The Corporate Governance of Sovereign Wealth Funds

Posted by Yaron Nili, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Thursday August 7, 2014 at 9:07 am

Editor's Note: The following post comes to us from Maria Cristina Ungureanu, a Corporate Governance Advisor at Sodali.

Initiatives of shareholder engagement must take into consideration the modern, complex nature of share ownership. Shareholders can no longer be considered as a single group, instead the shareholder base may include a range of institutional investors, hedge funds, private equity funds, sovereign wealth funds and other activist investors. There has been a significant transformation of institutional holdings in recent years, and company boards will need to adjust their behaviour and the nature in which these engage with these new categories of investors.

Among the most recent and interesting entrants on the activist scene have been the Sovereign Wealth Funds (SWFs), particularly from Asia and Middle East. Although SWF are long-term investors and the ability to engage in corporate governance correlates with such approach, SWFs have traditionally been passive investors.

A few years ago barely anyone was talking about SWFs, but over the last few years the term has become common in the economic vocabulary. In the same time, scientific interest in SWF, in particular literature on their economic impact, has been quite recent. In the past there has been a lot of scepticism and resentment over SWF taking stakes in companies all over the world, and for this reason SWFs have preferred taking a low profile. Their passive approach as shareholders was also aimed at avoiding claims that, through them, foreign governments would attempt to influence strategic industries in other countries. Aside from political pressure, the institutional structure of SWFs also generates certain constraints, limiting their effectiveness in corporate governance.

This partly explains why investor activism and corporate governance are still ripe and, only very recently, an emerging trend within the SWF framework. So far, SWFs have rarely aimed for board seats or interfering with the risk, internal audit or remuneration policies of the issuers.

The three investment types (private equity, hedge funds and SWFs) generally follow different business models hence their behaviour and investor expectations vary. Investment behaviours appear to have encouraged private equities towards the engagement in governance issues, differently from the SWF approach.

Most SWFs have so far been regarded as passive investors with little direct involvement in management business and strategy, while private equity and hedge funds have portrayed a much more activist investment style. SWFs' long-term agenda not only has financial goals, but also national economic policy objectives. Exit strategies also impact differently: for private equities these are important and part of the investment strategy, while SWFs do not have a defined strategy. The reward strategy for fund managers is different as well: private equities consider them as high performance-based compensation, while, again, SWFs do not have defined compensation strategies. The strategy envisaged for the target company also plays an important factor: in most cases private equities have a growth, turnaround or restructuring strategy while the SWFs have a strong interest in long-term competitive and financial base of the company.

Nonetheless, similar to private equities, the SWFs typically have a long-term investment horizon and both types of funds focus on medium to long-stage equity investments; hence displaying an opportunity for real engaging in the governance of the firm. This is an important base for an engaged behaviour.

However, total passivity may be detrimental for SWFs for themselves and for the target firms. SWFs, through their strategic investment, have a moral and fiduciary duty towards shareholders and governments to ensure profitable investments; failure to do so would encounter pressure from domestic governments. Their passivity could, have a negative effect for the governance of the firm: they may often hold a large shareholding, which might otherwise be engaged more effectively by other investors that portray a more activist stance.

Markets start to realize this and accept, even encourage, the response from SWFs to governance matters. There is also a clear trend in the dialogue between the funds and the senior management of the corporation they invest in. [1] The positive reaction to SWF investment—which has been documented by several studies—also suggests that they could make significant positive contributions to long-term shareholder value, either through their own governance principles or through pushing for specific governance changes at firms, particularly when these are in financial distress.

While it is still unclear to what extent SWFs will take an active role in influencing senior management of their portfolio companies, they are increasingly becoming corporate governance minded. With the rise of SWFs, certain common investment characteristics may place them in a similar position as active investors in the immediate future.

SWF Role in Corporate Governance

SWFs, as long-term investors, could increasingly engage in corporate governance from two main angles.

One approach could be considered as "proactive" governance, engaging in board nominations, proxy proposals, advising on business strategy. Most often (and this is similar to the private equities' engagement in the governance of the firm), a board seat would allow the SWF a more active role in overseeing management and in contributing to the strategy of the firm. However, in the same time, such position could be seen as a risk for the company that the fund would use its influence to extract private and/or political benefits. Therefore the SWF would need to prove certain stewardship duties.

A representative example of positive governance is the Norges Bank Investment Management (NBIM) approach. The entity has an extensive programme that engages companies on corporate governance and environmental and social matters. As such, it has even set an extensive programme of engagement with its target companies, thereby examining their policies related to ESG (Environment Social Governance), which is envisaged to be for the benefit of both the fund and the market. In addition, NBIM has recently filed several shareholder proposals for proxy access at US companies, as part of its efforts to strengthen shareholder rights. The right of shareholders to nominate candidates to the board of publicly listed companies is considered a fundamental principle of good corporate governance.

