

## **Speech by SEC Chairman: The Rise of Sovereign Business**

**Gauer Distinguished Lecture in Law and Policy at the American Enterprise  
Institute Legal Center for the Public Interest**

***By***  
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Thank you, Chris [DeMuth] for your generous introduction. I think you gave me more credit than is due for saving the free world. Of course I would never correct you.

Your introduction surpassed even the one Ronald Reagan gave me once. The President's introduction in California during my first campaign 20 years ago (he did three very generous introductions in the closing months of the campaign, and this was the last) was looking to be the most impressive encomium of all time. Dana Rohrabacher, the White House speechwriter who was running for Congress in the neighboring district, had arranged with his speechwriter friends to lay it on particularly thick in the President's draft remarks. So at the event, where more than 5,000 people turned out in Long Beach, President Reagan credited me with every domestic and foreign policy victory his administration had achieved. In winding up he said that "whether going to the summit with the Soviet Union or balancing the budget or cutting taxes, I have always relied upon the advice and judgment of this outstanding American leader ... Chris Fox."

To this day, I'm still not certain whether it was a slip of the tongue or a masterfully executed lesson in humility. (My mother, who was in the front row at the time, lived out her life holding firmly to a vote for slip of the tongue.)

It truly is an honor to be invited to deliver the Gauer Distinguished Lecture, and to follow in a line of men and women who have given this address that includes Supreme Court justices, Cabinet secretaries, prime ministers, and presidents. It's especially poignant for me to follow in President Reagan's footsteps as your speaker, here in this building named not only in his honor but for international trade. President Reagan always held fast to his vision of a global free market, and a generation after his presidency, that vision is far closer to reality than at any time in human history.

My remarks tonight are focused on "The Rise of Sovereign Business." Two recent phenomena — state-owned or controlled corporations in our public markets, and government-owned commercial investment funds — are challenging conventional approaches to the respective roles of government and the private sector. The auspices for this lecture are especially fitting for the topic. The American Enterprise Institute is dedicated to limited government, private enterprise, and individual liberty and responsibility. And the Institute's central goal today is to understand how free

economies function. The fundamental questions that underlie this rapidly growing trend of sovereign business require us to examine fully the strengths of private enterprise, to appreciate how to capitalize on its strength and keep it vigorous, and to know how to address the problems that arise. These are precisely the missions of the American Enterprise Institute.

The National Legal Center for the Public Interest, with which AEI recently merged, has likewise long been dedicated to the study of issues that are central to any analysis of these issues. For more than 30 years, it has focused upon the importance of the rule of law and a fair and independent judiciary as the keystones of property ownership, free enterprise, and limited government. An exploration of these very topics is absolutely essential to appreciating the implications of the more active role that national governments seek to play in the world's capital markets.

I have spent most of my career in government as a legislator, working to advance economic growth in America through lower taxes and limited government. More recently I have been a regulator, entrusted not with passing laws but enforcing them for the protection of investors. Now, I'm finding that defending the rule of law and the role of fair, predictable, and arm's length application of the law is just as important to protecting America's economic freedom as the battles for lower capital gains taxes I fought in the Congress.

That is because increasingly, the world's capital markets are converging. The pace of events in the world's capital markets has placed global consolidation at the top of everyone's list of what is important for the future. The combination of the New York Stock Exchange and Euronext, Nasdaq's bid to acquire the OMX exchange in Stockholm, Borse Dubai's investments in Nasdaq and in the London Stock Exchange, Eurex Frankfurt's acquisition of the US-based International Securities Exchange, and the London Stock Exchange's recently completed merger with Borsa Italiana are also significant manifestations of this shrinking world. In the next few years, the world's capital markets will become even more integrated as public companies increasingly raise capital beyond their geographic boundaries.

This accelerating integration of our capital markets nonetheless holds the potential to bring enormous benefits to America's investors. A world of borderless trading would mean more choice than ever before. And investors' transaction costs would be driven lower by the combined forces of competition and technology. They would have more, and better, opportunities to diversify their risk. And by participating in a truly global market that rations capital to its highest and best uses in a genuinely worldwide competition, their investments will be accelerating the pace of economic growth for everyone on the planet. That is why our nation welcomes, and will continue to welcome with open arms, both foreign investment in U.S. capital markets and the opportunity for Americans to invest beyond our borders.

