Sovereign Shareholder Activism: How SWFs Can Engage in Corporate Governance

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Introduction

As the number of, and assets controlled by, sovereign wealth funds (SWFs) has increased dramatically in recent years, so too has scrutiny about how SWFs are making use of these assets. With respect to equity investments in publicly traded firms, one facet of this concern is that SWFs will become "activist" shareholders. Notwithstanding genuine concerns about how governments exercise political power through economic entities, two threshold issues must be addressed before one can develop and evaluate proper policy responses to sovereign shareholder activism.

First, SWFs are often viewed through a single paradigm when, in reality, SWFs differ along many dimensions, including the way in which they are organized, their legal status, and their stated policies.[1] Even if one sets aside differences in internal governance and legal status, each SWF operates in unique political environments, and geopolitical realities affect their use and the ways in which they are viewed by other countries. For instance, Australia may view an investment by China's CIC as very different from an investment by Norway's GPF-G, even if the investment is for an identical 3% interest in an Australian company. Likewise, Italy may view an investment from the Alberta Heritage Fund as qualitatively different from an investment by the Russian National Wealth Fund, even though the same Italian regulatory framework may be used to analyze each investment. That SWFs are quite different and that they operate in very different political contexts is well known to asset managers, most SWF researchers, and of course, SWF officials, but these important distinctions are often lost when SWF activity is reported in the press and even in some academic literature.

[1] Capapé, Javier and Guerrero Blanco, Tomas, More Layers than an Onion: Looking for a Definition of Sovereign Wealth Funds (June 1, 2013). SovereigNET Research Papers; ESADE Business School Research Paper No. 21. Available at SSRN: http://ssrn.com/abstract=2391165 or http://dx.doi.org/10.2139/ssrn.2391165.

The second problem, which has received less attention, is one of equivocation on important terms in corporate governance, and particularly equivocation on the term "activism." Understanding the different forms of shareholder activism that occur today gives insight into how sovereign investors can engage in corporate governance while minimizing the risk of adverse regulation by host countries.

Types of Activism

Activism is linked to the increasing importance of corporate governance, a phrase that itself "only came into vogue in the 1970s in a single country–the United States—[and] became within 25 years the subject of debate worldwide by academics, regulators, executives and investors."[2] Even as recently as the 1990s, institutional investors spent relatively little on corporate governance matters, and the most prominent activist investors were "gadfly" individual investors that took stakes in companies in order to agitate for governance—and frequently, social—changes at publicly traded companies. Corporate governance has taken on increased importance for institutional investors for a variety of reasons, including enhanced focus on governance issues by regulators, as well as the rise of the corporate governance industry and proxy advisory services such as Institutional Shareholder Services. More recently, hedge funds have become important activist investors by pushing for governance and tactical changes at companies around the world.

The types of activism engaged in by hedge funds and most other institutional investors, such as public pension funds, differ in important ways. These differences are important to highlight when considering how sovereigns could (and perhaps should) engage in corporate governance. As Cheffins and Armour have recently noted, hedge funds tend to engage in what they term "offensive" shareholder activism. Offensive activism is typically event-driven: the offensive activist agitates for change at the company, seeking to squeeze out value that, in the view of the activist, may be locked up in a subsidiary or in cash reserves. Under what has become a traditional strategy, the activist may seek to force the company to (among other things) spin off a subsidiary or pay a special dividend.

An important feature of successful offensive activist campaigns has been the ability of the hedge fund to convince other shareholders, including relatively more passive shareholders such as mutual funds, pension funds and other large institutional investors, to support the hedge fund. Often, the hedge fund will seek approval of the strategy by proxy advisors, who can help influence large institutions. Supporting hedge funds does not make the other investors

[2] Cheffins, Brian R., The History of Corporate Governance (December 1, 2011). OXFORD HANDBOOK OF CORPORATE GOVERNANCE, Mike Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev, eds., Oxford University Press, 2013; University of Cambridge Faculty of Law Research Paper No. 54/2011; ECGI - Law Working Paper No. 184/2012. Available at SSRN: http://ssrn.com/abstract=1975404 or http://dx.doi.org/10.2139/ssrn.1975404.

"activists"—they were not the ones instigating the change, after all—but simply means that the offensive activists' value-creation story was convincing to other shareholders.