SWFs might also adopt a "reactive" governance approach, through exercising their shareholder rights as activists, for example engaging in approving or disapproving certain corporate transactions. In the Glencore-Xstrata merger (2013), Qatar Investment Authority provided a representative example of such activism from the part of a SWF, by acting as a roadblock against a transaction that would have otherwise concluded in the detriment of the investors (holding out for a better deal between Glencore and Xstrata, negotiations that took months and were eventually successful). In this case, the Qatari fund has not further engaged in ongoing proactive governance matters, but only initially as an activist.

A SWF may employ both the proactive and the restrictive approaches, but often one does not necessarily engage the other. Both NBIM and Qatar Holdings may have set examples for governance engagement and activism for other SWFs. Some other funds have also become vocal in respect of the governance of their portfolio companies. Examples include the Amar Dhari Investments (a Kuwaiti investment syndicate), which partnered up with another shareholder in PLUS Markets to push for board changes. Temasek Holdings, a Singapore fund holding a 18% in Standard Chartered Plc, called for appointment of more independent directors while abstaining from voting to re-elect the board's nonexecutive directors. Engagement resulted in increased voting rights; for example China Investment Corporation's stake in Blackstone reportedly including voting rights recently, unlike its previous non-voting stake.

Collaborative engagement among SWFs in respect of certain investments may also result in lobbying for engagement in governance matters. The role played by QIA and other SWFs in the Glenstrata merger was a wake-up call for boards all over the world, which once used to court SWFs' investments for their passive stance. After the role played by the

SWF in the merger by QIA, GIC, and Norway, some boards may try to lobby SWFs as well as other shareholders before some corporate actions take place.

However there is no guarantee that other SWFs will follow these leads swiftly. Much depends on the SWF's investment strategy. The significant political element portrayed by their investment structure may still lead to regulatory concerns related to the possibility of the fund to use its influence for objectives other than commercial.

SWFs are the typical long-term investor, investing through a wide array of vehicles such as hedge funds, private equity funds, infrastructure, real estate, and also direct equity investments. Historically, the funds have invested in riskless assets and debt instruments, such as treasury bonds.

As SWFs continue to diversify their holdings in pursuit of a better risk-return profile, more recently, they have pursued higher rates of return by targeting riskier assets such as equity stakes in publicly traded companies. This may encourage them to look towards longer-term objectives, such as ensuring the business sustainability of the target firm in which they hold direct investment. Such approach makes them more likely to take a more active interest in the management of their portfolio companies.

Still, structural constraints have impeded more engagement. Unlike private equity companies and many hedge funds, SWFs diversify their investment portfolio across various asset classes, limiting these to relatively small blocks of equity in each company, which are part of a larger portfolio. Because they hold small equity portions in any given company, many SWFs consider that they have limited economic incentives to engage in shareholder activism. It appears that, generally, SWFs do not generally invest in corporate governance: they do not engage specific human resources in this area, like most other large institutional investors, who dedicate a specific internal function to the corporate governance matters. (The NIBM is an exception.)

In order to engage in the governance of the firm, in many circumstances a SWF would need to ensure a larger stake in order to invest more resources in such an initiative. For example, in its campaign against Glencore-Xstrata deal, Qatar Holding had to purchase additional Xstrata shares so that its stake in the company allowed it to influence the transaction. Therefore, as they increase in size, SWFs may play an increasing role in financial markets and this will lead to a new era in shareholder activism. This is not a short process, and therefore, at least for several years, the SWF policy with regard to activism will not reach the approach of the activist institutional investors. In the same time, we should expect that, as SWFs continue to acquire equity interest in certain nations (e.g. US), the issue of their engagement in corporate governance will continue to raise questions.

These structural aspects add to the unique political challenges SWFs display to their domestic country and to the countries they invest in. In several instances, the funds target problematic firms, which do not engage in governance themselves. Therefore, whilst SWFs may start to follow the example of private equity activism, this is not going to be an easy process, which may need to strive to achieve similar levels of activism, due to the reasons explained above.

SWF: Political/Stewardship Trade-off

Governments, through their sovereign funds are increasingly playing a crucial role in the markets. The question is to what extent such circumstance stimulates or rather impedes SWFs to "compete" in the market for good governance.

By definition, SWFs' investment strategies entail acquisitions of equity interests in firms listed on international markets operating in sectors considered strategic by their countries of incorporation (aside from domestic investment). SWF act between the financial and political motivations and this line is not yet well marked. In several circumstances, they may invest for strategic purposes rather than for purely commercial objectives, e.g. to advance political aims such as infrastructure, security or industry interests. Political objectives of both the fund and the host state have an economic welfare maximization component.