Indeed, that is exactly what is already happening all around us. Investors large and small are increasingly allocating their capital — and their business assets — outside their home countries. But it is notable that even as individuals and firms are doing this, so too are governments. Dissolving borders have inevitably brought us face to face with the fact that many of these governments do not share the same view of the rule of law that undergirds our free enterprise system, nor do they attach similar importance to the leading role of private property and private economic ordering that is so central to our conception of securities markets.

As Lady Margaret Thatcher put it when she delivered the Gauer Lecture 14 years ago, "The Rule of Law as we understand it exists in only a small part of the world, of which your country and mine are the center."

These differences in the way we see the role of government — in America's case, as neutral arbiter and enforcer of the rules of the market, and in many other countries, as both player and referee — can have significant implications for the workings of the free market itself. In order to see how that is so, it will first be useful to scrutinize our conception of just what we understand a "free market" to be.

I have seen no better modern definition than that offered by the Chief Executive of the Hong Kong Monetary Authority, Joseph Yam, in 1999. Two years after the handover to the People's Republic of China, in an address to the Asian Investment Conference in Hong Kong, he described the underpinnings of a free market as follows:

First and foremost, buyers and sellers must be "free to trade on whatever terms they wish without government interference." The importance of keeping government from intervening in the transactions, he said, follows from the conclusions of the "great writers on free markets, from Adam Smith to Milton Friedman," who "argue that free markets and free enterprise, rather than governments or monopolies, are the most efficient means of producing and distributing wealth and, as a consequence, the soundest basis for a just and prosperous society."

"The philosophers," he said, "are agreed that, in general, the less a government has to do with these various functions the more efficiently the market can do its job ... governments should, at most, play a minimal, [but] instrumental role in fostering the conditions in which each individual has the freedom to make his or her own economic choices."

If this accurately states what each of us understands when we use the term "market," then the increasing involvement of governments as both owners of companies and investors in securities can be seen to challenge that understanding at a fundamental level. This is something of particular importance for the SEC, because the protection of fair, orderly, and efficient markets is at the very core of our mission. In order to succeed in that mission, we've got to have a clear conception of what it is exactly that we are to protect. So the question we are now grappling with is, what will be the effect of these new government participants *in* our markets *on* our markets? If the distinction between government and private activity in our capital markets is increasingly blurred, is there a point at which the entire financial activity we today call a free market stops being precisely that, and morphs into something else?

The presumption that markets comprise chiefly the activity of private economic actors is embedded within the DNA of the SEC. When the Securities and Exchange Commission was created in 1934, its purpose was to serve as an independent regulator of the profit-seeking activity of self-interested individuals and firms in the securities markets. It was not, however, to supplant the market or directly participate in it.

Even though government ownership of the economy was an issue in other countries at that time, it was not in America. That very much distinguished us from Europe. In

Germany during the 1930s, the independence of the private sector was a pre-World War I memory. In the Soviet Union, where the Bolshevik Revolution was not yet a generation old, government virtually occupied the field. And in Italy, where Benito Mussolini's Fascist party promoted an economic approach called syndicalism, nominally private property was devoted to state purposes. Even in France at that time, the corporatist spirit was in the ascendancy, and the government controlled many industries.

But for all of the time since America's founding, our country had far less government involvement in the economy than Europe. This was true mostly because we had far less government, period. Federal revenues totaled less than 5% of GDP in the early 1930s. Today, more than 70% of the U.S. economy remains in private hands, with the balance accounted for by federal, state, and all other government.

The clear separation between the public sphere of government and the private character of the economy stems also from the Constitution itself. Among its most fundamental features are its explicit guarantees for private property. Our Constitution has enshrined the right to property in repeated and specific guarantees to the individual, which are simultaneously denied to a central government whose powers are enumerated and strictly limited. This legal arrangement, in turn, reflects the presumptions of the culture and legal traditions from which our Constitution arose.

This is why, in the case of the securities markets, there was never an impulse for the federal government to own the exchanges, the investment banks, or the broker-dealers — or the companies whose securities they traded. The Securities Act of 1933 and the Securities Exchange Act of 1934 marked a deliberate effort to clearly define and separate the role of the national government, on the one hand, and the capital markets, on the other. Henceforth, fraud and unfair dealing in the stock and bond markets would be subjected to external discipline by the federal government. Appropriate standards would be enforced, such as requiring that every investor be told the essential details about the security in which he was investing. Registration of securities, and licensing of broker-dealers, would be required. It was, in short, arms-length regulation of an unabashedly private market, rather than nationalization.

