFIUS the list was not adequate to encompass every foreseeable threat. This amendment also provided the President the ability to block a foreign purchase if it was deemed a national security threat.\textsuperscript{26} When this amendment was codified into law the president passed on the review, decision making, and investigative duties to CFIUS.\textsuperscript{27} Eric Anderson notes, "A cursory review of CFIUS responsibilities-including authority to review a transaction upon voluntary filing by either party or upon an agency notice filed by one of the committee's members-would suggest that Exon-Florio was sufficient to meet the worst critics' fears." Once a transaction is recognized by either an investor, business, or committee member as a potential threat to national security, CFIUS conducts a 90-day review, investigation, and presidential decision.\textsuperscript{28}

CFIUS may seem comprehensive yet most of the literature on the subject contains some critiques. For instance, neither the original legislation establishing CFIUS nor the ensuing Exon-Florio amendment defines "national security." Congress tried to address this shortfall in 1993 with the Byrd Amendment to the National Defense Authorization Act. The Byrd Amendment

\textsuperscript{23} The following paragraph relies heavily on Anderson's work.
\textsuperscript{24} Ibid.
\textsuperscript{25} Ibid.
\textsuperscript{26} Ibid.
\textsuperscript{27} Ibid.
\textsuperscript{28} Ibid.
changed the Exon-Florio law and provided that an investigation must be sought, "in any instances in which an entity controlled by or acting on behalf of a foreign government seeks to engage in any merger, acquisition, or takeover of a U.S. entity that could affect the national security of the United States."  

Yet as Anderson points out, the Byrd Amendment did not strengthen criteria for CFIUS review or to better define the national security threats that might trigger concern, as demonstrated by Dubai Ports World incident. If the CFIUS process is meant to bolster the American public’s confidence in the benign nature of foreign acquisitions by reviewing foreign investment in the US economy, then this controversy undermined that confidence, despite the absence of any clear threat to US interests inherent in the deal itself. Initially, CFIUS approved the transaction and did not proceed with a full investigation of Dubai Ports World, which is owned by the government of UAE. The committee did not view the purchase of the port operations to be a threat, but the criteria for its decisions were unclear. Homeland Security also signed off on the deal as part of the review, provided they could access the company’s financial records and the managers at the ports remained. Representative Chuck Schumer (D-NY) brought attention to the purchase after it was reported in the press then prominent legislators on both sides of the aisle, such as now former Senators Hilary Clinton (D-NY) and Bill Frist (R-TN) voiced their disapproval. Ultimately Dubai Ports World gave up on the prospect of acquiring the port operations in the U.S. The Dubai Ports World controversy led to knew

29 Ibid., 34.
30 Ibid.
31 Ibid.
legislation affecting CFIUS: the Foreign Investment and National Security Act (FINSA), which passed in 2007.

FINSA did not change the CFIUS investigation process but did include the Director of National Intelligence (DNI) as a non-voting member of the committee; it strengthened the withdrawal process, and added the requirement of "critical infrastructure" to the original evaluating criteria established in Exon Florio.\(^\text{34}\) In addition, FINSA created a review mandate on any case that does not end in a full investigation by CFIUS such as Dubai Ports World. Now if a case goes through the investigation process and does not get passed on for a presidential review it can also qualify for a congressional review. The main provision of FINSA that has drawn criticism is the "critical infrastructure" requirement. In FINSA the definition of "critical infrastructure" is "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security."\(^\text{35}\) Anderson asserts that critics claim this could cover up to 75% of the national economy.\(^\text{36}\) For example, This broad definition is complemented by a list from Homeland Security that pinpoints "agriculture, banking and finance, chemical industry, defense industrial base, emergency services, energy, food, government, information and telecommunications, postal and shipping, public health, transportation, and water..." as critical infrastructure.

As with previous legislation, FINSA offers no specific filing criteria beyond whether or not a transaction poses a threat to national security. Rather, the Department of Treasury offers a


\(^{35}\) Ibid., 36.

\(^{36}\) Ibid., 36.
list of illustrative cases that one can refer to as guidance when assessing whether or not a transaction may pose a national security risk.\textsuperscript{37} There are shortfalls to the latest round of legislation on the subject, which speaks to the difficulty of legislating such activity. On one hand it would be helpful if specific criteria were laid out along with a definition of "national security" in the law. On the other hand something of that nature may be too restrictive. It would be practically impossible for policymakers to account for every situation that may have national security implications when developing the language for criteria. If policymakers try they may constrain the ability of corporations to participate in legal transactions. In short, the goal of Congress is to provide protection without financial protectionism.