To certain extent, during the credit crunch SWFs' influence was influential in saving the financial sector from the crisis; e.g. Citigroup, Morgan Stanley, Barclays. Although the financial crisis caused important losses among SWFs holding riskier investments, the larger funds started to look for new investments and their power have caught the attention of recipient countries, whose governments have closely been examining the benefits and risks associated with foreign

investments by SWFs.

In many occasions, the stock acquired may be issued by the target firm specifically to the SWF, who would then feel constrained from portraying a significant monitoring role, often under the pressure from the host state to remain passive foreign owners. This places the SWFs in a position where it needs to create an equilibrium between the domestic and the foreign economic pressures, i.e. between the internal political pressures to invest locally and the political interests of the host country. On the other hand, we see more and more that some SWFs do exercise their voting rights. So, a move towards shareholder rights and influence may exacerbate national security concerns in situations where SWFs have gained a significant equity stake in a corporation.

As SWFs continue to acquire important equity investments in certain countries, questions concerning their investment strategy and involvement in the governance of the firm will continue to arise. The concern over political investment is compounded by a lack of transparency in key aspects of the SWF's profile, i.e. objectives, assets and holdings, governance structure, performance. Because of potential political concerns, the lack of transparency of the SWF creates external pressures on SWFs, meaning increased regulatory scrutiny on their investment practices.

To overcome this, regulations aimed at SWFs' best practices have started to develop. For example, the Generally Accepted Principles and Practices for SWFs (GAPP) focus on creating a governance structure that encourages the separation of political and commercial interests of a fund. The Santiago Principles represent a sort of a code for the SWFs to follow were another of the first attempts to turn SWFs to behave more like institutional investors, particularly in the direction of transparency. Two Principles are particularly relevant: one (P.19) relates to the investment decisions, putting forward the commercial, non-strategic investing, thus aiming to maximise the risk-adjusted financial returns of the fund. The other (p.21) relates to the funds' participation in corporate governance, through exercise of ownership rights, which is considered by the SWF as mechanism for contributing to the governance of the firm. The Principles are non-binding, which actually explain the partial adoption so far. In fact, they allow for deviations for funds based in certain countries that have restrictive investment policies, due to "legally binding international sanctions and social, ethical or religious restrictions" (New Zealand, Kuwait but even Norway are mentioned).

These principle-based regulations are in essence based on international (OECD) ones, founded upon solid ideas of free, fair and transparent financial markets. The question as to the effectiveness of the Santiago Principles has however remained open. Meantime, new Stewardship Codes have been developed, aimed at enhancing the fiduciary duties of the investors.

Increased transparency on the part of the fund may reduce investment frictions, whilst in certain cases it may enhance pressures on the fund from the host country. Therefore the SWFs experience a trade-off: between foregoing the corporate governance in order to avoid too much attention and pressure by the foreign authorities or the public; and becoming more transparent, investing and engaging in corporate governance. Of course, it is not implicit that increased transparency from a fund would mean increased engagement in corporate governance. Some funds would still not see the benefits of activism, also in terms of costs, preferring to free-ride off the activism of other investors.

Se we expect to see SWFs adopting various approaches: some SWFs stand as examples of transparency and good governance (e.g. NBIM); other SWFs have objected to greater public disclosure for reasons such as privacy and competitive advantage (for example, both China Investment Corporation and the Kuwait Investment Authority publicly stated that increased transparency would compromise their first-mover advantage and inflate asset prices before they can establish their fund's position); other SWFs may reach the conclusion that engaging in corporate governance does not outweigh the relative costs; some of the latter would prefer to free-ride off the efforts of other institutional investors.

Going Forward

Going forward, the SWFs need more awareness about the values and mechanisms of corporate governance before embarking in major projects as activists. Proposed regulations and changes in corporate governance aimed at increasing shareholder power within the corporation promise to push the trend towards new levels of corporate democratization, including funds' activism.

SWFs are still finding their ways as investors. In line with their investment strategy and practises, some SWFs have sophisticated corporate governance infrastructure, others have not invested at all in this area. In order for the SWF to feel encouraged to engage in governance, authorities and regulators should also provide the appropriate framework for this to happen. Regulators can promote engagement and responsible sovereign investment by being more transparent in their regulatory efforts, whilst SWFs can smooth the checks and pressure from the politicians by enhancing transparency of their intentions relative to the governance of the target firm.

It is a trend. Shareholder activism is increasing everywhere and SWFs are no different. These funds are likely to insist that the companies in which they invest are managed more carefully in the future. Sovereign investing may, in the future, redefine the meaning of shareholder activism the way SWFs have begun to redefine the character of state investment in economic markets abroad.

Endnotes:

[1] BNY Mellon, in its yearly survey on investor activism, reveals that, while in 2010 47% of issuers reported engaging with SWFs, in 2012 the percentage grew to 62%. However, the empirical studies on SWFs are based on a small sample sizes, therefore it is better not to generalize their behaviours but rather look into specific cases.
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