The normative judgment implicit in this legislative and regulatory scheme is that free and private markets are good. So long as they are in fact operating efficiently, competitively, openly, and honestly, they are good for consumers, investors, producers, and our entire economy.

So it is against this backdrop that we now are dealing with the growing phenomenon of the state-owned, but publicly traded, company. This is a trend being driven by the semi-privatization of government enterprises in areas such as banking, oil and gas, infrastructure, transportation, and real estate, among others. The result of several large public offerings of government-owned enterprises outside the United States in recent years is that, post-offering, private investors have purchased a significant amount of stock, but even collectively they still represent a minority. The government, in turn, still owns a majority of the company and controls all of the decision-making — just as it did before the public offering. For example, PetroChina, which recently surpassed ExxonMobil as the world's largest company by market value, has offered just 12% of its shares to the public, according to regulatory filings. The rest of its ownership remains in the hands of the Chinese government.

This phenomenon can be observed in many of the world's countries, and it is both significant and growing. Of the 20 largest publicly traded companies in the world, eight are state-owned sovereign businesses.

A related, and growing, phenomenon is government ownership of large investment funds, or so-called sovereign wealth funds. This phenomenon is not new, but it is a markedly growing trend that raises many of the same issues of government ownership, and others as well. In operation, sovereign wealth funds are simply the investment arms of governments. But while they have existed in one form or another for many years, today they are making an increasingly obvious footprint in the global financial marketplace, growing in size relative to private assets.

Today, the world's sovereign wealth funds are significantly larger than all of the world's hedge funds combined. According to some estimates, they could grow as large as \$12 trillion over the next eight years. The Abu Dhabi Investment Authority, Norway's Government Pension Fund, and Saudi Arabia's wealth fund, according to IMF estimates, each currently have more than a quarter of a trillion dollars in assets to invest. Kuwait, Singapore, Russia, and Hong Kong also each have sovereign wealth funds totaling more than \$100 billion in assets.

Moreover, not all government-directed investment funds are foreign. For example, the Alaska Permanent Fund (a \$40 billion fund) has diversified its oil income into stocks, bonds, and real estate. The permanent funds of Texas were originally oil based (and continue to have income derived from oil royalties from state-owned lands), but are today mostly financial portfolios.

These examples serve to illustrate that the question of state ownership in the economy continues to present itself in a variety of ways, not just in other countries but in our own as well. And they help us to appreciate that the fundamental question presented by state-owned public companies and sovereign wealth funds does not so much concern the advisability of foreign ownership, but rather of government ownership. Precisely because the rise of sovereign wealth funds and publicly traded state-owned corporations portends a greater degree of state ownership in the economy, their new prominence raises many of the same questions that any program of state ownership entails.

The rise of sovereign business also raises several specific issues for the SEC.

One is enforcement. For example, the Commission has the power to pursue sovereign business and sovereign wealth funds for violating U.S. securities laws. Neither international law nor the Foreign Sovereign Immunities Act renders these funds immune from the jurisdiction of U.S. courts in connection with their commercial activity conducted in the United States. Today, when a foreign private issuer is suspected of violating U.S. securities laws, our experience working with our overseas regulatory counterparts indicates that we could almost always expect the full support of the foreign government in investigating the matter. But if the same government from whom we sought assistance were also the controlling person behind the entity under investigation, a considerable conflict of interest would arise.

Another issue is the conflicts of interest that arise when government is both the regulator and the regulated. When the government becomes both referee and player, the game changes rather dramatically for every other participant. Rules that

might be rigorously applied to private sector competitors will not necessarily be applied in the same way to the sovereign who makes the rules.

A corollary of such conflicts of interest is that the opportunity for political corruption increases. Graft, bribery, and other forms of financial corruption by governments and political figures is an unfortunate fact of life throughout the world — as the Commission's enforcement responsibilities under the Foreign Corrupt Practices Act remind us on a daily basis. When individuals with government power also possess enormous commercial power and exercise control over large amounts of investable assets, the risk of misuse of those assets, and of their conversion for personal gain, rises markedly.

