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Sovereign Investing and Corporate Governance

Paul Rose

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Cover Page Footnote

Associate Professor of Law, Ohio State University. The author thanks participants in the “The Role of Intermediaries in Corporate Governance” conference at Notre Dame Law School for their helpful comments, and Timothy Allen and Megan Walker for excellent research assistance.

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EVIDENCE AND POLICY

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INTRODUCTION

Discussions of corporate governance often focus solely on the attractiveness of firms to investors, but it is also true that firms seek out preferred investors.¹ What, then, are the characteristics of an attractive investor? With over \$5 trillion in assets,² sovereign wealth funds (“SWFs”) are increasingly important players in equity markets in the United States and abroad, and possess characteristics that firms prize: deep pockets, long-term (and for some, theoretically infinite) investment horizons, and potential network benefits that many other shareholders cannot offer. Indeed, in a recent BNY Mellon survey of large corporations, SWFs were identified as particularly attractive investors.³ The survey report notes that “[w]hile in 2010 47% of corporates reported engaging with SWFs, in 2012 that had grown to 62%.”⁴ But the report also notes an important concern for U.S. markets: of the companies reporting engagement with SWFs, companies based in Western Europe had the highest rate of engagement, with 79% of corporations reporting discussions with SWFs. On the other hand, at 49%, North American companies had the lowest rate of engagement with sovereign investors.⁵

Despite their economic power, their reach, and their general desirability as investors, SWFs are almost entirely disengaged from corporate governance matters in U.S. firms. Indeed, with the exception of Norway’s Government Pension Fund-Global,⁶ SWFs are notable primarily just for their passivity as shareholders. It is well documented that SWFs present unique challenges not only to the countries in which they invest, but also to their own domestic governments and citizen-beneficiaries, and it is these varied political challenges that provide the

1. See Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 CORNELL L. REV. 849 (2012).

2. See *Sovereign Wealth Fund Rankings*, SWF INST., <http://www.swfinstitute.org/fund-rankings> (last visited June 2, 2013).

3. See BNY MELLON, *GLOBAL TRENDS IN INVESTOR RELATIONS* 9 (2012), available at <http://www.adrbnymellon.com/files/PB30916.pdf>.

4. *Id.*

5. *See id.*

6. Larry Catá Backer has written extensively on Norway’s investment behavior. See, e.g., Larry Catá Backer, *Sovereign Investing and Markets-Based Transnational Legislative Power: The Norwegian Sovereign Wealth Fund in Global Markets* (Consortium for Peace & Ethics, Working Paper No. 2012-11/11, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2177778.

strongest explanation for SWFs' relative passivity in corporate governance.⁷ But complete passivity has a dark side, especially when combined with a long-term investment horizon. If, like consumers, shareholders' two primary means of affecting corporate behavior are voice and exit,⁸ then passive SWFs are not simply a non-factor in corporate governance, but may also have a negative effect by holding large, inert share blocks that could be held by more engaged shareholders who would be more vigilant in containing managerial agency costs.

Given the domestic and external political and regulatory factors that discourage SWF engagement in U.S. corporate governance, how can SWFs provide appropriate stewardship over their equity investments? This article answers that question by describing how SWFs and regulators can create the crucial "space" necessary for SWF engagement in corporate governance.

The analysis proceeds in four substantive sections. Part I lays out a definition of SWFs and describes SWF investment patterns. Part II reviews empirical evidence on SWF investment behavior and the effects that the investment has on firm values, and then examines evidence on SWF activities in corporate governance. Part III discusses the key factors that limit SWF involvement in corporate governance activities. Part IV describes how, given these limitations, SWFs may engage in governance without triggering regulatory reprisals, and how regulators can encourage SWF investment and engagement.

I. DEFINING SOVEREIGN WEALTH FUNDS

Defining a role for SWFs in corporate governance requires us to first define the universe of funds to which the term "SWF" applies. There are several categories of funds owned and controlled by sovereign entities, including sovereign wealth funds, central reserve funds (often used as currency stabilization funds), and sovereign pension funds.⁹ The two that are most important for corporate governance are SWFs and

7. Bassan notes that SWFs are beginning to emerge as more important players in corporate governance generally. See FABIO BASSAN, *THE LAW OF SOVEREIGN WEALTH FUNDS* 6 (2011). This is not the case in the U.S., however, as this article explains.

8. See generally ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* (1970).

9. See Eva Van der Zee, *Sovereign Wealth Funds and Socially Responsible Investing: Do's and Don'ts*, 9 EUR. COMPANY L. 141, 143 (2012).

sovereign pension funds. Sovereign pension funds face many of the same issues as SWFs in terms of investment decisions and governance, but have important differences from SWFs that become clear as one defines the term “sovereign wealth fund”.

Like hedge funds, SWFs resist definition.¹⁰ This challenge is exacerbated by connotations of the term “SWF”—funds may wish to be excluded from the definition for various reasons, including concerns that the label “SWF” carries a stigma that impacts the regulation of their investments. But while some funds that lie at the definitional fringes seek to distance themselves from the label, others have no choice but to own it—and, they might hope, to control the brand effects associated with the term—since they fall within every common definition of a “sovereign wealth fund.” For this reason, a logical place to begin is by looking at the definition offered by a self-selected group of funds, the International Working Group of Sovereign Wealth Funds (“IWG”):

SWFs are defined as special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports.

This definition excludes, *inter alia*, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, operations of state-owned enterprises in the traditional sense, government-employee pension funds, or assets managed for the benefit of individuals.¹¹

10. There are numerous definitions of SWFs. As one author observed:

The differences in definition reflect the ambiguity of the instrument itself: It is formally sovereign but functionally private. Moreover, it is not possible to treat all SWFs alike: They differ in size, age, structure, funding sources, governance, policy objectives, risk/return profiles, investment horizons, eligible asset classes and instruments, transparency, and accessibility.

Id. at 142.

11. INT’L WORKING GRP. OF SOVEREIGN WEALTH FUNDS, SOVEREIGN WEALTH FUNDS: GENERALLY ACCEPTED PRINCIPLES AND PRACTICES—“SANTIAGO PRINCIPLES” 27 (2008), available at <http://www.iwg-swf.org/pubs/eng/santiagoprinciples.pdf> [hereinafter SANTIAGO PRINCIPLES].

To add further clarity to this definition, the IWG notes three key elements that define a SWF:

- Ownership: SWFs are *owned* by the *general government*, which includes both central government and subnational governments.
- Investments: The investment strategies include investments in *foreign financial assets*, so it excludes those funds that solely invest in domestic assets.
- Purposes and Objectives: Established by the general government for macroeconomic purposes, SWFs are created to invest government funds to achieve *financial objectives*, and (may) have liabilities that are only broadly defined, thus allowing SWFs to employ a wide range of investment strategies with a medium- to long-term timescale. SWFs are created to serve a different objective than, for example, reserve portfolios held *only* for traditional balance of payments purposes. While SWFs may include reserve assets, the intention is not to regard all reserve assets as SWFs.

Furthermore, the reference in the definition that SWFs are “commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports” reflects both the traditional background to the creation of SWFs—the revenues received from mineral wealth—and the more recent approach of transferring “excess reserves.”¹²

The IWG definition is relatively precise, but other, independent definitions offer comparable precision with greater economy of text. For example, a leading academic commentator on SWFs offers this more concise definition that largely encompasses the same group of funds:

[A] SWF [is a] government-owned and controlled (directly or indirectly) investment fund that ha[s] no outside liabilities or beneficiaries (beyond the government or the citizenry in abstract) and that invests [its] assets, either in the short or long term,

12. *Id.*

according to the interests and objectives of the sponsoring government.¹³

This definition, like the IWG definition, focuses on SWFs from an objective perspective—a SWF has or adopts certain characteristics and may explicitly ally itself with other funds, as in the case of the IWG, in order to promote a shared vision of what a SWF is and should be in the hope that regulators will provide standardized, predictable policy responses to SWF investment activity.

As I argue in this article, however, SWF investment activity is inherently fact intensive. As a descriptive matter, SWF investment has political and economic dimensions that do not fit into objective definitions attempting to contain a fund within a set of governance assumptions and investment practices. I take it that it is in respect of this context—in which scholars and SWFs themselves offer objective and even soothing connotations, while host countries often view SWFs as latent threats, irrespective of how the SWFs define themselves and irrespective of whatever best practices they agree to abide by—that Bassan offers the following definition:

SWFs are “funds established, owned and operated by local or central governments, which investment strategies include acquisition of equity interests in companies listed on international markets operating in sectors considered strategic by their countries of incorporation.”¹⁴

This definition seems closest to the mark for my argument here: SWF investments, and the regulation of such investments, are best understood within a fluid and dynamic political environment. In this dynamic environment, certainty will be difficult to achieve without two fundamental anchor points that I attempt to set out in the article. First, SWF investment objectives and governance activities must become both more transparent and more stable (from both the perspective of individual SWFs and in the aggregate). Second, host countries must provide the kind of transparency and predictability in regulation that they seek from SWFs as investors. The next Part builds a foundation for

13. Ashby H.B. Monk, *Is CalPERS a Sovereign Wealth Fund?*, ISSUE IN BRIEF (Ctr. for Ret. Research at Boston College, Chestnut Hill, MA), Dec. 2008, at 1, 4, available at <http://www.publicpensionsonline.com/public/images/CalPERS%20Sovereignty.pdf>.

14. BASSAN, *supra* note 7, at 9.

these points by setting out the available empirical evidence on SWF investing and corporate governance activity.

II. EVIDENCE ON SWF INVESTMENTS AND THEIR EFFECTS

Sovereign wealth funds are some of the largest funds in the world. Depending on the market, they may make up a large portion of the total equity holder base.¹⁵ In the U.S., sovereign wealth funds have invested broadly in many different companies. As of the end of 2009, for example, China Investment Corp. (“CIC”) held securities in over 60 different U.S.-listed companies.¹⁶

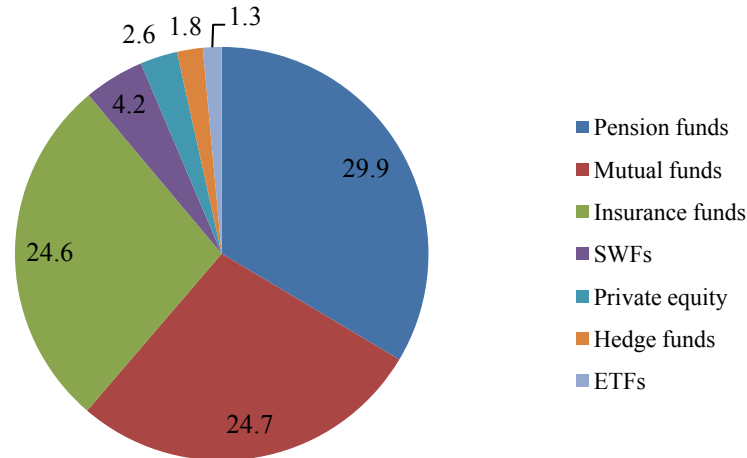
In general terms, sovereign wealth fund holdings as a group are smaller than “conventional” institutions, such as insurance companies, mutual funds, and pension funds, but in aggregate have significantly more assets under management than private equity funds and hedge funds (notwithstanding that they are prominent clients of both),¹⁷ and, because they are relatively few in number, tend to have a relatively larger amount of assets under management. The following chart shows the relative holdings of these different types of institutional investors:

15. Of the firms listed on the Italian Borsa, for example, SWFs are thought to control up to 36% of the total market capitalization. See Chiara Albanese, *Sovereign Wealth Funds Increase Exposure to Milan Stock Exchange*, INVESTMENT EUROPE (Nov. 8, 2012), <http://www.investmenteurope.net/investment-europe/news/2223332/sovereign-wealth-funds-weight-36-of-italys-stock-exchange-mps>.

16. See China Inv. Corp., Report for the Calendar Year or Quarter Ended: December 31, 2009 (Form 13-F) (Feb. 5, 2010), available at <http://www.sec.gov/Archives/edgar/data/1468702/000095012310009135/0000950123-10-009135.txt>.

17. See THECITYUK, FINANCIAL MARKETS SERIES: SOVEREIGN WEALTH FUNDS 3 (2012), available at <http://www.thecityuk.com/assets/Uploads/SWF-2012.pdf>.