In contrast to the offensive activism of hedge funds, some large institutional investors are engaged in "defensive" activism. The defensive activist monitors the firm not to seek ways to force value-creating changes, but to prevent losses from mismanagement. In other words, whereas offensive activism is designed to produce wealth in the short to medium term, defensive activism is designed to protect wealth in the long term. It is this type of defensive, "accountability" activism that is most commonly associated with large public pension funds and even some sovereign wealth funds. Norway's NBIM, which manages the Government Pension Fund – Global, provides perhaps the best example of this sort of activism among SWFs. In 2013, for example, NBIM submitted three shareholder proposals requesting access to the corporate proxy, which would enable a shareholder that has held 1% of the company's outstanding common stock for one year to nominate one director for the company's board of directors.

Moving Beyond the Passivity Paradigm

In contrast to these two types of activist shareholders, most shareholders are largely passive. They may choose not to exercise their shareholder rights at all, or simply to follow any management proposal. Many SWFs fit in this category. This passivity is attributable to the fact that SWFs tend to be what Bortolotti et al. have termed "Constrained Foreign State Investors" that "will refrain from taking an active corporate governance role in target companies in order not to generate political opposition or a regulatory backlash."[3] Even efforts to influence (as opposed to control) companies may result in dramatic regulatory consequences. For example, a SWF that pressures a poorly-performing CEO to step down could subject its investment in the company to review and even divestment under U.S. law.

And yet, a consensus appears to be developing that large institutional investors, including SWFs, should be aware of corporate governance issues at their portfolio companies, even if they choose not to actively attempt to influence management. Because they are long-term investors and often under political and regulatory scrutiny that makes them less likely to sell, SWF capital tends to be captive capital. Thus, protecting long-term returns by monitoring governance is a priority for many sovereign investors.[4] The difficulty for most SWFs, then, is how to hold mangers accountable without selling or directly engaging in ways that would concern regulators.

[3] Bortolotti, Fotak, Megginson and Miracky, Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity, and the Value of the Firm**,** FEEM Note di Lavoro 22.2009. Available at http://www.baffi.unibocconi.it/wps/allegatiCTP/SWF-paper-RFS-Final-oct25_2010.pdf.

[4] I note, however, that there is mixed evidence that active influence by institutional investors results in stronger performance, and no evidence that influence by public investors results in stronger performance. However, I am not

Fortunately for SWFs, the market for corporate influence in many countries has become sufficiently robust that portfolio companies with poor governance tend to be targeted early by activist investors; in other words, SWFs typically need not worry about initiating governance engagement, at least with firms that have significant institutional investor ownership. Hedge funds and, not infrequently, pension funds may be already pressuring a poorly-performing corporate management. Because SWFs are often large but passive blockholders, they can exert significant influence simply through the exercise of their voting rights.

While this kind of corporate governance engagement may seem like governance free-riding, it is more accurate to think of it as riding on a reduced fare; the SWF will incur some costs in developing robust policies and procedures for the exercise of voting rights. The effort is essential, however, because if SWFs fail to exercise their rights as shareholders they risk creating a monitoring deficit that has the perverse effect of entrenching poor managers.[5] This risk is increasingly relevant as SWFs take larger minority positions.

SWF should be as transparent as possible about how they intend to use corporate governance rights. For example, a SWF may believe, as NBIM does, that companies should apply the principle of one share, one vote, so that a shareholder's voting rights and dividend payments reflect the size of his or her shareholding.[6] Publishing such governance and voting policies, on the Internet and in annual reports, provides an important signaling effect to companies and other shareholders. It also provides a strong signal to the sponsor sovereign and its citizens of the quality of governance at the SWF itself. Moreover, so long as the SWF merely exercises its voting rights and does not directly try to influence the company, it is unlikely to run afoul of host country regulations. As the Santiago Principles make clear in GAPP 21, transparency with respect to the exercise of corporate governance rights helps to "dispel concerns about potential noneconomic or nonfinancial objectives."

Many SWFs will not choose to engage portfolio companies as Norway has (and indeed, the political reality is that many SWFs would invite unwelcome regulatory scrutiny if they did so). But all SWFs can and should develop a stated policy on corporate governance issues, even if the SWF believes that it, like most mutual fund companies, will generally support management.

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advocating influence through defensive activism, but merely engagement through normal governance mechanisms, including shareholder voting.

[5] This hypothesis finds support in Bortolotti, Bernardo, Fotak, Veljko and Megginson, William L., The Sovereign Wealth Fund Discount: Evidence from Public Equity Investments (September 17, 2013). Baffi Center Research Paper No. 2013-140; FEEM Working Paper No. 22.2009. Available at SSRN: http://ssrn.com/abstract=2322745 or http://dx.doi.org/10.2139/ssrn.2322745.

[6] Norges Bank Investment Management, Equal Treatment of Shareholders (accessed May 2014) . Available at http://www.nbim.no/en/responsibility/responisble-investments/equal-treatment-of-shareholders/.