



McDermott Will & Emery LLP.

2010 Litigation & Dispute Resolution
dealing with corporate and regulatory conflict



■ Sovereign wealth funds: regulatory and litigation issues in the United States

BY STEVEN SCHOLES AND MATTHEW DILLER

In recent years, international financial markets have witnessed the rise of a new set of players – sovereign wealth funds, or SWFs. The massive size and the foreign political nature of SWFs have caused some to wonder whether the investments of SWFs in US companies are subject to US regulation and litigation.

Generally speaking, SWFs are pools of money controlled by a national government or a government entity. The funds are derived from pools of national wealth, generally from revenue generated from natural resources (such as the Abu Dhabi Investment Authority, and the Norway Governmental Pension Fund) or currency exchange (such as the China Investment Corporation). SWFs are not a new creation – the first recognised SWF, the Kuwait Investment Authority, dates from 1953. But it is only in recent years that these funds have begun to receive international attention. As Ethiopis Tafara, Director of the Securities and Exchange Commission's Office of International Affairs 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". SWFs have begun to transition from a conservative investment model to a model seeking greater returns, and this change in strategy has caused funds to become aggressive in seeking out quality equity investments across the globe, including investments in companies headquartered in the US.

SWFs have access to enormous amounts of capital. At present, SWFs are commonly believed to have access to \$2 trillion, a number that is projected to rise to \$12 trillion by 2015. This massive pool of capital has allowed SWFs to make correspondingly large investments. For example, the China Investment Corporation, China's sovereign wealth fund,

acquired a 10 percent stake in Blackstone Group in 2007 for \$3bn, and invested \$5bn in Morgan Stanley in 2008. The Abu Dhabi Investment Authority bought a 4.9 percent stake in Citigroup for \$7.5bn in November 2007, and Singapore's sovereign wealth fund bought a \$6.8bn stake as well.

Naturally, increased investment activity of SWFs, their size, and their foreign sovereign origin, have caused many observers to raise concerns that are of paramount importance for US regulators and litigants.

One of these concerns is that sovereign wealth funds lack transparency. Generally, the business dealings of SWFs are not public knowledge. While this is true of many other entities that control large pools of money – such as hedge funds – the foreign national control of SWFs means that the lack of transparency may be especially damaging for US interests generally and for US investors particularly. Without knowledge of the goals of the controlling national entity, other activities of the entity, or its inner dealings, there may be no way to discover, monitor, and regulate the activities of SWFs effectively.

Another concern is that SWFs may also pose a national security threat to the US. While it may be that SWFs have only the protection and acquisition of national wealth as their goal, it is possible that SWFs might have other goals, such as seeking a national security advantage through marketplace activity. For example, US regulators have long been wary of the possibility of a foreign government purchasing a stake in a company that produced products that are crucial for national security – such as Boeing or General Dynamics – and then attempting to use that stake to transfer technology or intelligence back to the purchasing country.

Moreover, SWFs may possess information asymmetries that work against the more conventional investor. American regulation of securities markets is broadly premised on the philosophy of full and fair disclosure, attempting to ensure that all investors in the market generally have access to the same publicly available information. SWFs, however, may possess information based on their status as a national entity that goes beyond the information available to the average investor. If SWFs do possess such an asymmetrical information advantage, they may use that advantage to the detriment of other investors.

In addition, the foreign government and entities controlling SWFs may resist US regulatory authority over the activities of an SWF. Because SWFs are controlled by foreign governments, those governments could apply political and diplomatic pressure to further their goals, which may be inconsistent with US regulatory goals.

These concerns, however, may be tempered by the fact that SWFs – to the extent of their transactions involving American businesses and investments – are clearly subject to US legal and regulatory authority. Generally speaking, sovereign nations have immunity in US courts under the Foreign Sovereign Immunities Act (FSIA). This means they have immunity from suit in US courts and are generally immune from government regulation. However, FSIA does include exceptions. Perhaps the most important of these exceptions for SWFs is the commercial activity exception. Under this provision, the commercial activities of foreign governments in the US do not receive sovereign immunity. Thus, investments in American companies by SWFs generally will fall under that exception, allowing SWFs, foreign governments, and other such entities to be sued in US courts. Without this exception, there generally would be no legal recourse for private actors when dealing with national entities.