**Global Fund Management Industry, AUM as of year-end 2011
(USD in trillions)¹⁸**



Source: TheCityUK

Popular reaction to SWFs has ranged from fears that SWFs are politically-motivated to a belief, noted earlier, that SWFs are ideal investors: patient, passive and deep-pocketed. Academics and think-tanks have produced a number of studies in recent years to test these varied notions.

As a general matter, SWFs are, in theory, the quintessential long-term investor. They can and do invest through a wide array of investment vehicles, including hedge funds, private equity funds, direct equity investments, fixed income products, real estate, and infrastructure.¹⁹ SWFs tend to invest like other large institutional investors, although some studies have detected political influences on SWF investing, such as home bias; many public pension funds face the same challenge of politicization.

Scholars have produced a number of studies in recent years analyzing SWF investment behavior, as well as market responses to investment behavior and the effect of sovereign investment on firm

18. *Id.* at 1 fig.2.

19. For example, Ohio State University recently leased its parking operations to QIC, a “leading provider of dynamic investment solutions for sovereign wealth funds, superannuation funds and other institutional investors.” *Who Is QIC?*, QIC DYNAMIC INV. SOLUTIONS, <http://www.qic.com.au/who-is-qic/> (last updated Mar. 31, 2013).

values. The following section reviews the literature studying the share price effects of investments by SWFs and other types of government-controlled entities.

A. SWF INVESTMENT ACTIVITY AND MARKET RESPONSES

A necessary caveat before reviewing the available literature on SWF investment activity: all empirical literature on SWFs must contend with very small sample sizes. This problem is sometimes overlooked as authors attempt to generalize the results of their study to SWFs as a group, even though only a relatively small number of funds were studied and the results may be entirely dependent on the activities of one or two funds. In this light, these studies are like pieces of a puzzle made from a partially developed photograph: they provide useful hints of SWF behavior, but they do not present a full and clear picture.

Keeping that limitation in mind, a number of studies have found that markets react positively to investments by SWFs and other government-controlled entities. Karolyi and Liao find that cumulative market-adjusted stock price reactions to announcements of cross-border acquisitions by government-controlled entities are significant and positive, with a median stock price jump of 6% during a 3-day announcement day window.²⁰ However, they find that SWFs, compared to other government-controlled entities, have significantly smaller (yet still positive) stock price reactions to announced investments.²¹ They suggest that although a number of countries—including the U.S. through recent amendments to its foreign investment regulation via the Foreign Investment and National Security Act of 2007 (“FINSA”)—have increased scrutiny and regulation of foreign investments and especially investments by foreign government-controlled enterprises; the market response to these investments indicates that heightened scrutiny may not be necessary.²² On the other hand, they note that the more tepid investor response to SWFs suggests that “[g]reater attention on SWFs as a particular type of acquirer may indeed be worthy of further scrutiny.”²³

20. See G. Andrew Karolyi & Rose C. Liao, *What Is Different About Government-Controlled Acquirers In Cross-Border Acquisitions?*, FONDAZIONE ENI ENRICO MATTEI [FEEM] 29 (2009) (It.).

21. See *id.* at 25.

22. See *id.* at 29.

23. *Id.* The authors note that they did not attempt to separate SWFs by transparency or governance characteristics.

Aside from SWFs, government-controlled acquirers in general receive the same market response as corporate acquirers.²⁴

Unlike the Karolyi study, Kotter and Lel attempt to account for differences in SWF governance and transparency in their evaluation of market reactions to SWF investments.²⁵ They find that SWFs, like corporate acquirers, target firms that are poorly performing, cash constrained, and financially distressed.²⁶ This effect is more prominent with transparent SWFs compared to more opaque SWFs.²⁷ Taken together, they find that the short-term stock price effect for SWF investment is positive, but increases as the SWF is increasingly transparent and the firm is increasingly distressed.²⁸ They also find evidence that SWFs tend to be passive shareholders because the performance and governance of the target firms do not change significantly over the long term.²⁹

Fernandes compiles and analyzes a large dataset of over 42,000 SWF investments in over 8,000 companies located within 58 countries.³⁰ He documents a positive short-term price response to SWF investment as well as longer-term improvements in target firm operating performance as measured by higher Tobin's Q, return on assets, return on equity, and higher operating returns.³¹ He notes that some of the "channels of impact" for SWFs include "better access to capital, monitoring, and access to foreign product[ion] markets."³² His evidence suggests that SWFs can make a significant positive contribution to long-term shareholder value.³³ Intriguingly, his study suggests that SWFs may even push for governance changes at certain firms, as evidenced by a significant change in the CEO turnover rate following large SWF

24. *See id.* at 30.

25. *See generally* Jason Kotter & Ugur Lel, *Friends or Foes? Target Selection Decisions of Sovereign Wealth Funds and Their Consequences*, 101 J. FIN. ECON. 360, 367–76 (2011).

26. *See id.* at 380.

27. *See id.*

28. *See id.*

29. *See id.*

30. *See* Nuno Fernandes, *Sovereign Wealth Funds: Investment Choices and Implications Around the World*, IMD INTERNATIONAL 11 (Mar. 2011) (unpublished manuscript), available at <http://ssrn.com/abstract=1341692>.

31. *See id.* at 13–24.

32. *Id.* at 31.

33. *See id.* at 30.

investments; this is notwithstanding the fact that most SWF investments do not involve partial or complete control of target firms.³⁴

Dewenter et al. also review stock price reaction to SWF investment, and find that the announcement of SWF investment tends to accompany a significant positive stock price response.³⁵ On the other hand, divestment by SWFs typically accompanies a significant negative stock price reaction,³⁶ which could suggest either that other shareholders believe that SWFs are aware of negative material, non-public information, or that firm value is expected to decline because the SWF will no longer add value through monitoring or lobbying services provided by the SWF.³⁷ They also find that the market response to SWF purchases varies with the size of the transaction: the positive price impact increases with the size of the investment up to a point, then begins to decline.³⁸ SWF divestments show the opposite effect, with price declining in relation to the size of the divestment, then increasing.³⁹ They also find that, similar to the theory suggested by Shleifer and Vishny with respect to large shareholding blocks generally, SWFs exhibit monitoring, influence, lobbying, and possibly tunneling.⁴⁰ Taken together, these effects suggest that shareholders view SWF investment as increasingly positive as the investments become large enough for the SWF to have an influence on the governance of the firm, but not so large that the SWF is able to tunnel or otherwise extract significant control benefits from the investment. Finally, Dewenter et al. note that relative SWF transparency, as measured by the SWF's Truman score, does not seem to be linked to stock price reactions, but that the Truman score may be positively related to long-term target performance.⁴¹

34. *See id.* at 25–26.

35. Kathryn L. Dewenter, Xi Han & Paul H. Malatesta, *Firm Values and Sovereign Wealth Fund Investments*, 98 J. FIN. ECON. 256 (2010).

36. *See id.* at 258–59.

37. *See id.*

38. *See id.* at 257.

39. *See id.*

40. *See id.* (citing Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997); Andrei Shleifer & Robert W. Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461 (1986)).

41. *See id.* at 269.

In a similar study, Sojli and Tham examine the effects of SWF investment on both the target firms and the sponsoring government.⁴² They find a positive market reaction to SWF and SOE investment, and find evidence to suggest that the positive reaction is related to expectations that SWFs will provide monitoring and access to foreign markets, as well as increased internationalization of the business.⁴³ As with the Fernandes study, Sojli and Tham draw the conclusion that the benefits to shareholders from foreign political connections outweigh the costs of private benefit extraction by the SWF at the expense of other shareholders.⁴⁴ The study results also suggest that SWF sponsor countries benefit from SWF investment through the transfer of know-how and certification of the SWFs home market.⁴⁵

Avedaño and Santiso address arguments that SWFs should be treated as non-governmental investors, such as hedge funds, pension funds, and mutual funds, by comparing SWF investment activity to investments by mutual funds.⁴⁶ They find that while SWFs do engage in different asset allocation strategies (an unsurprising result given that mutual funds tend to be specific asset-targeted investment vehicles, and SWFs tend to invest much more broadly, as would an endowment fund or a pension fund), the motives suggested by their investment choices do not appear to differ radically.⁴⁷ They also review the effect of the target country political regime on investment decisions, and find evidence that SWFs are again similar to mutual fund investments in that they do not make asset allocation strategies based on the political regime of a target company's domicile.⁴⁸

A few other studies have found negative results from SWF investment. Knill et al. document a statistically significant decrease in firm performance, a smaller but significant decrease in firm volatility,

42. See Elvira Sojli & Wing Wah Tham, *The Impact of Foreign Government Investments on Corporate Performance: Evidence from the U.S.* (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1540555&download=yes.

43. See *id.* at 14–16.

44. See *id.* at 29.

45. See *id.*

46. See Rolando Avedaño & Javier Santiso, *Are Sovereign Wealth Funds Politically Biased? A Comparison With Mutual Funds* (OECD Dev. Ctr., Working Paper No. 283, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1525545&download=yes.

47. See *id.* at 29.

48. See *id.*

and a statistically significant decrease in market returns.⁴⁹ They note, however, that media attention may drive the market return results because, they report, “cross correlations found in the media coverage sub-sample suggest that in their coverage of SWF news the media may be partly culpable for the very negative characteristics that they report to fear (i.e., destabilization).”⁵⁰ In a subsequent paper, Knill et al. also study the connection between political relations and investment allocation decisions.⁵¹ They find that, contrary to the predictions of most analyses of foreign direct investment, SWFs are more likely to invest in countries with which they have *weaker* political relations, although the significance of the findings are dependent on the particular bilateral relationship.⁵² They draw the conclusion that SWFs do not appear to make decisions as purely economic actors would —politics do appear to play a role in investment allocation decisions.⁵³ They also find evidence that while political relations play a role in determining which countries to invest in, politics plays no significant role in determining how much to invest.⁵⁴ SWF investment between relatively closed countries (such as China, India, and Indonesia) tends to improve political relations between the countries, while investment between open countries (such as France, Japan, the United Kingdom and the United States) tends to deteriorate political relations.⁵⁵

Johan et al. provide evidence that political relations may affect SWF investment decisions.⁵⁶ The study specifically looks at SWF investment in private equity firms, as some anecdotal evidence suggests that SWFs seek private equity investment as a way to insulate their investments from the scrutiny that might accompany a direct public

49. See April M. Knill, Bong-Soo Lee & Nathan Mauck, ‘*Sleeping with the Enemy*’ or ‘*An Ounce of Prevention*’: *Sovereign Wealth Fund Investments and Market Destabilization* 13–16 (Inst. for Monetary and Econ. Research, The Bank of Korea, Working Paper No. 404, 2009), available at <http://ssrn.com/abstract=1353131>.

50. *Id.* at 24.

51. See April Knill, Bong-Soo Lee & Nathan Mauck, *Bilateral Political Relations and Sovereign Wealth Fund Investment* 3 (Mar. 9, 2011), available at <http://ssrn.com/abstract=1498518>.

52. *See id.* at 27.

53. *See id.* at 27–28.

54. *See id.* at 28.

55. *See id.*

56. See Sofia Johan, April Knill & Nathan Mauck, *Determinants of Sovereign Wealth Fund Investment in Private Equity* 3–4 (TILEC Discussion Paper, No. 2010-044, 2011), available at <http://ssrn.com/abstract=1722206>.

equity investment.⁵⁷ Their results do not provide conclusive evidence that SWFs invest in private equity for political reasons, but do show a pattern of SWF investment that differs from other large investors.⁵⁸ They also document a difference in investment patterns between the most transparent SWFs—which are less likely to be investing for political reasons because of the increased visibility of both their investment decisions and their investment policies—and less transparent SWFs.⁵⁹ The study also provides evidence that SWFs do not seek private equity investment to take advantage of strong investor protection laws in the target firms’ jurisdiction; on the other hand, the evidence does allow for the interpretation that SWFs may use private equity investment to take advantage of lax investor protection laws “to fulfil [sic] political goals if required to do so.”⁶⁰ Taken together, the results suggest that SWFs use private equity investment as a means to mitigate or avoid negative attention related to their investments.⁶¹

Bortolotti et al. provide a comprehensive analysis of SWF investment behavior by examining SWF investment patterns by fund, industry sector, and geography.⁶² They find that SWFs tend to buy significant minority stakes directly from companies rather than through open-market purchases. The stock purchased tends to be issued expressly for the transaction and is available only to the SWF and no other investors.⁶³ This suggests that target firms actively seek SWF investment and that “funds become the allies of target-firm managers and are thus constrained from playing a meaningful disciplinary or monitoring role.”⁶⁴ They also note that SWFs face significant pressure from target firms’ jurisdictions to remain passive owners—in their phrasing, that they are “constrained foreign state investors.”⁶⁵ They document a positive stock price reaction to SWF investment in the

57. *See id.* at 3.

