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Subprime – Law Firms

Sovereign Wealth Funds, Corporate Liquidity Problems, And The Foreign Investment And National Security Act Of 2007

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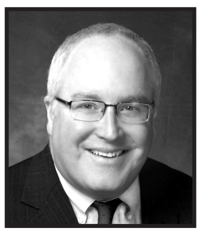

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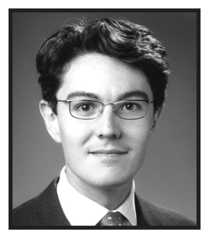

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Much ink has been spilled in the legal and financial presses detailing the catastrophes referred to collectively as the "subprime crisis." Valuations of collateralized debt obligations and mortgage-backed instruments have collapsed. America's largest financial institutions have written-down billions of dollars in assets, reflecting misplaced bets on now-valueless instruments. And, most troubling to the broader economy, the U.S. remains in the grips of a profound "credit crunch" in which once-plentiful wells of liquidity have run dry.

One aspect of this picture which is just beginning to come into focus is the growing role of foreign capital investment – and, particularly, that provided via sovereign-wealth funds ("SWFs") – as a source of otherwise scarce liquidity. Investment funds owned by foreign states awash in capital have in the past few months taken multi-billion-dollar stakes in U.S. financial institutions hardest hit by the subprime crisis, and have made plain their intentions to put their investment capital to work in various facets of the U.S. economy. Many in the financial community welcome this infusion of cash at a time when the nation's economy is staggering from the subprime crisis and teetering on the brink of recession.

A legal and political storm, however, is taking shape on the horizon. The rapid growth in SWFs in the past several years, their massive U.S. investments in the past several months, and their extraordinary capacity for further investments in the years to come, must be viewed against the backdrop of legislation enacted by Congress in July 2007: the Foreign Investment and National Security Act of 2007 ("FINSA"). FINSA, enacted before the full scope and extent of the subprime crisis became known, provides for significantly expanded administrative and congressional scrutiny of major foreign investments affecting the United States' "critical infrastructure" or "critical technologies," and mandates heightened scrutiny where the foreign investor is a government-controlled entity. Implementing regulations intended to flesh out the statute's more nebulous concepts are due for release in April 2008. There are growing signals from government officials that the FINSA implementation and review process – particularly as it applies to SWF investments – is likely to become a point of political contention in 2008. In the first salvos of what promises to be a lengthy dispute, accusations of protectionism and economic xenophobia are being met with claims of national security and suggestions of nefarious ulterior motives by foreign states and their SWFs.

In light of these barriers and uncertainties, U.S. companies contemplating a significant investment by a SWF must tread carefully.

A. Sovereign Wealth Funds

SWFs are not new – the earliest versions were formed in the 1950s – but their extraordinary wealth and growing prominence is a recent phenomenon. A SWF is a government investment vehicle that invests in foreign assets. While SWFs were originally conceived of as diversification or hedging tools to stabilize state reserves, the recent explosion in the size of the reserves of certain nations – from oil wealth in Middle East nations, and from export wealth in Pacific Rim nations – has shifted the investment focus of their SWFs toward active investment and the accumulation of wealth. In practice, the largest SWFs now operate similarly to hedge funds or private equity firms, albeit with state ownership and with little to no transparency as to their capitalization, holdings, or investment strategies. Their acquisitions and investments in recent years have run the gamut of industries, from financial institutions to technology developers to aerospace companies. Dollar-denominated assets have been particularly attractive as a result of continuing weakness of the U.S. dollar, and more recently, the collapse in valuations resulting from the subprime crisis.

The scope of the recent investments of SWFs in U.S. companies during the fallout from the subprime crisis is staggering. In mid-January, SWFs controlled by the governments of Singapore, Kuwait and South Korea invested over $20 billion in Citigroup and Merrill

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Lynch. Other SWFs from China and Abu Dhabi have recently invested billions in Morgan Stanley, Bear Stearns, Blackstone Group, and other major U.S. financial institutions. All told, SWFs are estimated to have injected nearly $70 billion into financial institutions in the past ten months as a result of the subprime crisis. Still more remarkable is the amount of total capital that SWFs are estimated to have available to invest. The largest SWFs are currently estimated to be worth about $2.9 trillion, about as large as the global hedge fund and private equity industries combined. And they are growing fast: SWFs are expected to be worth over $10 trillion within the next five years.

Given their newly-active investment strategies, their vast wealth, and the fact that such wealth may be devoted to serve the ends of foreign states, a political backlash against SWFs appears imminent, increasing the uncertainties for U.S. companies contemplating a SWF investment. Indeed, the first stirrings of this political reaction have arisen. Internationally, the governments of France and Germany have expressed concern with SWF activity, and various international organizations are formulating model regulations to promote transparency in SWF management and strategy. At home, Congress has convened hearings regarding the risks which SWF investment activities pose to the U.S. economy and to national security, during which concerns were raised about the potential "non-economic motivations" of state-controlled investors, such as "controlling strategic assets, securing access to sensitive information or technology, promoting a political agenda, or cornering a market on raw materials."[1] Members of Congress have expressed willingness to consider additional legislation in this area.[2] Business interests and Treasury Department officials have responded by warning that protectionist regulation aimed at SWFs would put vital foreign investment in the U.S. at risk.

B. FINSA Scrutiny Of Foreign Investments

The debate in the coming year is likely to coalesce around the implementation and application of FINSA, a statute enacted as the first waves of the subprime crisis were being felt in the U.S., and which speaks to much of the emerging debate regarding SWF investments.