\textit{Economic Espionage and Warfare}

The phrases "economic espionage" and "economic warfare" are more mainstream today than in prior years, and the interest surrounding economic security issues reaches from the Pentagon to the Department of State. As part of its counterintelligence effort, the FBI has a separate unit devoted to economic espionage and most recently the Pentagon commissioned a report on economic warfare.\textsuperscript{38,39} Some of the interest shown in these areas has colored the SWF debate. Part of the debate regarding SWFs centers on whether a foreign government could use its stake in a company to perform economic espionage. Or to a larger extent whether a foreign


\textsuperscript{38} The information on the FBI unit was gathered from the FBI website. FBI. Economic Espionage. http://www.fbi.gov/about-us/investigate/counterintelligence/economic-espionage.

government could wage a type of economic warfare against the recipient country. If a SWF threatened an action to influence a country by using voting rights or less traditional means of influence, such as selling off stock, that particular SWF could be considered a threat to security. Such steps could include voting foreign agents onto the board or using investments as political bargaining chips. A country could also simply withdraw its investment, which potentially could create severe consequences for the recipient country and business.40

The risk that a SWF could be used for economic espionage should be acknowledged however there is no evidence that this is happening. A possible scenario might be that a SWF could place an insider in a company who could gather proprietary information or a SWF could be privy to proprietary information legally and use it to benefit the government overseeing the SWF. An argument could be made that the risk for espionage may rise as the percentage of ownership in a certain company increases. However, data on the relationship of SWFs to cases of economic espionage – either criminal or national security related – are not available. Individual people perpetrated most of the espionage cases reported in the media within the past few years and, while links to foreign governments, such as China, exist those individual actions may speak more to greed than to malice toward the U.S. from a sovereign nation.41

The current literature for the most part dispels the notion that SWFs might be used to conduct economic espionage. Self-interested gains could be acts such as reverse engineering or manipulating the value of shares through purposeful devaluation or destabilization. Truman asserts that risk of economic espionage is present, however countries probably have better,

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means to exact economic warfare and espionage. Others in the financial community such as Philip Winder, flatly state that the SWFs are not a security threat. Winder asserts that xenophobia fuels arguments that SWFs could undermine the security of a recipient nation such as the U.S. and that in fact U.S. businesses benefit the most from SWFs enjoying the capital flows from these funds. Finally, Anderson believes that the true “peril” for America lies in the fact that these funds could go elsewhere which would potentially remove U.S. access to "cheap money."

Security concerns over economic warfare typically refer to the looming national debt and particularly China's role as holder of U.S. debt. For instance, there is documentation of Chinese government and military officials specifically citing the American economy as a potential U.S. vulnerability. There is potential for SWF to be used an economic instrument of a foreign government in an economic warfare scenario. The fact that the most prominent funds are held by countries that are not under democratic regimes, such as the Chinese Investment Corporation (CIC) and the Abu Dhabi Investment Authority (ADIA), fuel the suspicions around SWFs. Jurgen Braunstein examined SWFs from an international political economy perspective. Braunstein recognized that the recent rise of SWFs may represent a larger shift in the global economic balance of power from Western countries to the developing nations of the world,

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which could threaten the economic superiority of the West.\textsuperscript{46}

The most pertinent threat is not necessarily how SWFs have acted in the last 10 years, but rather the potential for the funds to be used to undermine U.S. security in the future.\textsuperscript{47}

Economic success may be vital to recovering from the global recession and maintaining security and in order to compete in a global market the U.S. strives to remain open to foreign investment. Yet, as citizens and shareholders it is also important that we understand where the future of that market is going. It is important to examine the potential negative aspects of SWFs but it is also important to investigate what economists and scholars such as Truman point to as the positive aspects of SWFs. The potentially positive aspects of SWFs center around the long-term nature of the investment and the large capital flow that can boost, and in some cases, save a business. It is for the above reasons that competing ideas exist in the debate about SWFs. One side warns against financial protectionism while the other camp is focused on potential implications to national security.