58. *Id.* at 22.

59. *See id.*

60. *Id.*

61. *See id.*

62. *See* Bernardo Bortolotti, Veljko Fotak, William L. Megginson & William F. Miracky, *Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity, and the Value of the Firm* 28 (Oct. 25, 2010) (unpublished manuscript), available at http://www.centrobaffi.unibocconi.it/wps/allegatiCTP/SWF-paper-RFS-Final-oct25_2010.pdf.

63. *See id.* at 28–29.

64. *Id.* at 29.

65. *Id.* at 9.

three-day window surrounding the SWF purchase.⁶⁶ However, contrary to other studies, they find significant and larger negative returns to SWF investments in the three years following the initial investment.⁶⁷ They find that SWFs rarely seek board seats, and that this effect is more pronounced with investments made in firms based in OECD countries.⁶⁸ Further, firm performance appears to deteriorate when SWFs take seats on target firm boards.⁶⁹ As with the Dewenter study, Bortolotti et al. find that the size of the SWF investment is important: long-run returns are negatively related to the size of the stake in the target firm, and are also negatively related to the size of the target firm.⁷⁰ Their results provide support for the notion that SWFs are constrained investors that are “especially reluctant to ‘interfere’ in target firm management by demanding high performance or by holding managers to account.”⁷¹

Finally, Paltrinieri and Pichler reviewed the portfolio choices of 56 SWFs to test whether they, like other institutional investors such as pension funds and mutual funds, invest to “maximise the risk-return ratio subject to the pursuit of specific institutional goals (stabilisation, saving, intergenerational transfer of wealth).”⁷² They find similar motivations in the medium- to long-term, but then find that some SWFs tend to display home bias, and that “[t]his [is] particularly evident for SWFs based in the U.S. and Europe, but was less obvious for Middle Eastern SWFs; Asia-Pacific region funds showed mixed behaviour.”⁷³

Taken together, several trends emerge from these studies. First, shareholders tend to view SWF investment positively, but also appear wary of political activity by SWFs. For their part, SWFs tend not to seek to engage in “controlling” behavior at firms in which they invest. There is some suggestion that SWFs will seek to avoid scrutiny of their investments, a suggestion that should not be surprising if, as I argue, SWFs are concerned with protectionist behavior by the countries in which they invest. Some SWF investment behavior also indicates political influence, although the influence tends to be directed to

66. *See id.* at 16.

67. *See id.* at 1.

68. *See id.*

69. *See id.*

70. *See generally id.*

71. *Id.* at 29.

72. Andrea Paltrinieri & Flavio Pichler, *Are Sovereign Wealth Funds Different?* 20 (unpublished manuscript) (on file with author).

73. *Id.*

domestic ends, such as “home bias” investments in local enterprises as a means to deploy capital to struggling local firms.

B. REGULATORY INDICATORS OF SWF INVESTMENT

1. CFIUS

The article now turns from investor reaction to SWF investment to regulatory indicators of SWF investment. While most of the studies reviewed above looked at SWF investment across various markets, this section will explore SWF investments in the U.S. While detailed data on U.S. investments by SWFs is somewhat limited,⁷⁴ the U.S. does make available summary information on sovereign investment generally (which includes investment not just by SWFs but also by state-owned or controlled enterprises). Foreign investments by state-owned or state-controlled enterprises are covered under the Defense Production Act of 1950⁷⁵ as amended by the Foreign Investment and National Security Act of 2001.⁷⁶ Under those statutes, parties to a “covered transaction,” which includes mergers, acquisitions, or takeovers by or with any foreign person that could result in foreign control of an entity engaged in interstate commerce, may file a voluntary notice filing with the Committee on Foreign Investment in the United States (“CFIUS”).⁷⁷ After receiving notice, a CFIUS staffer will determine whether the notice is complete and otherwise in compliance with the filing requirements, and, if so, will circulate the notice to all of the CFIUS members.⁷⁸ CFIUS then has thirty days in which to review the

74. As discussed in Part IV.A below, this is due in part to a lack of transparency by SWFs.

75. See 50 U.S.C. app. § 2170 (2006).

76. See Foreign Investment and National Security Act of 2007, Pub. L. No. 110-49, 121 Stat. 246 (to be codified in scattered sections of 50 U.S.C.).

77. See 50 U.S.C. app. § 2170(a)(3), (b)(1).

78. See *Process Overview*, U.S. DEP'T OF THE TREASURY, <http://www.treasury.gov/resource-center/international/foreign-investment/Pages/cfius-overview.aspx> (last updated Dec. 1, 2010, 8:08 AM). CFIUS includes the Secretary of the Treasury, the Secretary of Homeland Security, the Secretary of Commerce, the Secretary of Defense, the Secretary of State, the Attorney General of the United States, the Secretary of Energy, the Secretary of Labor (nonvoting, ex officio), the Director of National Intelligence (nonvoting, ex officio), and “[t]he heads of any other executive department, agency, or office, as the President determines appropriate, generally or on a case-by-case basis.” 50 U.S.C. app. § 2170(k)(2).

transaction.⁷⁹ The purpose of the review is to “identify and address, as appropriate, any national security concerns that arise as a result of the transaction.”⁸⁰ CFIUS members may ask the parties to provide additional information concerning the transaction.⁸¹ Most CFIUS reviews end favorably within the initial thirty-day review period.⁸² However, some transactions require a separate, more extensive investigation following or in lieu of the thirty-day review. A forty-five-day investigation is required for transactions that (1) threaten to impair the national security of the United States, and that threat has not been mitigated during or prior to a thirty-day review; (2) transactions involving a foreign government-controlled entity (including a SWF); (3) transactions that would result in control of any U.S. “critical infrastructure”⁸³ by or on behalf of any foreign entity, and CFIUS determines that the transaction could impair national security, and that the risk of impairment has not been mitigated by agreement with or assurances by the foreign entity; or (4) the lead agency tasked with review of the CFIUS’s advice recommends, and CFIUS concurs, that an investigation be undertaken.⁸⁴ If after review and/or investigation CFIUS determines that the transaction does not present an unmitigated national security risk and the President has not elected to take action on the transaction pursuant to his authority to so do under the statutes,⁸⁵ CFIUS grants the transacting parties a “safe harbor” for the transaction.⁸⁶

SWFs tend to avoid taking large stakes in U.S. businesses.⁸⁷ This is partly the case because of the broad definition of control set out in the Treasury’s regulations. Under those regulations:

79. See 50 U.S.C. app. § 2170(b)(1)(E).

80. See *Process Overview*, *supra* note 78.

81. See *id.*

82. See *id.*

83. “The term ‘critical infrastructure’ means, subject to rules issued under this section, 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.” 50 U.S.C. app. § 2170(a)(6).

84. See *id.* § 2170(b)(2).

85. See *id.* § 2170(d).

86. See 31 C.F.R. § 800.601 (2012); see also Exec. Order No. 12,661, 54 Fed. Reg. 779 (Dec. 27, 1988).

87. See *infra* Part II.B.2.

The term *control* means the power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity, board representation, proxy voting, a special share, contractual arrangements, formal or informal arrangements to act in concert, or other means, to determine, direct, or decide important matters affecting an entity; in particular, but without limitation, to determine, direct, take, reach, or cause decisions regarding . . . important matters affecting an entity.⁸⁸

SWFs operate under suspicion from many host country regulators, including CFIUS, and thus tend to avoid controlling or even influencing their portfolio companies. Undoubtedly, this suspicion is felt more strongly towards investments originating from countries that are political rivals than from countries that are allies. This is borne out by the following chart, which shows summary information regarding covered transactions (including transactions by SWFs) and the country of the bidder:

88. The regulations include a number of examples of behavior that might be deemed to constitute “control” for purposes of the statute, including: “(1) The sale, lease, mortgage, pledge, or other transfer of any of the tangible or intangible principal assets of the entity, whether or not in the ordinary course of business; (2) The reorganization, merger, or dissolution of the entity; (3) The closing, relocation, or substantial alteration of the production, operational, or research and development facilities of the entity; (4) Major expenditures or investments, issuances of equity or debt, or dividend payments by the entity, or approval of the operating budget of the entity; (5) The selection of new business lines or ventures that the entity will pursue; (6) The entry into, termination, or non-fulfillment by the entity of significant contracts; (7) The policies or procedures of the entity governing the treatment of nonpublic technical, financial, or other proprietary information of the entity; (8) The appointment or dismissal of officers or senior managers; (9) The appointment or dismissal of employees with access to sensitive technology or classified U.S. Government information; or (10) The amendment of the Articles of Incorporation, constituent agreement, or other organizational documents of the entity with respect to the matters described in paragraphs (a)(1) through (9) of this section.” 31 C.F.R. § 800.204(a) (2012).

Covered Transaction by Acquirer's Home Country/Economy, 2008-10 ⁸⁹				
Country/Economy	2008	2009	2010	Total
United Kingdom	48	17	26	91
France	12	7	6	25
Canada	6	9	9	24
Israel	12	5	7	24
Japan	8	4	7	19
China	6	4	6	16
Australia	11	1	3	15
Russia	8		4	12
Italy	5	2	3	10
Netherlands	2	4	2	8
Sweden		3	5	8
Germany	3	1	2	6
Switzerland	4		2	6
UAE	2	2	1	5
Lebanon	4			4
Spain	1		3	4
Hong Kong	1	1	1	3
Austria	2			2
Brazil	2			2
India	1		1	2

If one takes account of the size of the economies of these home countries, there seems to be relatively little correlation between the size of the economy (or the SWF, for those countries that have them) and the number of transactions involving foreign control of U.S. enterprises. By contrast, close political allies tend to dominate the top end of the list, with the UK-based enterprises engaging in nearly as many covered transactions as the next four countries combined.

89. COMM. ON FOREIGN INV. IN THE U.S., ANNUAL REPORT TO CONGRESS (2011) [hereinafter CFIUS ANNUAL REPORT].

2. 13D and 13G Filings

Section 13 filings also provide an important indicator of SWF investment behavior. Pursuant to Schedule 13D, 5% or greater beneficial owners must provide, among other things, their name, information about criminal and civil proceedings, the source of funds used or to be used in making purchases, and the purpose of the transaction.⁹⁰ The description of the purpose of the transaction must include discussion of any plans that relate to or would result in the acquisition of additional securities, changes in management or the board of directors, changes in the capital structure of the corporation, and changes in the articles and bylaws of the company. Schedule 13D must be filed within ten days of the acquisition.⁹¹

A Schedule 13D filing serves as a useful proxy to gauge whether an investor intends to use his investment power to influence a corporation. By contrast, a person who would otherwise be required to file under 13(d) may instead use the shorter Schedule 13G⁹² if the person “acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect,”⁹³ and the person falls under one of the enumerated categories of institutional investors set out in the rules under 13(d).⁹⁴ This list includes banks, investment advisers, investment companies, broker-dealers, insurance companies, or foreign entities that are “the functional equivalent of any of the institutions [listed above] so long as the non-U.S. institution is subject to a regulatory scheme that is substantially comparable to the regulatory scheme applicable to the equivalent U.S. institution.”⁹⁵ Schedule 13G requires many of the same identifying disclosures that are found on Schedule 13D, such as name, residence, and the amount of securities held by the filer, but does not require disclosure of the purposes of the transaction⁹⁶ (it being assumed that the purpose is for passive investment, and not for purposes of control and management of the

90. See 17 C.F.R. § 240.13d-1(a) (2012).

91. See *id.*

92. See *id.* § 240.13d-1(b).

93. *Id.* § 240.13d-1(b)(1)(i).

94. *Id.* § 240.13d-1(b)(1)(ii)(J).

95. *Id.*

96. See *id.* § 240.13d-102.

company). In contrast to the relatively short ten-day filing requirement under Schedule 13D, Schedule 13G need only be filed within forty-five days after the end of the calendar year in which the ownership exceeded (and at the end of the calendar year remains greater than) 5%.⁹⁷ Sovereign wealth funds and other governmental acquirers of listed securities file under both Schedule 13D and Schedule 13G, just as non-governmental acquirers do. The fact that SWFs do file under 13D demonstrates that at least in some instances SWFs are seeking or possess active influence, if not outright control, of listed companies. However, the chart⁹⁸ below, covering all 13D and 13G filings by the largest SWFs, shows that few SWFs make investments large enough to require a filing under either Schedule 13D or 13G.