Another equally pressing concern is market efficiency. As Harvard economist and former Treasury Secretary Larry Summers recently wrote, "The logic of the capitalist system depends on shareholders causing companies to act so as to maximize the value of their shares. It is far from obvious that this will over time be the only motivation of governments as shareholders." This observation is probably true even if the government we are talking about is our own. Investors and regulators alike have to ask themselves whether government-controlled companies and investment funds will always direct their affairs in furtherance of investment returns, or rather will use business resources in the pursuit of other government interests. And if the latter is the case, what will be the effect on the pricing of assets and the allocation of resources in the domestic economies of other nations? Ultimately, that is a judgment that economists will have to make. But if the trend toward government-owned or controlled enterprise and investment accelerates, as has been forecast, the answer to that question will continue to grow in importance.

A fourth issue is transparency. In many industrial countries today, the ability of journalists and citizens to inquire into government affairs, or to criticize the conduct of government, is severely limited. In some countries, criticism of government policies lands you in jail, or worse. Is it reasonable to expect that these same governments will be magically forthcoming with investors? This raises significant questions for regulators such as the SEC, whose mission includes investor protection. Indeed, when it comes to transparency, the track record to date of most sovereign wealth funds does not inspire confidence.

Because one of the most important byproducts of what the SEC does is the maintenance of investor confidence, we are focused on yet another unique feature of sovereign business, and that is information disparities. If ordinary investors — an estimated 100 million retail customers in America own more than \$10 trillion in equities and stock funds in U.S. markets — come to believe that they are at an information disadvantage when they compete head to head in markets with government, confidence in our capital markets could collapse, and along with it, the market itself. That's why so much of our effort is focused on full and fair disclosure to all market participants, and the prevention of fraud and unfair dealing such as insider trading. With the powers of government at our disposal, we can make life difficult for inside traders. But if the powers of government are no longer used solely to police the securities markets at arm's length, but rather are used to ensure the success of the government's commercial or investment activities, not only retail customers but every private institutional investor could be put at a serious disadvantage.

That disadvantage could include significant disparities in the information that is available to government as compared to private marketplace actors. Unlike private investors and businesses, the world's governments have at their disposal the vast amounts of covert information collection that are available through their national intelligence services. Current legal restrictions in some countries on the domestic collection and use of such information might serve to protect the civil liberties of that nation's citizens. But there are normally no concomitant protections for foreign nationals, or for intelligence collection activities conducted in other countries. Unchecked, this would be the ultimate insider trading tool. Think Bill Belichick on a global scale — but with far greater consequence.

A final set of questions concerns the impact on U.S. markets and the U.S. economy from significant new government ownership, if that were to occur. It simply does not do to take a snapshot of this interesting new development, and to observe that as things stand now there is no observable change. The question is where is this trend taking us. What are the logical and likely outcomes of growth in this kind of activity? Could the rise of sovereign business ultimately change the character of U.S. markets? It is an interesting question.

The former Prime Minister of the People's Republic of China, Chou En-Lai, was asked in the early 1970s by an American journalist about his thoughts of the French Revolution of 1789. After a long, contemplative pause he answered: "For me it is too early to have an opinion." Perhaps that is the right frame of mind for assessing the potential impact of other nations' government-owned businesses and investment funds on America's capital markets.

And here, policy makers and defenders of free markets must be on guard. It would be easy, and wrong, to consider restrictions on such investment for the purported reason of protecting the integrity of our free markets. Indeed, one need only consult the ongoing debate in parliaments around the world about sovereign wealth funds and sovereign business to observe that these developments are provoking a new round of protectionism. For America to address one problem — the special concerns that arise from government ownership of business — by creating another one — betraying our commitment to open markets — would only result in more government interference in our own markets. Far better would be to address the underlying issues of transparency, independent regulation, de-politicizing of investment decisions, and conflicts of interest.

Concerns about changing the character of our own free market need also take into account the massive size of the U.S. economy and our securities trading compared to other nations. The United States isn't simply the world's largest and most productive economy; we are vastly bigger than any other nation's economy or capital market. To provide some perspective, the U.S. economy is bigger than the next four largest economies of the world put together. That includes Japan, China, Germany, and the UK — combined. Or consider that the entire economy of Russia is roughly the same size as the gross state product of Texas. Or that California's economy is over twice the size of India's.

Even given the current projections for growth in sovereign business and sovereign wealth funds, it would take far more to exert a dominant influence. Far more likely is that, over time, the markets and market participants in other countries will be influenced by their exposure to America's capital markets.