\textit{SWFs stabilizing or destabilizing the international economy?}

Proponents of SWFs often argue that these investment vehicles are good for the global economy because the funds promote stabilization. Typically, SWFs are long-term investments, which tend to be more stabilizing for an economy rather than short-term investments that result in more variation in a market and may cause volatility. Sovereign governments are typically around for long lengths of time so the investment horizon is naturally long-term. In addition, the

\textsuperscript{46} Jurgen Braunstein, "Sovereign Wealth Funds: The Emergence of State Owned Financial Power Brokers" (PhD diss., The Australian National University of Vienna, 2009) 28.

management style of most SWFs tends to be that of a passive investor. A passive investor is one who rides out the ups and downs of the market without adjusting their investment strategy along the way. The passive investor does not become involved with the management of the corporation in which it has invested. In 2008, a CIC spokesman stated that the CIC did not seek control of firms through investment, thus suggesting the CIC has a passive investment strategy. Endorsing passive practices may help attract investors and preempt skeptics that could challenge CIC's motives. Even though CIC made that claim, there were still some representatives in the U.S. Congress such as Marcy Kaptur (D-OH) that questioned China's SWF strategy writ large and argued for greater transparency.

It is difficult to assess the consequence that the recent increase in investments by SWFs will have on market stability. The difficulty lies in the scarce data available on SWF impact; the funds are new and remain secretive. Yet, in spite of the preliminary nature of the data, the recent studies are promising. Curzio and Miceli cite a study by Bortolotti, Fotak, Megginson and

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51 Ibid., 63.
52 Curzio and Miceli note that the study by Bortolotti, Fotak, Megginson and Miracky draw on the Monitor-FEEM SWF Transaction Database. The Monitor-FEEM database uses transactions that SWFs have made public, which the authors assess to be 10-20% of all SWF transactions. "This happens because some transactions are anonymous investments in liquid assets, or because third parties (asset managers) are used to act on the behalf of the SWFs."

Miracky that finds SWFs have a positive short-term impact on returns. The short-term impact may be caused by a positive market reaction fueled by the initial influx of capital. This particular study found that the positive impact was felt at a greater level when the recipient company was in the banking and financial sector. Curzio and Miceli interpret the above finding to the overall market reaction to a bailout. Even though there is a positive short-term effect the authors of the study also conclude that SWFs have a negative effect on medium-term profits. Curzio and Miceli also cite two other studies, one by Chhaochharia and Laeven and another by Knill, Lee and Mauck, that both found similar results: an increase in market values at the beginning of a SWF transaction and more nonstandard and negative mid-longer term reactions. With regard to the two studies Curzio and Miceli note:

"Concerning market volatility they find that a reduction in abnormal returns is accompanied by a reduction in volatility. However, risk reduction is not sufficient to offset the reduction in returns in order to preserve the return/risk relationship. This suggests that SWF investments could be potentially destabilising factors for financial markets."

In all three studies Curzio and Miceli note that while volatility is lessened that does not outweigh the fact that the fiscal returns are reduced in the long-term. The authors sum up their examination of the studies by stating that even grouped together the studies do not represent a

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53 The following section relies heavily on Curzio and Miceli’s examination of current studies.


54 Ibid., 118.

55 Ibid.

56 Ibid., 119.

57 Ibid.
concrete answer to SWF performance because there are other studies that show opposing data points. Curzio and Miceli believe the lack of clarity can be attributed to the complex nature of the economic factors that impact SWF investment would happen regardless of the choices made by SWFs to invest.

There are non-economic factors that have the potential to make SWFs agents of destabilization. Some potential factors are related to economics but most are related to political perception. Concerns about any destabilizing effects of SWFs are primarily founded in the notion that a fund, such as the CIC, could use its capital to purchase important sectors of the U.S. economy and that in a time of vulnerability or conflict the U.S. could find itself beholden to China's interests. There is also concern about the reasoning behind the development of the CIC. China has stated that the intended use is to gain greater returns on their investment than they would make by, for example, buying U.S. treasury bills. Anderson believes this statement and cites the fact that the CIC stated the SWF needs to make "$40 million a day" just to cover their interest from the bonds used to start the CIC. So there is financial risk involved with the venture even though China has a vast amount of reserves. That China has taken the financial risk could be viewed as proof that the motives behind the creation of CIC were not sinister because the fund has something to lose. That said, critics may charge that the CIC is just another vehicle China will use to create American reliance on China's goodwill. The fact that SWFs are tied back

58 Ibid., 119-120.
59 Ibid., 119.
60 Ibid.
61 This comment is based off of a citation from Peter Navarro a professor at the University of California-Irvine. His language as quoted by Anderson is much stronger and calls China's SWF a "strategic danger" to "American sovereignty." (p. 64)
Evidence from the US Financial Crisis