Assets (\$Billion)	Fund Name	Country	SC 13D	SC 13G
\$ 627.0	Abu Dhabi Investment Authority	UAE -Abu Dhabi	0	2
\$ 593.0	Government Pension Fund – Global	Norway	6	24
\$ 482.0	China Investment Corporation	China	5	4
\$ 296.0	Kuwait Investment Authority	Kuwait	0	1

97. See *id.* § 240.13d-1(b)(2). As a proviso to this requirement, the rule also states that “if the person’s direct or indirect beneficial ownership exceeds 10 percent of the class of equity securities prior to the end of the calendar year, the initial Schedule 13G shall be filed within 10 days after the end of the first month in which the person’s direct or indirect beneficial ownership exceeds 10 percent of the class of equity securities, computed as of the last day of the month.” *Id.*

98. The chart is based on the Sovereign Wealth Fund Institute’s (SWFI) ranking of the largest sovereign wealth funds, and so makes use of the SWFI’s definition of a sovereign wealth fund. Under their definition, “[a] Sovereign Wealth Fund (SWF) is a state-owned investment fund or entity that is commonly established from balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, governmental transfer payments, fiscal surpluses, and/or receipts resulting from resource exports. The definition of sovereign wealth fund exclude (sic), among other things, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises (SOEs) in the traditional sense, government-employee pension funds (funded by employee/employer contributions), or assets managed for the benefit of individuals.” *What Is a SWF?*, SWF INST., <http://www.swfinstitute.org/sovereign-wealth-fund/> (last visited June 2, 2013).

\$ 157.5	Temasek Holdings	Singapore	0	12
\$ 100.0	Qatar Investment Authority	Qatar	0	3

III. SWF CORPORATE GOVERNANCE STRATEGIES AND RESPONSES TO REGULATION

Having reviewed available evidence on investor responses to SWF investment and regulatory indicators of significant SWF investments, the article now turns to evidence of SWF corporate governance engagement strategies, and then explains why SWFs tend to take a passive role in corporate governance with respect to their U.S. investments.

A. SWF STRATEGIES

Although some of the studies discussed above reviewed some aspects of governance engagement by SWFs (notably, Bortolotti et al. considered whether SWFs took board seats at companies in which they invested), the most comprehensive evaluation of SWF behavior in corporate governance is found in Mehrpouya, Huang and Barnett's comprehensive 2009 study⁹⁹ reviewing the proxy voting and engagement policies and practices of SWFs. The study examined the behavior of the largest ten SWFs: Abu Dhabi Investment Authority (ADIA), Australian Government Future Fund (AGFF), China Investment Corporation (CIC), Government of Singapore Investment Corporation (GIC), Kuwait Investment Authority (KIA), Libyan Investment Authority (LIA), Norway's Government Pension Fund Global (GPF), Qatar Investment Authority (QIA), Russian Reserve Fund (RRF) and National Wealth Fund (NWF), and Temasek Holdings (Singapore).¹⁰⁰ All but the Russian funds—RRF and NWF—held equity positions at the time of the study.¹⁰¹

Obtaining information on engagement and proxy voting is difficult because most countries do not require disclosure of shareholders' proxy

99. See AFSHIN MEHRPOUYA, CHAONI HUANG & TIMOTHY BARNETT, IRRIC INSTITUTE, AN ANALYSIS OF PROXY VOTING AND ENGAGEMENT POLICIES AND PRACTICES OF THE SOVEREIGN WEALTH FUNDS 30–41 (2009), available at http://www.irricinstitute.org/pdf/Sovereign_Wealth_Funds_Report-October_2009.pdf.

100. See *id.* at 15.

101. See *id.* at 55 fig.17.

votes.¹⁰² Most SWFs (like many other institutional investors) do not publish data on their proxy votes, though Norway's GPF is a notable exception to this rule; the authors were therefore required to search numerous public and proprietary sources¹⁰³ to find indications of SWF engagement and proxy voting behavior.¹⁰⁴ The authors looked at several markers of engagement, such as whether the SWF seeks board seats, whether it actively votes its shares, whether it makes other engagement efforts (such as direct contact with management), whether the SWF has proxy voting guidelines, and whether it discloses proxy votes.¹⁰⁵

A board seat would allow the SWF a more active role in management, but would create a heightened risk that the SWF would use its influence to extract private (and possibly political) benefits.¹⁰⁶ Unsurprisingly, the authors found little evidence of SWFs seeking board seats.¹⁰⁷ They found that when SWFs do hold board seats, the cases fall into two categories: the first where a SWF holds a large percentage of the outstanding shares or has historically held controlling stake,¹⁰⁸ and the second (rarer) case in which a SWF holds a non-controlling stake, but nevertheless secures a board seat.¹⁰⁹ They note two such instances, one of which involves an 8% shareholding in German company GEA Group by KIA, and the other a 10% holding in Beijing Capital International Airport by GIC.¹¹⁰

As noted above, most SWFs do not disclose their proxy policies. Of the ten largest SWFs, only GPF is disclosed its proxy voting

102. *See id.* at 21.

103. The study was supervised by RiskMetrics Group, Inc. (the parent company of proxy advisor Institutional Shareholder Services), which itself was under contract with the IRR Institute, both of which may be assumed to own or have access to proprietary information on shareholder voting practices.

104. *See* MEHRPOUYA, HUANG & BARNETT, *supra* note 99, at 21.

105. *See id.* at fig.9.

106. *See id.* at 21.

107. The result is unsurprising since, as the authors note, "due to the lack of disclosure on their board seat-seeking strategy, it is very difficult to assess to what extent SWFs either hold board seats or engage to appoint or approve board members." *Id.* at 22. But given the fact that SWFs tend to own relatively small blocks of shares, *see infra* Part III.B.7, it would also be surprising if SWFs were willing and able to secure board seats.

108. Temasek is an example of this type, "most likely due to the nature of Temasek as a vehicle to take over management of government assets." MEHRPOUYA, HUANG & BARNETT, *supra* note 99, at 22.

109. *See id.*

110. *See id.*

policies.¹¹¹ GPFG's proxy voting policies are based on guidelines from the OECD's Principles for Corporate Governance, the OECD's Guidelines for Multinational Enterprises, and the UN Global Compact.¹¹² The authors report that, while not disclosing detailed proxy voting policies, "[a] number of the funds, including KIA and Temasek indicate that they exercise their shareholder rights, including voting on resolutions, in order to protect their financial interests."¹¹³ In its most recent annual report (following the publication of the Mehrpouya, Huang and Barnett study), CIC also provides some discussion of its proxy voting and corporate engagement approach:

As a financial investor, we usually maintain a minority shareholder status and do not seek to control or influence investee companies. Nor do we always exercise our full ownership rights. When we do, we are consistent with our investment policy to protect the value of our investment. CIC continues to strengthen its postinvestment management process and strives to do what we can as a minority shareholder to help our investee companies achieve success. By helping these companies thrive, we also fulfill[sic] our own value creation objectives.¹¹⁴

As with proxy voting policies, only GPFG discloses actual proxy votes.¹¹⁵ This lack of transparency makes it difficult to ascertain whether SWFs behave similarly to other types of funds, such as pension funds, endowment funds, or mutual funds.¹¹⁶ Although a few countries, including Italy, require disclosure of actual proxy votes, there are insufficient investments in these jurisdictions with which to draw definitive conclusions about SWF proxy voting behavior.¹¹⁷ However, from interviews with some prominent SWF portfolio companies, the authors were able to determine that most SWFs exercise their proxy voting rights.¹¹⁸ They also noted examples of engagement with management.¹¹⁹ As suggested by the language from CIC's annual

111. *See id.*

112. *See id.*

113. *Id.*

114. CHINA INVESTMENT CORP., ANNUAL REPORT 2011, at 26 (2011), available at http://www.china-inv.cn/cicen/include/resources/CIC_2011_annualreport_en.pdf.

115. *See* MEHRPOUYA, HUANG & BARNETT, *supra* note 99, at 23.

116. *See id.* at 22.

117. *See id.* at 23.

118. *See id.*

119. *See id.*

report, SWFs may attempt to engage management in an effort to enhance the value of their investment.¹²⁰ In some cases, portfolio company managers have close relationships with SWFs.¹²¹ Norges Bank Investment Management, which manages GPF, has an extensive program that engages companies on corporate governance, environmental, human rights and other issues.¹²² The authors report that “[i]n 2008, NBIM engaged with 16 companies on corporate governance and shareholder rights; with 19 companies on child labor, risk management in the supply chain, and board competence; and with ten companies about their stance on greenhouse gas emissions.”¹²³ Aside from GPF and a handful of examples of engagement that are connected to large equity purchases, it is unclear to what extent SWFs attempt to take an active role in influencing management of their portfolio companies. The available evidence suggests that SWFs are passive investors. The following section seeks to explain why this is the case.

B. EXPLAINING SWF PASSIVITY

As Balding has stated, sovereign wealth funds operate at the intersection of money and politics.¹²⁴ This puts the managers of SWFs—who in some cases are bureaucrats with experience in the sponsor country’s central bank or ministry of finance, or in other cases professional managers recruited from private financial services firms—in a position that requires balancing of both domestic pressures (financial, such as the responsibility to meet an internal benchmark, and internal political pressures to invest locally) and foreign (political pressures from host governments). This section sets out the ways in which SWF managers respond to these pressures and shows how the investment behavior of SWFs is directly shaped by both foreign and domestic pressure.

120. As noted above, Fernandes argues that SWFs achieve this through channels of impact that include better access to capital, monitoring, and access to foreign product markets. *See* Fernandes, *supra* note 30, at 31.

121. MEHRPOUYA, HUANG & BARNETT, *supra* note 99, at 26.

122. *See id.* at 40.

123. *Id.* at 26.

124. *See* CHRISTOPHER BALDING, SOVEREIGN WEALTH FUNDS: THE NEW INTERSECTION OF MONEY & POLITICS (2012).

The numerous explanations for SWF passivity have been discussed amply elsewhere,¹²⁵ and only a brief review of these pressures is necessary here. The following is not a definitive list of the factors (and, particularly, regulations) that may affect ownership decisions, but does reflect the most important of these factors from the perspective of a sovereign wealth fund.

1. *Taxation of Sovereign Wealth Funds*

Under section 892 of the Internal Revenue Code, income earned by foreign governments on investments in the United States in stocks, bonds, or other domestic securities, financial instruments held in the execution of governmental financial or monetary policy, or interest on deposits in banks in the United States, is exempt from taxation.¹²⁶ This exemption does not apply to commercial activity, however, with the justification that as an extension of the doctrine of sovereign immunity, section 892's exemption should be limited to activities that are related to sovereign activities of the government, as opposed to commercial activities.¹²⁷ The definition of commercial activity under section 892 turns on whether income was received from a controlled commercial entity, a term defined to mean:

[A]ny entity engaged in commercial activities (whether within or outside the United States) if the government (i) holds (directly or indirectly) any interest in such entity which (by value or voting interest) is 50 percent or more of the total of such interests in such entity, or (ii) holds (directly or indirectly) any other interest in such entity which provides the foreign government with effective control of such entity.¹²⁸

125. See, e.g., Paul Rose, *Sovereign Wealth Funds: Active or Passive Investors?*, 118 YALE L.J. POCKET PART 104 (2008), <http://thepocketpart.org/2008/11/24/rose.html>.

126. See I.R.C. § 892 (2006).

127. This explicit distinction was codified by the Foreign Sovereign Immunities Act of 1976, 28 U.S.C. § 1602 (2006); for a discussion of the development of the Foreign Sovereign Immunities Act and Section 892, see N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON THE TAX EXEMPTION FOR FOREIGN SOVEREIGNS UNDER SECTION 892 OF THE INTERNAL REVENUE CODE 14–16 (2008), available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1157report.pdf>.