To begin to enumerate these many questions provoked by the rise of sovereign wealth funds and state-owned public-traded companies, of course, is not to answer them. But systematizing our thoughts about the possible good and ill effects of increased direct participation in the world's capital markets by governments can help in the process of structuring norms and practices to maximize the potential benefits and minimize the risks. This important analysis is well underway in a number of venues, including the President's Working Group on Financial Markets, of which the SEC is a member, as well as in the G-7, the World Bank, and the IMF. The outcome of these analyses may well be more generalized agreement about the kinds of strong fiduciary controls, disclosure requirements, professional and independent management, and checks and balances to prevent corruption that will help protect both investors and markets.

From the SEC's standpoint, working to ensure the transparency of sovereign business and investment will be of paramount importance. The mutual trust and investor confidence that this would establish will address many of the special concerns these activities raise. To the extent sovereign investing is conducted through professional management of these funds, this could help to de-politicize the process both in practice and in perception.

Meanwhile, as securities regulators, we will continue to pursue a cooperative and collaborative dialogue with our regulatory counterparts in other nations, and to engage them regarding the best way to apply our regulatory approaches in light of the growing presence of government-owned businesses and investment funds in our markets. And we will continue to vigorously pursue tough, independent regulation, which is the bedrock of investor protection, and the sine qua non of efficient capital markets — because in the end, our entire free enterprise system depends upon the rule of law that the SEC upholds.

America has embraced markets: it is because in doing so, we give substance to our support for individual freedom, our suspicion of government excess and abuse of power, and our skepticism that the few can make wiser choices than the many. And by our commitment to arm's length regulation of those markets, we have simultaneously acknowledged the need for the policeman and the referee — in other words, for the rule of law, and the role of the SEC.

Our nation's support for markets, and our commitment to independent regulation, represent a fragile balance — yet one of such enormous strength, it has supported the hopes and dreams of the world's most powerful and prosperous nation.

The endurance of these principles has ushered in one of the most exciting, hopeful times in history. It is a time when the miracles of science and medicine offer our children the hope of living productive lives for a full generation longer than their grandparents. It's a time when communications technology has connected every nation on the planet, and when the near-complete triumph of markets the world over holds the potential to set billions more of the earth's people free to choose their passions and their destinies.

This is a vision for our capital markets and for our world that I believe we are on the verge of realizing.

So as we gather here in Washington, in a place dedicated to international trade and one its greatest champions, perhaps we can draw inspiration from the example of great leaders before us. They earned their place in history because they had a sweeping vision and never lost sight of it. In that, we could do no better than to look to the example of our Founders, whose dedication to the rule of law upon which our free markets have been built continues to guide us even now.

On a September morning in Philadelphia 220 years ago, when our Constitution was finally completed, the delegates came forward, one at a time, to sign their names. As the last members filed up, Benjamin Franklin pointed out the painting of the sun on the back of the President's chair. He said that he had often wondered during the proceedings whether the sun was rising or setting. "But now at length," he said, "I have the happiness to know that it is a rising and not a setting sun."

As we hammer out and refine our approaches to the growing presence of government in markets, the decisions we make will likely depend upon whether we view the current half-embrace of private enterprise that they represent as a rising or setting sun.

For my part, I believe that these developments are part of a continuing shift away from statism and toward genuinely free markets. In this, I see only a rising sun, a stabilizing and modernizing influence in global finance. And I believe if Ronald Reagan were with us still, he too would view these developments with cautious optimism.

The optimism would be warranted by the extraordinary progress the world has made in recognizing the importance of markets, and in relying upon them for the allocation of society's resources. The caution comes in recognizing that the rising sun, for all its friendly promise, is still a ball of fire. Whether we ultimately bask in its warmth, or blister under its heat will be determined by wise choices made now, and the continued vigilance of all people dedicated to truly free markets.

Ronald Reagan, like Benjamin Franklin, knew full well that the course of future events is determined not by chance, but by the choices that leaders make at critical moments in history.

There is a postscript to the story about Benjamin Franklin. You all know that he had just made an impassioned speech to the delegates, because even at that final moment, many of them had refused to sign. So at the same time that he asked whether the sun was rising or setting on America, he wasn't even yet sure he'd get the necessary signatures on the document to give our nation the chance to succeed. You might imagine that such pressing problems would have weighed heavily on him, General Washington, and the other leaders of the Convention.

But that didn't prevent them from maintaining a healthy perspective. Because here is what happened next: "The business being thus closed," George Washington recorded in his private diary, the delegates proceeded to City Tavern.

And today, faced as we are with weighty problems in the world's capital markets, and the business of my speech thus being closed, so perhaps should we.

*<http://www.sec.gov/news/speech/2007/spch120507cc.htm>*