During the recent financial crisis SWFs performed as any major investment fund. Many of the SWFs lost revenue during the financial crisis; however some such as CIC were able to make some market gains in 2008.\textsuperscript{63} The majority of studies center on publicly available information such as the data in the Monitor-FEEM SWF database. The Monitor database, used by Miracky and Bortolloni, is by no means comprehensive but it is one of the largest databases on the subject.\textsuperscript{64,65} The Monitor group uses the publicly available data of SWF transactions to try determining behavior and performance of SWFs as a group. Curzio and Miceli cite a study done by Miracky and Bortolotti using the Monitor-FEEM data and concluded:

"While the first half of the year was characterised by an investment boom...in the second quarter of 2008 investments started to decrease declining by almost 50\% by number and 14\% in value terms compared with the previous quarter. This sharply contrasted with 2007...that saw a doubling of the 2006 value."\textsuperscript{66}

Overall the current research shows that SWFs weathered the financial crisis and appear to have acted as other investors did.


\textsuperscript{64} The Monitor Group can best be described as a consulting firm that provides research services to various industries. The Fondazione Eni Enrico Mattei (FEEM) is a "non-profit, non-partisan research institution" that is "devoted to the study of sustainable development and global governance."


FEEM. "About Us." from http://www.feem.it/getpage.aspz?id=24&sez=About us


\textsuperscript{66} Ibid., 104-5.
SWFs have aspects that can be both calming and volatile to international markets. It is possible that negative financial impacts of SWFs are caused by the reaction to the investment based on the fact that the investment vehicle is owned by a foreign government. This has generated negative press, especially in democracies, that can create volatility for transactions associated with SWFs. Conversely, the very fact that SWFs are associated with governments that have long investment outlooks has proven to be a positive factor for the soundness of the market based on the previous studies cited above. The consideration for U.S. economic and policymaking communities is whether the potential benefits of stabilization-long-term investment and capital flow outweigh the potential destabilizing factors- association with foreign governments. This will likely remain a murky area for the foreseeable future and it is arguable that a good first step toward clarity would be greater transparency into SWFs management and operations. Greater transparency would allow for a more comprehensive examination of internal and external factors on SWF performance, which could lead to an answer regarding stabilization versus destabilization.

The level of transparency surrounding SWF activities

Transparency is an important part of the debate surrounding SWFs. The lack of transparency leads some to be suspicious about the intentions of SWFs. As noted in the previous section the lack of transparency also affects the knowledge base in this field of study. In the West there is an expectation that good governance is provided when transparency is enforced. The fact that SWFs are linked to sovereign governments and are not forced to be transparent makes it difficult for western observers to have a high level of comfort with SWFs. There are
those who believe that SWFs should be more transparent and others who argue that it is necessary for some SWFs to maintain opacity to protect their investments.

Throughout the last few years there have been efforts by individuals and groups in the financial community to develop frameworks for understanding and rating transparency among SWFs. Two such frameworks will be presented and compared here: the "Truman Scoreboard" and the "Linaburg-Maduell Transparency Index" used by the Sovereign Wealth Fund Institute. After presenting those two models I will look at what the current ratings are for CIC and ADIA on each model.

In 2007, Edwin Truman developed a way to think about and organize sovereign wealth transparency. His work is referred to as the "Truman scoreboard," which Truman updated in 2008 and 2009. Truman's scoreboard considers 53 SWFs in 37 countries. Truman scores each SWF based on the following four factors: "structure, governance, accountability and transparency, and behavior." The factors were developed by asking "yes" or "no" questions. "Structure" refers to the "basic organization" of a fund and a high score in the "structure" category means that both publics from the country of origin and the recipient country find a

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68 I chose the LMTI because it was developed by the SWF Institute which is relatively new on the scene but is devoted to studying and tracking SWFs for interested parties. Sovereign Wealth Fund Institute, Linaburg, C. & Maduell, M. (2010). *Linaburg-Maduell Transparency Index*, http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index/.
70 Ibid., 69-74.
71 Ibid., 71-74.
particular fund's "organization is transparent." This first factor includes "elements" that consider everything from a clear mission statement to whether there are mechanisms to in place to "change the structure" of the SWF. The next factor used to categorize SWFs is "governance." "Governance" includes those institutions inside a SWF that help to operate and oversee the activities of a SWF. "Accountability and Transparency" are comprised of the following: "investment strategy implementation, investment activities, reports, and audits." Lastly, "behavior" is composed of how a SWF "manages its portfolio," the "risk management policy," and "the use of leverage and derivatives."