128. I.R.C. § 892(a)(2)(B).

Because “effective control” may come at shareholdings significantly below 50%, SWFs have a tax incentive to avoid making investments that might trigger tax liability under section 892.¹²⁹

2. *Regulation by the Committee on Foreign Investment in the United States*

As discussed above, CFIUS reviews every covered transaction in which a foreign government-controlled entity takes control of a U.S. firm. The definition of control is the crucial trigger in determining not only whether the transaction will be deemed a covered transaction, but, assuming the threshold of control is passed, whether it may result in a mitigation arrangement that reduces the ability of the foreign government-controlled entity to control the target firm. The Treasury regulations promulgated after the FINSA amendments to the Exon-Florio framework not only clarifies in what situations the investor might be deemed to have taken a controlling stake in a target firm, but also encourage interests acquired and held passively.¹³⁰ Section 800.302 of the regulations, which lists “[t]ransactions that are not covered transactions,” includes the following safe harbor:

(b) A transaction that results in a foreign person holding ten percent or less of the outstanding voting interest in a U.S. business (regardless of the dollar value of the interest so acquired), but only if the transaction is solely for the purpose of passive investment. (See § 800.223.)¹³¹

Although the 10% safe harbor provides some comfort, the Treasury also makes clear that holdings of less than 10% are not presumptively passive.¹³² The regulations further clarify that an ownership interest is

129. For arguments that SWFs should not receive the benefit of Section 892’s exemption, see Victor Fleischer, *A Theory of Taxing Sovereign Wealth*, 84 N.Y.U. L. REV. 440 (2009); for arguments that the exemption should stand, see Matthew A. Melone, *Should the United States Tax Sovereign Wealth Funds*, 26 B.U. INT’L L.J. 143 (2008) and Mihir A. Desai & Dhammika Dharmapala, *Taxing the Bandit Kings*, 118 YALE L.J. POCKET PART 98 (2008), <http://thepocketpart.org/2008/11/17/desaidharmapala.html>.

130. See 31 C.F.R. § 800.302(b) (2012).

131. *Id.*

132. See *id.* The regulations include the following examples:

Example 1. In an open market purchase solely for the purpose of passive investment, Corporation A, a foreign person, acquires seven percent of the voting securities of

held for the purpose of passive investment if “the person holding or acquiring such interests does not plan or intend to exercise control, does not possess or develop any purpose other than passive investment, and does not take any action inconsistent with holding or acquiring such interests solely for the purpose of passive investment.”¹³³

If an investment does not clearly fall within the safe harbor, CFIUS may require a mitigation agreement. Under the statute, “[CFIUS] or a lead agency may, on behalf of the Committee, negotiate, enter into or impose, and enforce any agreement or condition with any party to the covered transaction in order to mitigate any threat to the national security of the United States.”¹³⁴ There are two primary hurdles that CFIUS must overcome before entering into a mitigation agreement with a party undertaking a covered transaction. First, CFIUS must provide “a written analysis that identifies the national security risk posed by the covered transaction and sets forth the risk mitigation measures that the CFIUS member(s) preparing the analysis believe(s) are reasonably

Corporation X, which is a U.S. business. Assuming no other relevant facts, the acquisition of the securities is not a covered transaction.

Example 2. Corporation A, a foreign person, acquires nine percent of the voting shares of Corporation X, a U.S. business. Corporation A also negotiates contractual rights that give it the power to control important matters of Corporation X. The acquisition by Corporation A of the voting shares of Corporation X is not solely for the purpose of passive investment and is a covered transaction.

Example 3. Corporation A, a foreign person, acquires five percent of the voting shares in Corporation B, a U.S. business. In addition to the securities, Corporation A obtains the right to appoint one out of eleven seats on Corporation B’s Board of Directors. The acquisition by Corporation A of Corporation B’s securities is not solely for the purpose of passive investment. Whether the transaction is a covered transaction would depend on whether Corporation A obtains control of Corporation B as a result of the transaction).

Id.

133. 31 C.F.R. § 800.223 (2012). This section also contains the following illustration:

Example. Corporation A, a foreign person, acquires a voting interest in Corporation B, a U.S. business. In addition to the voting interest, Corporation A negotiates the right to appoint a member of Corporation B’s Board of Directors. The acquisition by Corporation A of a voting interest in Corporation B is not solely for the purpose of passive investment.

Id.

134. 50 U.S.C. app. § 2170(l)(1)(A) (2006). The statute also states that “[a]ny agreement entered into or condition imposed under subparagraph (A) shall be based on a risk-based analysis, conducted by the Committee, of the threat to national security of the covered transaction.” *Id.* § 2170(l)(1)(B).

necessary to address the risk.”¹³⁵ CFIUS must then, as a committee, agree that “risk mitigation is appropriate and must approve the proposed mitigation measures.”¹³⁶ Second, “CFIUS may pursue a risk mitigation measure intended to address a particular risk only if provisions of law other than section 721 do not adequately address the risk.”¹³⁷ If, for example, another statute or set of regulations, such as the National Industrial Security Program Operating Manual (“NISPOM”) adequately mitigates the risk posed by the investment, then CFIUS would not enter into a separate mitigation agreement.¹³⁸

When analyzing the investment and governance behavior of SWFs, generalizations often conceal important issues arising between specific SWFs and home countries. While CFIUS lets the overwhelming majority of transactions pass through review without requiring a further investigation or imposing a mitigation agreement,¹³⁹ the earlier analysis of the bilateral behavior of acquisition activity originating from certain SWF sponsor countries (particularly China) suggests caution in viewing the CFIUS process as overwhelmingly successful for foreign investors. For which SWF is CFIUS review most likely to be successful? It seems

135. Guidance Concerning the National Security Review Conducted By the Committee on Foreign Investment in the United States, 73 Fed. Reg. 74,567 (Dec. 8, 2008) [hereinafter CFIUS Guidance]. With respect to the identification of risk, Executive Order 11,858 (as amended by Executive Order 13,456) clarifies that the assessment of risk must be “based on factors including the threat (taking into account the Director of National Intelligence’s threat analysis), vulnerabilities, and potential consequences.” Exec. Order No. 13,456, 73 Fed. Reg. 4,677, 4,679 (Jan. 23, 2008). Mitigation agreements are (and are intended to be) rare. As discussed in the Treasury’s guidance, “CFIUS may not, except in extraordinary circumstances, require that a party to a transaction recognize, state its intent to comply with, or consent to the exercise of any authorities under existing provisions of law.” CFIUS Guidance, *supra* at 74,568 n.4. Between 2008 and 2010, CFIUS received 313 notices of covered transactions. Of these, ninety-three resulted in investigations, and only sixteen resulted in mitigation agreements. CFIUS ANNUAL REPORT, *supra* note 89, at 3.

136. CFIUS Guidance, *supra* note 135, at 74,568.

137. *Id.*

138. *See id.* at 74,568–69.

139. *See* David Zaring, *CFIUS as a Congressional Notification Service*, 83 S. CAL. L. REV. 81, 87 (2009) (quoting Alan Holmer of the U.S. Treasury as explaining to a Chinese audience that “less than 10 percent of all foreign direct investments were reviewed by [CFIUS], and the vast majority of those were resolved without controversy, including those by state-owned enterprises.” Press Release, Alan F. Holmer, Special Envoy for China, U.S. Dep’t of Treasury (May 21, 2008), available at <http://beijing.usembassy-china.org.cn/052108p.html>).

obvious that it is likely to be more successful for SWFs from countries that are not political rivals with the United States. It should not come as a surprise that CFIUS might view an acquisition by a Chinese SWF differently from an acquisition by a large Canadian pension fund. China poses concerns for the U.S. government that Canada or Norway does not. What is problematic, however, is the perception—and perhaps reality—that Chinese investment is actively discouraged. This concern is particularly worrisome when the U.S. political climate tends to reward such discouragement; this is perhaps most likely to be the case in an election year, when charges of being soft on China or other political or economic rivals become especially pronounced. Suspicions of this brand of politicization were recently expressed by Gao Xiqing, the Cice Chairman and President of China Investment Corporation, who according to reports said that “when CIC seeks to invest in the United States, despite the fact that U.S. infrastructure is in pretty dire straits, he is politely asked to look elsewhere, even when the investment represents only a small stake.”¹⁴⁰ No doubt referring to CFIUS, Gao stated that while roadblocks to investment in the United States appear to be technical in nature, they are in reality political: “It’s not serendipity, it’s by design.”¹⁴¹ The U.S. regulatory structure thus presents an irony: while U.S. regulations have actively promoted shareholder engagement (to take just two recent examples, through the SEC’s failed efforts to promote proxy access and Dodd-Frank’s say-on-pay regulations), the CFIUS rules work against engaged SWF investment.

3. Securities Regulations

Several securities regulations may also impact the extent of a SWF’s holdings in U.S. listed companies. As noted above, holdings of over 5% of a company’s outstanding stock may necessitate disclosures as dictated by sections 13G or 13D of the Exchange Act of 1934.¹⁴² A more important limitation, not unique to SWFs but acting as a deterrent to large block holdings generally, is section 16 of the Exchange Act. Section 16 has two relevant components. First, section 16(a) imposes

140. Len Costa, *China Investment Corp.’s Gao Xiqing: Economy “Still on Right Track”*, CFA INST. (Oct. 9, 2012), <http://blogs.cfainstitute.org/investor/2012/10/09/china-investment-corp-s-gao-xi-qing-economy-still-on-right-track/>.

141. *Id.* (internal quotations omitted).

142. *See supra* Part III.A.2.

potentially burdensome disclosure obligations on any person who beneficially owns more than 10% of any class of equity security.¹⁴³ Beneficial ownership of shares may be determined by reference to the definition under Exchange Act Rule 13d-3, which, among other things, links ownership investment and voting rights over the shares.¹⁴⁴ Section 16 reporting includes the filing of Form 3¹⁴⁵ once section 16's 10% threshold has been passed; statements of changes in the beneficial ownership of the shares under Form 4,¹⁴⁶ and an annual statement filed under Form 5.¹⁴⁷

Second, section 16(b) imposes what is known as the “short-swing profit rule”, which forces disgorgement of any profits made by the section 16 filer on any sale and purchase, or purchase and sale, within a given six-month period.¹⁴⁸ Unlike the Exchange Act's general antifraud provision, section 10(b),¹⁴⁹ the section 16 filer need not be in possession of material or non-public information, and need not have acted with scienter. Indeed, through the matching rules under section 16(b), a series of trades need not produce a profit to result in liability; only a single matched pair, within a six-month time frame, need show a profit.¹⁵⁰ As Bernard Black has noted, “[t]hese rules create a strong incentive not to cross the 10% threshold. The forfeiture rules greatly

143. See Securities Exchange Act of 1934 § 16(a), 15 U.S.C. § 78p(a) (2006).

144. See Rule 13d-3 provides that:

For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or, (2) Investment power which includes the power to dispose, or to direct the disposition of, such security.

General Rules and Regulations Under the Securities Exchange Act of 1934, 17 C.F.R. § 240.13d-3(a) (2012). The rules also provide that persons will be deemed to have beneficial ownership of a security if they have the right to acquire a security through the exercise of options, warrants, conversion rights, or pursuant to the automatic termination of or the power to revoke a trust, discretionary account, or similar arrangement. *Id.* § 240.13d-3(d).

145. See Initial Statement of Beneficial Ownership of Securities (Form 3), available at <http://www.sec.gov/about/forms/form3.pdf>.

146. See Statement of Changes in Beneficial Ownership (Form 4), available at <http://www.sec.gov/about/forms/form4.pdf>.

147. See Annual Statement of Changes in Beneficial Ownership of Securities (Form 5), available at <http://www.sec.gov/about/forms/form5.pdf>.

148. See Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p (2006).

149. See Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j (2006).

150. See, e.g., *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir. 1943).

reduce a shareholder's liquidity, and the reporting burden is substantial, especially for a large institution which is frequently buying and selling."¹⁵¹

Black also cites additional federal securities regulations that generally discourage investors from becoming a "control person,"¹⁵² including the limitations on the sale of stock imposed by Rule 144 of the Securities Act¹⁵³ and potential liability for the corporation's activities under section 15 of the Securities Act of 1933 and section 20 of the Exchange Act of 1934. The SEC defines control very broadly, so that ownership amounting to as little as 10% might be considered a control stake for purposes of the statutes and regulations.¹⁵⁴

151. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 545 (1990).

152. The term "control person" is not defined in the Securities Act of 1933 or the Exchange Act of 1934, but Rule 405 under the Securities Act provides the following:

The term *control* (including the terms *controlling*, *controlled by*, and *under common control with*) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

General Rules and Regulations Under the Securities Act of 1933, 17 C.F.R. § 230.405 (2012).