As a consequence, in the United States SWFs are subject to suit by private parties in civil courts and to regulation by the Securities and Exchange Commission. Federal and state securities laws apply to SWFs and, among other consequences of this situation, SWFs face disclosure requirements for exceeding certain ownership thresholds of securities in US issuers.

SWFs also face the possibility of oversight for transactions that raise national security concerns. Although most SWFs have chosen to adopt a passive strategy and generally do not attempt to acquire controlling stakes in American businesses due to US disclosure requirements, federal law provides a review mechanism of such controlling transactions. The Committee on Foreign Investment in the United States (CFIUS), an inter-agency committee of the executive branch of the US government, has the authority to review transactions that may result in 'control of a US business by a foreign person', including transactions by SWFs. CFIUS will review the transaction and

determine if it constitutes a national security risk. If so, they may refer the transaction to the president, who may then take action under the Foreign Investment and National Security Act of 2007 to block the transaction.

While the regulatory environment for SWFs in the United States appears relatively clear, litigation involving SWFs still presents many questions and concerns. Cross-border litigation of any sort will naturally be rife with difficulties not encountered in litigation confined to one country. The political nature of SWFs will only increase these difficulties.

Litigation involving SWFs will likely fall into two different categories: enforcement litigation; and private civil litigation. Enforcement litigation refers to actions taken by US regulatory authorities to enforce federal or state securities laws. Civil litigation refers to general litigation in American courts by private parties.

Enforcement litigation carries with it one crucial difficulty from a comity perspective. Ordinarily, when seeking to enforce US securities laws against a foreign entity, US regulators will have little difficulty securing the assistance of foreign governments, whether it be to enforce a US judgment, assist with discovery, or any other form of assistance necessary. In the case of an enforcement action against an SWF, however, the US regulatory authority will be seeking assistance from the very nation that owns and controls the SWF. While it is possible that the nation will agree to assist American authorities out of respect for international law, it is also possible that the nation will resist those efforts.

Comity concerns in private party litigation will extend both to American courts and to foreign jurisdictions. Judges and lawyers in American courts must be aware of comity concerns when dealing with SWFs as parties to litigation. They must be cognisant of the laws, jurisdiction, and authority of the other nation, as those aspects may have an effect on the litigation. Similarly, enforcing American laws and rules in foreign countries will naturally be somewhat difficult. Such enforcement will depend greatly on the assistance of local authorities. In international law, the principle of comity applies both ways – foreign judges and authorities must be just as cognisant of comity principles as American courts must be – but in the case of SWFs, receiving comity may be difficult.

The impact of the increasing pace and size of SWF investments in US companies remains to be seen. While existing enforcement and litigation tools exist to subject SWFs to the same regulatory regime and civil liabilities other investors face, only time will tell whether the sheer size and political nature of SWFs will impact the practical application of US laws to them.

Steven Scholes is a partner and Matthew Diller is an associate at McDermott Will & Emery LLP.

**Steven S. Scholes**

Partner

Chicago

T: +1 312 984 7762**E:** sscholes@mwe.comwww.mwe.com

Steven S. Scholes is a partner in the law firm of McDermott Will & Emery LLP based in the Firm's Chicago office. He is the head of the Chicago Trial Department, Chairman of the Firm's SEC Defense Group and leader of the Subprime and Credit Markets Litigation Group. Steve concentrates his trial practice in all varieties of securities and other complex commercial litigation. He has tried civil, criminal and administrative cases in federal and state courts, and he regularly represents clients before the Securities and Exchange Commission and self-regulatory organizations, such as the Financial Industry Regulatory Authority, the Public Company Accounting Oversight Board and numerous stock, options and futures exchanges.

**Matthew T. Diller**

Associate

Chicago

T: +1 312 984 7695**E:** mdiller@mwe.comwww.mwe.com

Matthew T. Diller is an associate in the law firm of McDermott Will & Emery LLP and is based in the Firm's Chicago office. Matthew is a member of the Trial Department.

While in law school, Matthew served as co-president of the International Law Society and was a summer associate with McDermott in 2007.

Matthew received his J.D. from the University of Chicago Law School and his B.A. in political science and history from the University of Illinois Urbana-Champaign.

Matthew is admitted to practice in the state of Illinois.