A system for considering the U.S. national security implications of foreign investments assumed its general outlines with the 1988 passage of the Exon-Florio amendment to the Defense Production Act (*see* 50 U.S.C.A. § 2170 *et seq*.), as implemented by regulation and executive order. Under the pre-FINSA structure, the Committee on Foreign Investment in the United States ("CFIUS") – a body drawing members from various federal agencies – was responsible for reviewing proposed acquisition transactions, and blocking those with the potential to affect national security. Notification of prospective transactions to CFIUS was voluntary, although CFIUS was empowered to initiate review on its own initiative. In practice, few transactions were notified to CFIUS, fewer were investigated, and far fewer still were blocked.

FINSA was enacted in July 2007 in the wake of CFIUS's 2006 approval of a controversial proposed acquisition by a Dubai company of a company operating U.S. ports. Effective as of October 24, 2007, FINSA's stated purpose was to "ensure national security while promoting foreign investment and the creation and maintenance of jobs, [and] to reform the process by which such investments are examined for any effect they may have on national security . . . ."[3] Without presenting a comprehensive review of FINSA practice, the elements of FINSA's enhanced transactional scrutiny of particular importance to SWF investments follow:

• FINSA identifies "foreign government-controlled transaction[s]" for particular scrutiny. CIFUS now must generally conduct a full 45-day investigation of any acquisition that could result in control of a U.S. entity[4] by an entity owned or controlled by a foreign government, even indirectly.

• The pre-existing concern with transactions affecting national security was explicitly expanded in scope to include transactions affecting U.S. "critical infrastructure" (that is, "systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such assets would have a debilitating impact on national security") or "critical technologies."

• In CFIUS's review of "foreign government-controlled transaction[s]," it must take into account the foreign country's compliance with nonproliferation and export control regimes, and the "relationship of such country with the United States, specifically on its record in cooperating in counter-terrorism efforts . . . ."

• FINSA increases the congressional oversight of the CFIUS process, requiring CFIUS to notify Congress of the results and rationales of its transactional reviews.

As with most legislation, FINSA's devil will be in the details of its regulatory implementation. Implementing regulations are currently being formulated by the Treasury Department in its role as CFIUS's chair, and are expected to be released in April 2008. In the meantime, vital questions concerning the degree to which FINSA will limit SWF investments remain unanswered. Among these uncertainties are the following:

• The expanded application to "critical infrastructure" provides expanded bases for challenge to SWF investments, but the extent of that expansion is presently unknown. Questions concerning which industries are encompassed (energy? transit? telecom? technology? banks?), and how large a company's footprint must be for it to be deemed "critical," will be answered – *if* they are answered – no sooner than the release of FINSA's implementing regulations. In the meantime, investments by SWFs in such industries must be structured wherever possible to minimize the degree of SWF control over aspects of the business touching infrastructure.

• The Treasury Department has noted that, in the course of considering implementing regulations, it is considering the definition of "control" upon which the FINSA's scope of covered acquisition transactions will be determined. SWFs have historically been passive investors, limiting their investments to substantial – but sub-controlling – stakes. Some have suggested, however, that this passive investment role may change, as SWFs continue their evolution toward a more activist private equity model. A change in the existing definition of "control" provided in 31 C.F.R. § 800.204, however, could have a significant effect on efforts by SWFs to expand the degree of control over their holdings. In the meantime, transactions should be structured where possible to eliminate or circumscribe the ability of SWFs to "determine, direct or decide matters" affecting the U.S. entity.

• The heated congressional rhetoric concerning SWFs, and the enhanced congressional oversight envisioned by FINSA, represent the greatest source of uncertainty for SWF investments. Key members of Congress have suggested that they are keen to legislate if they consider FINSA, as implemented and applied, to provide insufficient regulation of SWFs. These pronouncements enhance the prospect that CFIUS transactional reviews of specific SWF investments will become a source of political dispute – and, perhaps, political interference – once reported to Congress as required by FINSA. And they present the possibility that Congress will enact specific legislation subjecting SWF investments to additional layer(s) of political scrutiny founded on concerns other than the national security concerns already addressed in FINSA.

As is apparent, the ultimate treatment of SWFs under U.S. law is in the earliest stages of a battle which will not conclude quickly. In the meantime, so long as U.S. economic and currency weakness continues, SWF investment will continue to expand. U.S. companies contemplating an infusion of SWF liquidity, however, must be aware of the risks and uncertainties discussed above, and should take care to address potential issues in the earliest stages of due diligence.

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[1] *Opening Statement of Sen. Charles E. Schumer, Joint Economic Committee Hearing: Do Sovereign Wealth Funds Make the U.S. Economy Stronger or Pose National Security Risks?, February 13, 2008.*

[2] *For example, a February 2008 letter from Senate Banking Committee Chairman Chris Dodd (D-CT) and Ranking Member Richard Shelby (R-AL) to members of the Senate advised of the Banking Committee's ongoing oversight of sovereign wealth funds, and its willingness to consider appropriate legislative authority under its jurisdiction to ensure the strength and security of the U.S. economy.*

[3] *Preamble, U.S. Public Law 110-49.*

[4] *Under implementing regulations existing prior to FINSA enactment, "acquisition" was broadly defined to include all manner of acquisitions of a company or its business, and "control" was defined as the "power, direct or indirect, whether or not exercised or exercisable through the ownership of a majority or a dominant minority of the total outstanding voting securities of an issuer, or by proxy voting, contractual arrangements or other means, to determine, direct, or decide matters affecting an entity." 31 C.F.R. §§ 800.201, 800.204.*