153. See *id.* § 230.144(e)(1) (imposing on "affiliates" a limitation on the number of shares that may be sold in a given 3-month period to the greater of one percent of the outstanding shares or the average weekly trading volume during the four prior calendar weeks). Under Rule 405 of the Securities Act, an "affiliate" is defined as "a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified." *Id.* § 230.405. The SEC determines whether a person is an affiliate through a fact-specific inquiry that focuses on the Rule 405 definition of control cited above, which keys on the power to direct or cause the direction of management and the policies of the company. A filing with the SEC is required if the affiliate intends to sell in excess of 5,000 shares or securities with a value over \$50,000. *Id.* § 230.144(h).

154. Black notes:

The standard practitioner's advice is that a 10% holding "should create caution" and might even "creat[e] a rebuttable presumption of control, especially if such holdings are combined with executive office, membership on the board, or wide dispersion of the remainder of the stock." Thus, control person liability adds an additional strong impediment to a shareholder or group owning more than 10% of a company's stock.

Black, *Shareholder Passivity Reexamined*, *supra* note 151, at 549 (quoting A.A. Sommer Jr., *Who's "in Control"?*—S.E.C., 21 BUS. LAW. 559, 568 (1966)).

4. Transaction Costs and Headline Risk

As I have argued elsewhere, transaction costs may have an effect on a SWFs' investment decisions.¹⁵⁵ If navigating the CFIUS process requires significant expenditures of effort by the SWF and its attorneys, or the SWF fears that the transaction may become politicized, it may choose to invest elsewhere or to limit the scope of the investment so as to avoid creating a risk that the transaction would be closely investigated by CFIUS and, possibly, ultimately blocked.¹⁵⁶ Some deal-making behavior by SWFs may be characterized as a kind of regulatory arbitrage,¹⁵⁷ as SWFs limit investments to ownership levels so as to avoid CFIUS filings and attention, securities regulations, or other regulations or internal governance provisions¹⁵⁸ that might trigger increased costs for the SWF.

Transaction costs also play another very important role in encouraging SWF passivity: they encourage SWFs to avoid appearing political in their investment and governance decisions. This may be viewed as "headline risk" for SWFs. SWFs are already viewed with suspicion by many regulators, and publicity suggesting that a sovereign

155. See Paul Rose, *Sovereign Wealth Fund Investment in the Shadow of Regulation and Politics*, 40 GEO. J. INT'L L. 1207, 1207–08 (2009).

156. CFIUS rarely recommends that a transaction be blocked, and the president even more rarely issues an executive order blocking foreign acquisitions. In fact, 2012 saw the first blocked transaction since 1990. See Rachele Younglai, *Obama Blocks Chinese Wind Farms in Oregon Over Security*, REUTERS (Sept. 28, 2012, 7:15 PM), <http://www.reuters.com/article/2012/09/28/us-usa-china-turbines-idUSBRE88R19220120928> ("This . . . is the first time since 1990 that the president of the United States has either blocked a transaction from occurring or divested a transaction that has occurred," said Clay Lowery, a former assistant secretary at Treasury who oversaw the CFIUS process and now is with Rock Creek Global Advisors.").

157. See Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 247 (2010).

158. One example of a governance provision that might affect SWFs is the shareholder rights plan (or, as they are more commonly known, a "poison pill") designed to protect net operating losses (NOLs). Essentially, the pill is designed to protect a NOL tax asset of the corporation that might be jeopardized under tax laws in the event of a change in the beneficial ownership of the corporation. Mark D. Gertstein et al., *Lessons From the First Triggering of a Modern Poison Pill: Selectica, Inc. v. Versata Enterprises, Inc.*, LATHAM & WATKINS LLP M&A COMMENTARY, Mar. 2009, at 2, available at http://www.lw.com/upload/pubContent/_pdf/pub2563_1.pdf. A defining feature of NOL pills is their low trigger point: typically any purchase of 5% or more of the company's shares will trigger the pill, compared to a typical poison pill trigger of 10-20%. *Id.*

is using its SWF for political purposes can have a profound effect on the costs of SWF investment; alarmist portrayals of SWF investment activity routinely ignore these headline risks and the ways that they impact large, diversified portfolios. Imagine, in an extreme scenario involving national security, that a SWF decided to use an investment in a U.S. firm as a tool of espionage. An SWF makes an investment in a company and begins to pressure the company for information on certain operations or products. Leaving aside potential violations of Regulation FD,¹⁵⁹ if a company were to share such information, what would be the effects? First, CFIUS may be triggered, and the investment could be frozen or unwound. Second, and more devastatingly, regulators would take an interest in every other investment made by the SWF. Other home countries' regulators, seeing that a SWF investment was used for political purposes, would apply enhanced scrutiny to existing investments¹⁶⁰ and proposed investments, and countries would likely consider protectionist regulations governing SWF investment. All of these effects would dramatically increase the cost of investment by the SWF: increased legal fees, increased managerial time and effort in explaining investment decisions, and potential losses as the SWF is forced to forego or unwind some investments and instead shift funds to less attractive opportunities.

In a more likely scenario, a SWF may invest for more benign strategic purposes—arguably, for political purposes in the sense that the investment extends beyond purely commercial gains for the SWF itself and serves to further some political end, such as food security or the support of a local industry. Some of the research reviewed above

159. Regulation FD prohibits selective disclosure to certain shareholders of material, non-public information. Regulation FD, 17 C.F.R. §§ 243.100–03 (2012). In the hypothetical, one may imagine that the company's executives might attempt to keep their disclosure secret. Similar issues arise with Regulation FD. While it is possible, a company has less incentive to pass along this information than they might in the typical Regulation FD context, in which companies would pass along information in order to garner favor with certain analysts. Arguably, however, a company would be less inclined to serve as the political instrument of a foreign government, especially in cases involving the transfer of the company's technology.

160. As an example of this effect's magnitude on other investments, consider that as of year-end 2009, China Investment Corporation owned shares in over sixty companies listed in U.S. markets, and surely owned stock in dozens, perhaps hundreds, of companies worldwide. China Inv. Corp, Report for the Calendar Year Ended: December 31, 2009 (Form 13F) (Feb. 5, 2010), *available at* <http://www.sec.gov/Archives/edgar/data/1468702/000095012310009135/c95690e13fvhr.txt>.

suggests that some SWFs have invested strategically. It is helpful to distinguish here between strategic investing that implicates the national security of host nations and strategic investing that does not, since the U.S. regulatory structure (and most other host country regulations of foreign investment activity) restricts activity that implicates the host country's national security, but does not restrict strategic activity that might be politically beneficial to the SWF sponsor country without impacting the national security of the host country. Examples of such strategic investing may include establishing links to resource-producing or extracting firms as a means of buttressing resource supplies, or investing in a firm in order to acquire know-how (for example, a relationship with a private equity firm may enable a SWF to learn valuable investment techniques). Assuming such investments are not prohibited by CFIUS—e.g., there is no unmitigated national security risk—why, then, does the U.S. not see more such investments from China and other political rivals? One explanation is that even when investments do not create national security risk, the use of a SWF for any purpose that suggests a double-bottom line, whether in the United States or not, creates headline risk not just for the SWF but also for U.S. regulators, who may be wary of the perception that U.S. firms are part of a politically strategic investment program. Or, more simply, the strategic use of a SWF—CIC, for example, or even other nationally-sponsored funds from the same country, such as the China-Africa Development Fund—may provide political cover to U.S. politicians who would like to discourage investment for their own political purposes.

5. *The Santiago Principles*

By design, the IWG's "Generally Accepted Principles and Practices," ("GAPP") more commonly known as the "Santiago Principles,"¹⁶¹ are designed to affect SWF investment behavior. The Santiago Principles were intended, among other things, "to continue to demonstrate—to home and recipient countries, and the international financial markets—that the SWF arrangements are properly set up and investments are made on an economic and financial basis."¹⁶² The principles are non-binding, however, and many host countries remain suspicious of SWF motives.

161. SANTIAGO PRINCIPLES, *supra* note 11, at 3–6.

162. *Id.* at 4.

The Santiago Principles contain two principles that are especially relevant to this article. The first, GAPP 19, relates to SWF investment decisions.¹⁶³ The second, GAPP 21, relates to SWF participation in corporate governance.¹⁶⁴

GAPP 19 states that “[t]he SWF’s investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.”¹⁶⁵ The baseline policy position of the Santiago Principles is commercial, non-strategic investing. However, Subprinciple 19.1 provides SWFs with some liberty to deviate from purely return-based investing: “[i]f investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.”¹⁶⁶ Notwithstanding this liberty, the commentary on this subprinciple does not discuss strategically-oriented deviations from return-based investing. It instead references deviations due to “legally binding international sanctions and social, ethical, or religious reasons,”¹⁶⁷ and specifically mentions Kuwait, New Zealand and Norway, which all have internally restrictive investment policies.¹⁶⁸ The commentary goes on to state that “[m]ore broadly, some SWFs may address social, environmental, or other factors in their investment policy. If so, these reasons and factors should be publicly disclosed,”¹⁶⁹ a vague principle that would arguably encompass some kinds of strategic behavior provided the strategic policy is disclosed.

GAPP 21, which addresses governance, states:

SWFs view shareholder ownership rights 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

163. *See id.* at 22.

164. *See id.* at 23–23.

165. *Id.* at 22.

166. *Id.*

167. *Id.*

168. *See infra* Part III.B.6 for a discussion of Norway’s internal investment restrictions.

169. SANTIAGO PRINCIPLES, *supra* note 11, at 22.

to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.¹⁷⁰

The commentary explains:

SWFs' demonstrated ability to contribute to the stability of global financial markets results in part from their ability to invest on a long-term, patient basis. The exercise of voting rights is seen to be important by some SWFs for their capacity to hold assets and preserve value rather than becoming a forced seller and, by definition, a shorter-term investor. The exercise of ownership rights is also seen by some SWFs as a mechanism for keeping the management of a company accountable to the shareholders, and thus contributing to good corporate governance and a sound allocation of resources.¹⁷¹

6. *Internal Political Constraints*

Some SWFs, and perhaps particularly those founded in democratic regimes, may come under pressure to conform their investment and corporate governance practices with the governance preferences of the public. As Norway's GPF-G explains,

[I]nvestors should also share responsibility for how the companies in which they invest are conducting themselves, for what they are producing and for how they are treating the environment. The Government deems it important to integrate this type of responsibility into the management of the Government Pension Fund, because it promotes values that are important to the

170. *Id.*

171. *Id.* at 22–23. The Commentary continues:

To dispel concerns about potential noneconomic or nonfinancial objectives, SWFs should disclose ex ante whether and how they exercise their voting rights. This could include, for example, a public statement that their voting is guided by the objective to protect the financial interests of the SWF. In addition, SWFs should disclose their general approach to board representation. When SWFs have board representation, their directors will perform the applicable fiduciary duties of directors, including representation of the collective interest of all shareholders. To demonstrate that their voting decisions continue to be based on economic and financial criteria, SWFs could also make appropriate ex post disclosures.”

Id. A review of the compliance of ten large SWFs with GAPP 19 and 21 shows that all ten were in full compliance with GAPP 19, while four were not in compliance, three were in partial compliance, and three were in full compliance with GAPP 21. MEHRPOUYA, HUANG & BARNETT, *supra* note 99, at 60.

Norwegian people, and because it represents an important contribution to raising awareness amongst investors and companies domestically and abroad.¹⁷²

As a more general matter, the ability to engage in corporate governance correlates with long-term investment. Internal political pressures may make long-term investment objectives more difficult to obtain. As Dixon and Monk argue,¹⁷³ sovereign investors may have difficulty explaining performance results and investment strategies to their constituencies. But even when funds attempt to provide higher-quality disclosure, explanation, and education regarding results and investment policies, “such a strategy still may prove ineffective and be trumped by the salience of and desire for short-term performance metrics.”¹⁷⁴ Additionally, “domestic opponents of a country’s SWF could utilize the poor performance to reinforce their argument against the existence of the fund or the fund’s strategy.”¹⁷⁵ These concerns may lead SWFs to adopt a short-term investment approach, and/or decrease transparency to avoid signaling investment strategies.