The Linaburg-Maduell Transparency Index (LMTI) is used by the Sovereign Wealth Fund Institute. This index was created by using the Norwegian SWF as a model. The LMTI uses 10 principles that are assigned one point each. The 10 principles that are listed on the Sovereign Wealth Fund Institute website include:

1. Fund provides history, including reason for creation, origins of wealth, and government ownership structure.
2. Fund provides up-to-date, independently audited annual reports.
3. Fund provides ownership percentage of company holdings and geographic locations of holdings.
4. Fund provides total portfolio market value, returns, and management compensation.
5. Fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines.
6. Fund provides clear strategies and objectives.
7. If applicable, the fund clearly identifies subsidiaries and contact information.
8. If applicable, the fund identifies external managers.

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72 Ibid., 74.
73 Ibid.
74 Ibid.
75 Ibid.
76 Ibid.
77 Ibid.
79 Ibid.
10. Fund provides main office location address and contact information such as telephone and fax.\textsuperscript{80}

If a SWF does comply with the first five principals, then it will receive a rating of five. The Sovereign Wealth Fund Institute recommends that a SWF have a minimum rating of eight,\textsuperscript{81} which means that the SWF in question would have to meet eight principals out of the ten in the list.

Of the two models, Truman's scoreboard seems to be a more comprehensive system for rating transparency. The strength of the LMTI lies, however, in its simplicity. The intention here is to find out more about the ways in which transparency affects the larger debate about SWFs, not to definitively rate a particular index as a standard.\textsuperscript{82} ADIA is ranked 58 on the Truman scoreboard. A score of 58 places the ADIA right around the median scores for all of the funds.\textsuperscript{83} In comparison, ADIA received 4 out of 10 on the Linaburg-Maduell Transparency Index for the third quarter of 2010.\textsuperscript{84} The CIC received a 57 on the Truman scoreboard and 7 out of 10 on the Linaburg-Maduell index. The popular perception is that the CIC is much more open and transparent compared to the ADIA\textsuperscript{85} yet the most current numbers from the Truman Scoreboard

\begin{flushleft}
\textsuperscript{80} Ibid.
\textsuperscript{81} Ibid.
\textsuperscript{82} I chose to examine the Truman scoreboard because I have seen it referenced in multiple publications, which probably indicates some level of comfort with the rating system among the financial community.
\textsuperscript{83} This score was just 11 in 2009 but after the ADIA released its first annual report in 2010 the score jumped to 58.
\end{flushleft}
actually indicate that the opposite is slightly true. The difference between the ADIA and CIC on the LMTI is -3. Perhaps this discrepancy indicates the dynamic nature of measuring SWFs.

Ways to measure transparency are likely to change as SWFs become more mature financial actors and as more and more SWFs implement the Santiago Principles. The Santiago Principles are non-binding guidelines established in 2008 by the International Working Group on SWFs that the IMF took part in organizing. Thirteen of the 24 principles address "disclosure" issues from "legal relationships" to "withdrawal and spending operations" making the Santiago Principles a key factor in SWF transparency.

Some critics argue that the Santiago Principles are for show and countries may sign off on the guidelines to quell protectionism but not abide by the principles. After their inception, the GAPP received negative press because there was no real noticeable difference in SWF behavior, such as issuing regular reports. Two years later in 2010, as mentioned previously, ADIA produced an annual report on its activities. The annual report provided some information on the percentage of investments by region but failed to provide the total amount of assets. On the whole, this turn of events is positive and displays what proponents of the Santiago Principles believed would take place. The somewhat ambiguous language and non-binding nature of the

86 The Santiago Principles were briefly mentioned in this paper in the section on security implications but will be discussed in more depth here.
88 Ibid.
91 D.Drezner, "BRIC by BRIC: The Emergent Regime of Sovereign Wealth Funds," in
Santiago Principles still cause some debate regardless of any one SWF’s particular steps at implementation.

