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Sovereign Wealth Funds: Active or Passive Investors?

Sovereign wealth funds (SWFs)—capital pools created by governments to invest surplus funds in private markets—are increasingly important global financial actors. Many fear that the economic power of SWFs, which is measured in trillions of dollars, will be used strategically and politically. Are fears that SWFs will be used as political tools justified? If political use of SWFs depends on their *control* of U.S. firms, the answer is almost certainly "no." There is no significant evidence that SWFs have or will use control of U.S. firms to implement governmental policy. Indeed, American political and regulatory constraints will pressure SWFs not only to avoid control, but also to avoid exercising significant influence over U.S. companies in their portfolios. Instead, the present cycle of SWF investment is likely to be characterized by passivity.

If Wall Street is ruled by the emotions of fear or greed, SWF investment seems to generate both. Many U.S. firms welcome SWF money, and a number of distressed financial firms have desperately sought SWF investment: SWFs invested nearly $40 billion in U.S. financial institutions in 2007 alone. [1] But desperation invites opportunism, and while many find SWF investment merely humbling and regrettable, others fear it is politically perilous. As the overseer of Norway's SWF observed, recipient nations such as the United States "don't like us, but they need our money."[2]

1. Anders Åslund, *The Truth About Sovereign Wealth Funds*, FOREIGN POL'Y, Dec. 2007, http://www.foreignpolicy.com/story/cms.php?story_id=4056.

2. Marcus Walker, *Russia Government Fund Will Tread Carefully*, WALL ST. J., Jan. 25, 2008, at C3 (quoting Norway's Minister of Finance Kristin Halvorsen).

AVOIDING CONTROL

Anxious to avoid a political backlash, SWFs have attempted to assure recipient nations that their motives are purely commercial. Thus, the funds intentionally structure their transactions so that they do not acquire a controlling interest in the portfolio firm. Such structures are also designed to avoid adverse regulatory consequences. For example, a SWF's proposed acquisition of a controlling interest brings the transaction under investigation by the Committee on Foreign Investment in the United States (CFIUS), a multi-agency government committee that analyzes the national security impact of foreign acquisitions of U.S. firms. Under its proposed regulations, CFIUS defines control as the direct or indirect power to determine, direct, or decide important matters affecting a company.[3] Government agencies also vet proposed transactions by applying various industry-specific regulations. In the past year the most prominent SWF investments have been in financial firms, many of which are governed by the Federal Reserve and regulations under the Bank Holding Company Act (BHC Act) and the Change in Bank Control Act (CIBC Act). SWFs have avoided acquiring more than ten percent of a company's outstanding capital in order to avoid triggering the definition of control under these Acts.[4] If a SWF's investment were deemed to be controlling, the SWF would fall under the definition of a "bank holding company"[5] and would be subject to examination, reporting, and capital requirements and the Act's restrictions against mixing banking and commerce.[6]

Control also brings disclosure obligations for the SWF under the securities laws, as well as potential liability for a controlling SWF should the portfolio company fail to disclose accurate information about itself. Under Section 15 of the Securities Act of 1933 and Section 20(a) of the Exchange Act of 1934, a control person is vaguely defined as one with the "possession, direct or indirect, of the power to direct or cause the direction of the management and

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3. Regulations Pertaining to Mergers, Acquisitions and Takeovers by Foreign Persons, 73 Fed. Reg. 21,861 (proposed Apr. 23, 2008) (to be codified at 31 C.F.R. pt. 800).

4. For a useful explanation of the operation of the BHC Act and the CIBC Act in the context of sovereign wealth investment, please see *Hearing Before the Subcomm. on Domestic and International Monetary Policy, Trade, and Technology, and the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises, of the H. Comm. on Financial Services,* 110th Cong. (2008) (statement of Scott G. Alvarez, Gen. Counsel, Federal Reserve Board).

5. 12 U.S.C. § 1841(a) (2000).

6. 12 U.S.C. § 1844 (2000).

policies."[7] This broad formulation brings even some minority investments under a functional definition of control.

MINIMIZING SWF INFLUENCE

These rules, among others, compel SWFs to avoid acquiring a controlling investment in U.S. firms. While SWFs may not acquire control under the various applicable statutes, they could nonetheless exercise considerable power in the murkier realm of shareholder influence. A SWF can still hold sway over a company without formal control, even if it votes in a predictable, apolitical fashion. Indeed, some see this softer power as a greater threat since the SWF may exercise influence outside of—and without the checks and transparency that generally come with—formal governance processes. This concern is reflected in the Treasury's recently proposed rules[8] governing the CFIUS process, which broadly define control so as to diminish the sphere of shareholder influence. For example, the regulations would find SWF control whenever a SWF directs the company to engage in certain "important matters."[9] While the power to "determine, direct or decide" important matters is straightforward enough, other terms in the statute are more slippery. For instance, if a SWF causes a decision to sell assets, reorganize or merge, engage in a major expenditure or investment, issue securities, or pursue new lines of business (among other things), the Treasury Department may regard SWF as controlling the company.[10] Such a finding initiates a CFIUS investigation that could result in the unwinding of the transaction. Perhaps in recognition of Prince Al-Waleed bin Talal's influence at Citibank—which arguably led to the recent firing of CEO Chuck Prince—the regulations also find control where a SWF causes the appointment or dismissal of officers or senior managers.[11]