7. Institutional Constraints

Finally, most SWFs have two significant internal constraints which limit their effectiveness in corporate governance. The first is structural, and it is simply the reality that unlike private equity firms and some hedge funds, SWFs are typically designed to act as broad-based investors that tend to follow the tenets of modern portfolio theory, which prescribes diversification of investments across various asset classes. The very structure of SWFs—often, as decreed by the governing documents of the SWF—is designed to limit the SWF’s investments in equity to relatively small positions as part of a larger portfolio that includes numerous asset classes. This does not prevent SWFs from engaging in activism, of course; pension funds generally invest

172. Norwegian Ministry of Finance, *On the Management of the Government Pension Fund in 2006* ¶ 4.1.1 (2007), available at http://www.regjeringen.no/pages/1966215/PDFS/STM200620070024000EN_PDFS.pdf.

173. See Adam D. Dixon & Ashby H.B. Monk, *Reconciling Transparency and Long-Term Investing Within Sovereign Funds*, 2 J. SUSTAINABLE FIN. & INVESTMENT 275 (2012).

174. *Id.* at 280.

175. *Id.*

similarly, for example, and many are active shareholders in governance matters. However, because they hold relatively small amounts of any given company in the portfolio, SWF managers may believe that they have relatively little economic incentive to engage in shareholder activism.¹⁷⁶

The second structural concern with SWFs' ability to engage in corporate governance matters is that SWFs tend to be relatively thinly staffed, and more importantly, it appears that none (with the exception of Norway's GPF) invest in governance matters by creating specialized internal governance-focused groups. To be sure, the absolute ratio of staff to assets is not dispositive on the issue of whether the SWF will be able to engage in governance. In 2010, GPF had a staff of only 217 employees and \$322 billion in assets and engaged extensively in governance activities,¹⁷⁷ while the Qatar Investment Authority had a staff of 110 and assets of \$60 billion and did not engage in governance.¹⁷⁸ However, the many reasons suggested above for why SWFs are passive and reluctant to engage in governance also help to explain Norway's interest in governance. Most particularly, Norway is a democracy in which the population holds relatively strong views on social issues, and yet the country is not viewed as a political rival or potential threat to host countries. At the same time, most other SWFs come from non-democratic (or less democratic) regimes, and some are viewed as political rivals to host countries. Both domestic and international politics are inseparably linked to the ability and will of SWFs to engage in corporate governance.

IV. TOWARD BI-LATERAL TRANSPARENCY IN SOVEREIGN INVESTING

As SWFs continue to acquire equity interests in the United States and around the world, questions concerning their proper role in

176. Some scholars, most notably James Hawley and Andrew Williams, have argued that some large institutional investors hold a "small but highly diversified cross section of publicly traded stock (and debt) in the economy, and therefore, have the characteristic of representing the entire economy." JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM: HOW INSTITUTIONAL INVESTORS CAN MAKE CORPORATE AMERICA MORE DEMOCRATIC* 17 (2000). These investors are thus, in Hawley and Williams' theory, "universal owners." and cannot escape poor corporate governance by divesting from particular companies. They thus have an incentive to push for "good governance" across markets. *Id.*

177. See MEHRPOUYA, HUANG & BARNETT, *supra* note 99, at 42.

178. See *id.*

corporate governance will continue to arise. SWFs have many reasons to remain overly passive. Some may even hesitate to exercise their basic voting rights. This is unfortunate, however, because SWFs are designed to be long-term investors and should be well-incentivized to provide an important voice in corporate governance matters. How then, can SWFs manage to avoid the political and regulatory ramifications that would likely arise from efforts to engage in corporate governance? In this section, I outline two key roles for transparency and how it links to the role of SWF in corporate governance. First, SWFs must become more transparent in their investment decision-making and corporate governance activities. Second, and equally important, regulators must be more transparent in how they deal with SWFs.

A. SWF TRANSPARENCY

Because of concerns with the potential politicization of SWFs, regulators and observers have called on SWFs to become more transparent in how they invest and in how they engage with their portfolio companies—for example, how SWFs vote proxies and disclose proxy-voting policies. Others have attempted to provide benchmarks to encourage transparency. The Sovereign Wealth Fund Institute, for example, publishes the Linaburg-Maduell Transparency Index, which rates SWFs on ten measures of transparency.¹⁷⁹

Transparency can be evaluated across a number of dimensions. Dixon and Monk identify five: political transparency (the fund's objectives and relationship with the sponsoring government); procedural transparency (governance and decision-making procedures); policy transparency (internal fund operations and policies); operational

179. The criteria are:

(1) the fund provides history including reason for creation, origins of wealth, and government ownership structure; (2) the fund provides up-to-date independently audited annual reports; (3) the fund provides ownership percentage of company holdings, and geographic locations of holdings; (4) the fund provides total portfolio market value, returns, and management compensation; (5) the fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines; (6) the 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; (9) the fund manages its own website; (10) the fund provides main office location address and contact information such as telephone and fax.

Linaburg-Maduell Transparency Index, SWF INST., <http://www.swfinstitute.org/statistics-research/linaburg-maduell-transparency-index> (last visited June 2, 2013).

transparency (implementation of investment strategies); and performance transparency (fund outcomes, benchmarking, and risk profile).¹⁸⁰ All of these aspects relate to and build upon one another, and all have an impact on the ability of a SWF to engage in activism, as well as signaling what kind of activism the SWF might engage in. For example, political transparency equates to disclosure of fund motives, as well as disclosure of the relationship of the sponsor government to the SWF. These disclosures help establish confidence that the SWF will be used for commercial purposes. If there is no political transparency, host country regulators will be inclined to examine transactions more carefully because of the risk that the SWF will act non-commercially, and may put in place mitigation agreements (as is not uncommon in the U.S.) that limit the ability of a SWF to engage in governance. Lack of transparency thus creates external pressures on SWFs that manifest themselves through increased regulatory scrutiny and attendant transaction costs. On the other hand, transparency may also invite scrutiny of a fund's holdings and investment practices, which in turn can create internal popular or political pressures on the fund to alter its practices. Transparency thus reduces investment frictions, but may also enhance domestic pressures on the SWF.

While transparency is connected to corporate governance engagement, obscurity is linked to passivity and disengagement. This may be a conscious trade-off for many funds: they are willing to forego corporate governance activities in order to avoid unwanted attention by either foreign regulators or by politicians, bureaucrats, or citizens of their own country. It is certainly also the case that even if all SWFs were highly transparent, some SWFs would still not engage in governance. First, they may not believe that the benefits of engaging in corporate governance efforts outweigh the costs. Alternatively, they may choose to free-ride off the efforts of other investors and avoid the costs of engagement. For some SWFs, however, engagement has costs that extend beyond those expended by other investors because SWFs present risks that most other investors do not. Some kinds of engagement may be risky for SWF investors in U.S. firms because of the reach of CFIUS. The U.S. Treasury regulations implementing FINSIA broadly define "control" to encompass activities in which an investor has the ability to "determine, direct or decide important matters

180. See Dixon & Monk, *supra* note 173, at 281–82.

affecting an entity”¹⁸¹ including major transactions, closing or relocating operations, dividend payments, equity and debt issuance, selection of new business lines, entry or termination of significant contracts, appointment and dismissal of senior officers, or amending the articles of incorporation.¹⁸² These matters typically fall far outside the range of actions that even the most active shareholders would engage in (excepting transactionally-oriented activist hedge funds), but what about aggressively criticizing pay practices at a firm? Or asking a company to cease dealing with companies in certain countries? These activities would seem to invite scrutiny, even if the engagement falls comfortably within “mere influence” and does not suggest control. In other words, if SWFs engage as “activist” investors, they may worry that they will not be treated like other investors. Further, the reality faced by SWFs is that risks presented by sovereign investment differ from one SWF to another; U.S. regulators likely do not consider the risks presented by Chile or Norway’s SWFs to be equivalent to the risks presented by China’s. Thus, the range of governance activities that may be undertaken by Norway’s GPFG with respect to U.S. firms would be far greater than what could be undertaken by China’s CIC.

If SWFs are concerned about signaling investments and practices to the market, it is possible in the U.S. to selectively disclose some information to regulators without disclosing it to other parties. The SEC provides a limited exemption for institutional investors who would be otherwise required to disclose all of their holdings under Form 13F.¹⁸³ The exemption is intended to protect investment strategies, and so is limited as to duration (one year) and is generally not used for a large number of stocks because the SEC requires that “[i]f confidential treatment is requested as to more than one holding of securities, discuss each holding separately unless the Manager can identify a class or classes of holdings as to which the nature of the factual circumstances and the legal analysis are substantially the same.”¹⁸⁴ The SEC also requires filers to describe, among other things, the investment strategy being followed, why public disclosure of the securities would be likely to reveal the investment strategy, and an explanation of how failure to

181. 31 C.F.R. § 800.204 (2012).

182. *See id.*

183. *See* Information Required of Institutional Investment Managers (Form 13F), available at <http://www.sec.gov/about/forms/13f.pdf>.

184. *Id.* at 2.

grant the request for confidential treatment would likely cause substantial harm to the filer. The exemption does not contemplate political motivations for requesting confidential treatment, such as the desire to avoid domestic political pressures.

Unfortunately, most SWFs are not filing 13Fs at all, let alone filing confidential treatment requests for portions of their holdings. Only two foreign-based SWFs, Norway's GPF and Singapore's Temasek Holdings, have filed recent 13Fs.¹⁸⁵ As will be discussed in the next section, SWFs are treated differently from other investors by regulators. However, in this instance, most SWFs are not acting like other investors, and because of their status as entities controlled by a sovereign government, the SEC is limited (by politics, if not by legal authority) in its ability to enforce its rules against them.

B. ENHANCING REGULATORY TRANSPARENCY

Just as regulators and some observers call for more transparency from SWFs, SWFs and other observers have raised the need for enhanced transparency from regulators. The risk of SWF politicization has been amply discussed, but equally important is the risk that politicians and regulators from countries in which an SWF seeks to invest will use the cover of "national security" review to prohibit SWF investment. In each case, SWF investment has become politicized. This is not to ignore the reality that SWFs are, indeed, unlike other investors in important ways, and that regulatory structures must be adapted to take these differences into account. However, reciprocal transparency helps to facilitate both the investment decision by the SWF and the analysis of national security risk (if any) by the regulator.

Lawyers who regularly advise foreign investors (not only SWFs, but any foreign investor that would be subject to a CFIUS investigation) are familiar with the transactional frictions that mark the current CFIUS process. An opinion piece written by two attorneys, Stephen Paul Mahinka and Sean P. Duffy, outlines these challenges.¹⁸⁶ The piece

185. Complete lists of all 13Fs filed by Norges Bank and Temasek Holdings can be found through SEC's EDGAR recording system. See *Filings & Forms*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/edgar/searchedgar/companysearch.html>.

186. See Stephen Paul Mahinka & Sean P. Duffy, *CFIUS Review Needs Greater Transparency*, INT'L FIN. L. REV., Oct. 11, 2012, available at http://www.morganlewis.com/pubs/CfiusReviewNeedsGreaterTransparency_IFLR_11oct12.pdf.

notes that CFIUS could reduce the uncertainty surrounding its reviews and investigations by “providing brief general summaries of the bases for its determinations with respect to proposed transactions.”¹⁸⁷ CFIUS provides little clarity to its proceedings except through the annual report provided to Congress, a portion of which is made public. As described above, this report provides general statistics about notices submitted, investigations and reviews initiated, industries involved, and the nationalities of the bidders. The public report does not provide any information regarding specific transactions or the mitigation agreements that may have been entered into as a consequence of an investigation. Mahinka and Duffy compare this opacity with other agencies:

In contrast, numerous US regulatory and enforcement agencies, including the Department of Justice Antitrust Division and the Food and Drug Administration, commonly provide public statements describing their decisions, while accommodating confidentiality concerns. Any similar brief summaries of Cfius’ parameters of decision would necessarily be circumspect, in view of security concerns and the need to protect the Agency’s deliberative process. Nonetheless, it is difficult to conclude that US government, foreign government, foreign investors and acquirers, and indeed Cfius itself, would not be better served by a short statement of the parties to the transaction, the industry involved, and the Agency’s general rationale for its determination. Such transparency, which would require an amendment of the Agency’s statute, would enhance the predictability and likely the legitimacy of Cfius’ decisions, enabling both US sellers and foreign investors and acquirers to better gauge Cfius’ probable concerns and more efficiently undertake investments in US businesses.¹⁸⁸

The recent *Ralls* suit shows the difficulty in obtaining clarity on CFIUS decisions. On July 25, 2012, CFIUS issued an order identifying national security risks associated with the acquisition by Ralls of wind farms located near a U.S. navy facility.¹⁸⁹ Ralls, a subsidiary of Sany, China’s largest machinery manufacturer, filed a complaint against

187. *Id.*

188. *Id.*

189. See Letter from Aimen N. Mir, CFIUS Staff Chair, Dep’t of the Treasury, to Stephen Heifetz & Todd J. Guerrero (July 25, 2012), available at <http://www.volokh.com/wp-content/uploads/2012/09/July-CFIUS-Order.pdf>.