Conclusion

SWFs do raise potential risks for security because of their link to foreign governments that have sovereign political objectives. The issues of transparency, combined with the recent surge in activity are troubling. In addition, the way that we view security should be expanded to include economic threats. SWFs can and do benefit the U.S. economy, however the U.S. cannot fully benefit from SWFs if Wall Street is not made to address the looming security implications. As long as SWFs remain mysterious the more likely it is that their investments will incur backlash. Transparency is a very important issue in the debate around SWFs. In order to ensure that SWFs do not undercut democracy binding international agreements not just norms need to be in place. The Santiago Principles were a good start and SWFs like ADIA have been responsive. Now that progress has been made the international community should take it a step further and turn principles into binding parameters.

The recent uptick in the creation of SWFs may be an area for concern. The recent growth may indicate that countries are mimicking one another in an effort to compete at a strategic level. Economic competition is disconcerting because the regulation that governs these investments is lacking from an international standpoint. Rather each individual nation is burdened with crafting its own policy with regard to the funds. If economic competition is the driver for the establishment of the funds it could also be a driver behind recipient-country regulation that could result in an imbalanced market that is driven less by economic forces and more by political

forces.

In the case of Dubai Ports World it seemed obvious to many in Congress at the time that a disconnect existed between our economic policies and our security. The disconnect seemed especially apparent because of the large public outcry over the ports and the "ask questions later" mentality in the case of the acquisition of Citigroup. Yet, after going through the key issues within this debate that may be overly simplistic. The fact of the matter is it may not be so much of a disconnect between economic policy and security policy as much as it is the way that our public thinks about security policy. In this global economy the U.S. has to accept a level of foreign involvement. However, there is a difference between a private foreign entity investing in your small business and the government of that entity directly investing in your business. It is this issue which must be reconciled. Ports are hard targets and have implications as points of entry. As citizens who study security issues we need to look beyond the hard targets and also focus on financial points of entry. The financial point of entry into the U.S. with the most implications regarding foreign government control is the sovereign wealth fund.

Areas for Further Research

This paper set out to explore three key issues in the debate around SWFs with the hope of addressing the issue of whether SWFs present a security threat to the U.S. The link between SWFs and independent governments has the potential to undercut security if a government were to use a SWF as a tool to undermine the U.S. economy. The current research points to that potential threat as overblown. Great effort needs to be made to understand and potentially add regulation for these investment vehicles going forward.
Two specific implications were identified in relation to a government's use of power to threaten American interests: influence on critical business decisions and critical economic sectors as well as economic espionage and warfare. If SWFs choose not to exercise voting rights then the SWF may pose no overt direct threat of imposing their government's power through the business. That statement is not to imply that a hidden or an indirect threat could not exist. The security implication of voting rights is an area for further study. Protecting critical economic sectors is more crucial at this juncture to American security than are voting rights. Through all the legislative permutations with regard to CFIUS and the different considerations about "critical infrastructure" this is an area where much more work needs to be done. For now, it is not an area that poses an imminent threat but there are significant problems here that have far-reaching implications for security and efficiency. Lastly, it is far-fetched to assert that SWFs pose threats in the form of economic espionage and economic warfare. However, in the current security climate, which has an ever-increasing focus on economic issues, SWFs present another set of economic data and possible vulnerabilities that should be examined in much more detail when considering issues like America's national debt.

The argument that SWF may contribute to short-term positive market stabilization but cannot be counted on to deter market volatility in the long-term seems to have some merit, however due to the scarcity of available data that point must be examined further. Overall, SWFs seem to be more of a stabilizing and positive factor in the finance sector while SWFs should probably avoid controversial purchases such as defense or critical technology as their shear involvement could at the very least destabilize an economic sector. In addition, if the SWF remains a passive, long-term investor it would be hard to make an argument that an SWF is a destabilizing factor. If skepticism exists about the strategy of an investor, for instance the CIC,
then a SWF has the potential to be very damaging. The area of stabilization research could benefit from refining current measures that are used to document transparency. The Truman scoreboard and the LTMI are innovative given the nuanced nature of SWFs, however additional work may reveal a simpler method that could be geared toward those SWFs that pose the biggest security implications—those owned by foreign governments.

The last area for further research that shows promise is the relationship between economics and politics in both the host and recipient countries. Is there a finite amount of foreign government involvement that free-market democracies can tolerate? How could a country use a SWF to impact decision making in the U.S.? Is there a tipping point for SWF investment where the investment vehicles can overwhelmingly hurt U.S. business interests? With regard to the investing country is there a certain percentage of loss that could cause severe political backlash affecting the stability of a sovereign government? All of these questions raise interesting issues that can challenge researchers in a quest to reconcile the good and potentially bad impacts of SWFs.
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