The regulations are cleverly structured so that the definition of control is easily triggered, and an expansive interpretation of the definition by CFIUS should be expected. There are many reasons to avoid engaging in a control transaction at the outset of an investment, but if an investment does fall under the definition of a control transaction, CFIUS will formally review it. If CFIUS finds no national security concern, it will sign off on the transaction, usually conditioned upon executing a mitigation agreement with the SWF. Once

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7. 17 C.F.R. § 230.405 (2008).

8. Regulations Pertaining to Mergers, Acquisitions and Takeovers by Foreign Persons, 73 Fed. Reg. 21,861.

9. *Id.* at 21,869.

10. *Id.*

11. *Id.*

CFIUS has approved the transaction, its only regulatory recourse is to enforce a breach of the mitigation agreement.

On the other hand, if the SWF structures the deal to avoid acquiring control, as is typically the case, the threat of CFIUS investigation perpetually hangs over the investment—the transaction has not been formally vetted by CFIUS, and thus may be revisited by CFIUS should the nature of the investment change (for example, if the SWF seems to be using its investment in ways that may jeopardize national security). As a result, even though most SWF deals are not directly subject to CFIUS, an expansive interpretation of the rules allows for negative regulatory control on SWFs as the possibility of formal investigation acts as a check on SWF behavior.

Despite its reach, the CFIUS scheme has limitations. First, such a regulatory system requires ongoing monitoring by CFIUS, which may become more difficult as the number of investments increases. Also, CFIUS relies on the companies themselves to report controlling activities by the SWF. This dependence on self-reporting creates a circularity problem—in theory, if a SWF gains control of a firm, it could prevent the firm from reporting that acquisition to CFIUS. On the other hand, given the consequences if CFIUS did detect an unreported change in control, few SWFs would risk engaging in any activity that CFIUS might construe as control.

PASSIVITY BY DESIGN

By expanding the definition of control, the Treasury's proposed regulations diminish the threat of inappropriate SWF influence. Indeed, given the Treasury's view of causation, one may wonder what could constitute legitimate engagement between SWFs and their portfolio companies under the proposed rules. The uncertainty of the rules' application will likely encourage SWFs to maintain their shareholder strategy of passivity or understated influence.

SWF passivity is effectively a regulatory design; but while regulators encourage SWF passivity to minimize political and security risks, this passivity also raises concerns. Existing investors have typically welcomed SWF investment, but in some cases this positive reception may be due to the fact that SWF investment resolved serious capital deficiencies. New research suggests that SWF investment might have a significant negative impact on returns.[12] There are two agency cost explanations for this decline. The first

12. The average abnormal buy-and-hold return is negative 40.96%, as measured 480 trading days after the SWF investment. Veljko Fotak, Bernardo Bortolotti & William L. Megginson, The Financial Impact of Sovereign Wealth Fund Investments in Listed Companies 16 (Sept. 18, 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1108585.

(and perhaps likelier) is that SWFs increase agency costs: SWFs may increase monitoring costs by other investors because SWFs might not hold purely economic interests in the portfolio firm. These increased agency costs, in turn, lower the share prices of SWF portfolio companies. The threat of a decrease in the value of the portfolio, however, will presumably encourage SWFs to invest passively and to reassure other investors of their passivity.[13]

The second agency cost explanation is that SWF passivity decreases shareholder monitoring of management and thus raises agency costs. This account also explains why CEOs and boards have courted SWF money. They welcome SWF investment because it tends to be both long-term and passive. Unlike hedge funds or labor unions, SWFs rarely pursue governance influence. In practice, SWFs act like a large block of management votes, to the displeasure of more active investors.

Yet long-term passivity may not satisfy SWFs either, and unhappy SWFs could shift their investment capital to less restrictive markets. With respect to U.S. investment, however, structured passivity is the bargain that SWFs and regulators have struck. It is the cautious, reasonable response by regulators to an overall lack of transparent and accountable fund governance by SWFs. This arrangement will probably continue so long as SWFs need U.S. investment opportunities more than U.S. firms need SWF investment capital.

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13. This is not to say, however, that SWFs with political motives would not accept losses if they believe their political gains would offset such losses. Nevertheless, the evidence suggests SWFs would pay a heavy premium for political gains.