CFIUS on September 12.¹⁹⁰ The complaint sought, among other things, an order and judgment declaring that CFIUS violated the APA; that CFIUS lacks the authority to issue an order prohibiting the Ralls transaction or regulating future transactions not resulting in foreign control of a person, and enjoining CFIUS from attempting to do so; and an order and judgment declaring “arbitrary and capricious” CFIUS’s determinations that the Ralls transaction falls within CFIUS jurisdiction and that it presents national security risks.¹⁹¹ Ralls then filed a motion on September 13 seeking a temporary restraining order and preliminary injunction.¹⁹² Ralls argued that to avoid irreparable harm it needed to resume construction by September 20, which would allow the company to finish construction by the end of the year and be eligible to claim \$25 million in federal tax credits.¹⁹³ The suit was thought to have little chance of success, but did have some interesting implications:

The plaintiffs challenge CFIUS’s procedures for reviewing transactions. Ralls objects to CFIUS’s failure to provide any “evidence or explanation for its determination[s]” that the transaction was a “covered transaction” (and thus under CFIUS jurisdiction), that the transaction poses national security risks, and that those risks cannot be mitigated by less-restrictive means than the overbroad (in Ralls’ view) measures in the amended order. The challenges should be understood in the context that CFIUS review is generally confidential (CFIUS does not disclose even the fact that a review was requested). When CFIUS has a national security concern, the Committee will often explain to parties that there is evidence of a national security concern but, in the interest of national security, the Committee often will not share the reasoning or evidence with the parties. Here, Ralls is complaining about the inability to hear or understand the issues. If successful, the suit could increase the transparency of the review—such as a requirement that the Committee articulate for the parties its justification for orders beyond a bare finding of “national security risk.” It could also open the door for CFIUS to explain the reasons for recommending to the President that a transaction poses national

190. See Complaint for Declaratory and Injunctive Relief, *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, No. 1:12-cv-01513 (D.D.C. Sept. 12, 2012), ECF No. 1.

191. See *id.* at 21.

192. See Motion for Temporary Restraining Order and Preliminary Injunction, *Ralls Corp. v. Comm. on Foreign Inv. in the U.S.*, No. 1:12-cv-01513 (D.D.C. Sept. 13, 2012), ECF No. 7.

193. See *id.* at 2.

security threats. If this were to come to pass, such disclosure could open the door to fruitful mitigation discussions.¹⁹⁴

Unfortunately for Ralls, on the recommendation of CFIUS, President Obama issued an order blocking the transaction, and by statute the order is not reviewable.¹⁹⁵ As noted above, however, there are important justifications for enhanced transparency of CFIUS actions, particularly when the transparency takes the form of a short public statement setting out the reasons for the action. As stated by Mahinka and Duffy, more disclosure of the bases for its recommendations would make CFIUS reviews and investigations more predictable and provide foreign investors with a better sense of the types of investments that are likely to create national security concerns.¹⁹⁶ More generally, an explanation of its actions would help inoculate CFIUS against claims that its decisions are susceptible to political manipulation, and that increased frictions for certain deals, particularly from political and economic rivals, are not “by design.”¹⁹⁷

More disclosure is not a panacea for politicization of SWF investment, and it is crucial to recognize the limits of transparency. Transparency does not eliminate political influence in business transactions, just as more transparency through campaign finance laws does not eliminate business influence in political elections. But transparency can raise the costs of improper behavior. In the case of CFIUS rulemaking, a statement accompanying an action would require CFIUS to provide principled reasons for its determinations, which could then be evaluated by the public and other nations. The U.S. has much to gain from eliminating politicized treatment of foreign investments, and could take a lead in providing a stable foreign investment environment that would strengthen the U.S. case when it demands similar treatment for U.S.-based firms investing in foreign markets.

194. Vinson & Elkins, *Chinese Energy Developer Sues Committee on Foreign Investment in the United States (CFIUS) for Blocking Oregon Wind-Farm Investment on National Security Grounds*, V&E CFIUS AND NATIONAL SECURITY REVIEW E-COMMUNICATION, Sept. 17, 2012, available at <http://www.velaw.com/resources/ChineseEnergyDeveloperSuesCFIUSBlockingOregonWindFarmInvestment.aspx>.

195. See Regarding the Acquisition of Four U.S. Wind Farm Project Companies by Ralls Corporation, 77 Fed. Reg. 60,281 (Sept. 28, 2012).

196. See Mahinka & Duffy, *supra* note 186.

197. See Costa, *supra* note 140.

C. CREATING SPACE FOR SWFs IN CORPORATE GOVERNANCE

As noted at the outset, complete passivity may be detrimental to SWFs and the firms in which they invest. On the other hand, regular, active engagement may not be necessary or even desirable for all SWFs. But if SWFs are indeed investing for the long term, how can they play a meaningful role in corporate governance? In this Part, I will outline ways in which even the most constrained SWF can find space to play an important role in corporate governance matters: a role that is not problematically passive, but does not create regulatory risks for the SWF.

As noted above, Treasury rules restrict what may be called “positive” or “offensive” governance.¹⁹⁸ Positive or offensive governance efforts are typified by engagement with management on social issues, governance changes, and even business matters. Examples of positive governance outcomes include board nominations, shareholder proposals, and advice on business strategies. Most of the shareholders classified as “activist”, including activist hedge funds, and even some labor union and public pension funds, are engaged in positive governance efforts. Positive governance efforts, especially those resulting in strategy changes and changes on board composition, are more likely to create regulatory concern because they increase the risk that the SWF is using or could use its influence for non-commercial purposes.

For SWFs that are viewed by U.S. regulators as presenting more significant political risks, positive governance is not a realistic option, even if the SWF intends to only engage in what it believes are shareholder value-producing governance efforts. However, the same SWFs may be able to focus on “negative” or “defensive” shareholder rights.¹⁹⁹ Examples of defensive or negative governance include merger approvals, exercise of voting rights, approval or ratification of

198. See Paul Rose, *Qatar Holdings an “Activist Investor”?*, THE STATE CAPITALIST BLOG (Sept. 17, 2012), <http://www.statecapitalist.org/2012/09/17/qatar-holdings-an-activist-investor/>. The typology of “offensive” and “defensive” activism described here borrows from research on hedge fund activism by Brian R. Cheffins and John Armour in *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 53 (2011).

199. See Rose, *supra* note 198. See also Paul Rose, *Qatar Holdings and SWF Passivity*, THE STATE CAPITALIST BLOG (July 2, 2012), <http://www.statecapitalist.org/2012/07/02/qatar-holdings-and-swf-passivity/>.

transactions in which there is self-dealing, and the creation of bounded governance structures, such as supermajority approval requirements for certain transactions or for certain governance changes. Negative or defensive governance is typified by rules creation and approval of major events, but passivity with respect to most corporate governance matters.

Qatar's SWF provides a useful recent example of negative governance. Qatar Holdings, an investment vehicle of the Qatari SWF, owned approximately 13% of Xstrata, a large mining company with operations around the world.²⁰⁰ Glencore, a large commodities trading and mining company, sought to merge with Xstrata. Glencore held shares in Xstrata, but because the deal required approval by a majority of disinterested shareholders, Qatar Holdings' ownership block was sufficient to successfully block the merger. Qatar Holdings engaged in lengthy discussions with Glencore and Xstrata, and consistently held out for a better deal over months of negotiations (which it succeeded in getting, even though it was not as much as Qatar Holdings had hoped to gain). Some viewed Qatar Holdings' efforts as "activist" investing.²⁰¹ However, the SWF was not engaged in positive governance, which is typified by efforts to catalyze change. Indeed, they were acting as a roadblock, as a check on a management decision that was exceedingly material to their investment.

Significantly for SWFs, negative governance efforts are implicitly granted a safe harbor by the Treasury rules. The Treasury rules state that various activities which fall under the definition of negative governance outlined above will not trigger the "control" definition under FINSA, including (1) the power to prevent the sale or pledge of all or substantially all of the assets of an entity; (2) the power to prevent an entity from entering into contracts with majority investors or their affiliates; (3) the power to prevent an entity from guaranteeing the obligations of majority investors or their affiliates; (4) the power to purchase an additional interest in an entity to prevent the dilution of an investor's pro rata interest; and (5) the power to prevent the change of

200. Jill Treanor, *Xstrata investor refuses to back miner's £140m merger pay package*, THE GUARDIAN, Nov. 15, 2012, <http://www.theguardian.com/business/2012/nov/15/xstrata-glencore-merger-qatar-holding>.

201. See, e.g., Richard Levick, *Game-Changer: Qatar Plays Historic Role in Glencore's Bid for Xstrata*, FORBES, Sept. 12, 2012; see also Max Nisen, *Watch Out For This Dangerous New Type Of Activist Investor*, BUS. INSIDER (Sept. 6, 2012, 2:49 PM), <http://www.businessinsider.com/watch-out-for-this-dangerous-new-type-of-activist-investor-2012-9>.

existing legal rights or preferences of the particular class of stock held by the SWF.²⁰² As I have argued elsewhere, this regulatory posture makes good sense from a policy perspective, because negative rights do not tend to divert management authority away from the directors and officers, but instead place limits on the ability of directors and officers to impair the rights or interests of the negative right-holder. On the other hand, positive rights necessarily involve the exercise of management influence or power, which is precisely the kind of activity that one might worry about with SWFs, i.e., that management is influenced to do something that inures to the political benefit of the SWF. Exercising positive rights makes you an activist, but exercising negative rights makes you a responsible shareholder.²⁰³

While positive governance activities may raise suspicion with regulators, depending on the political relations between the host country and the SWF sponsor country, negative governance efforts merely set limits to or check managerial behavior,²⁰⁴ and are less likely to concern regulators. These are generalities, of course, that will not hold for every SWF investing in the United States. Particular decisions by SWFs with respect to corporate governance are intensely context-specific. A given SWF must consider the effects of its activism on numerous parties, including corporate managers and other shareholders, host country regulators, home country citizens, and regulators in other countries in which the SWF has or invested or may invest in the future. The political relationship between the SWF sponsor country and the host country plays a large role in shaping governance behavior, as does economic necessity (a desperate host country may welcome investments that it would otherwise prefer to discourage; see, for example, the investments by numerous SWFs in U.S. financial institutions in 2008–09).²⁰⁵ Finally, layered on to these factors, internal pressures may encourage certain types of engaged governance behavior, as with Norway’s environmental and social shareholder activism.

202. See 31 C.F.R. § 800.204(c) (2012).

203. See Rose, *Qatar Holdings an “Activist Investor”?*, *supra* note 199.

204. Examples of negative governance include merger approvals, exercise of voting rights, approval or ratification of transactions in which there is self-dealing, and the creation of bounded governance structures, such as supermajority approval requirements for certain transactions or for certain governance changes. Negative governance is typified by rules creation and approval of major events, but passivity with respect to most other management decision-making.

205. See Rose, *supra* note 155, at 1230–36.

CONCLUSION

SWFs as a group are still finding their way as investors. While some SWFs are very sophisticated investors, others are still developing their investment capabilities. So it is with SWF engagement in corporate governance. While a few SWFs have sophisticated governance engagement programs in place, most do not invest in corporate governance. I have argued that this consequence is not solely the result of SWF choices, however; regulatory frameworks in the U.S. and elsewhere discourage engagement by SWFs. This is not to say that all SWFs should engage in positive corporate governance. However, they should at least have the ability to effectively engage in negative governance efforts, and markets and regulators should expect SWFs to engage in such efforts.

Available empirical evidence indicates that markets tend to welcome minority SWF investment, but some studies suggest the presence of suspicions that SWFs will engage in tunneling or political activities. SWFs can alleviate these suspicions by enhancing transparency of when and how they engage in corporate governance efforts. Regulators can promote engagement and responsible sovereign investing by providing greater transparency regarding their regulatory efforts.