Riding the Tiger of Sovereign Wealth Funds
A Middle Ground Approach in the Post-COVID 19 World

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Abstract

Rationalising the effects of Sovereign Wealth fund investments during economic crises, such as the contemporary coronavirus (COVID-19) crisis, is not an easy task. On the one hand SWFs, due to their formidable financial capacity, seem to curtail the negative effects of exogenous economic shocks through investments, but on the other, they threaten the national sovereignty of recipient states by penetrating their financial markets. States approach this threat by regulating and restricting investments whereas the funds react to these restrictions by investing passively which comes at the expense of good corporate governance practice. To this end, this paper seeks to search for a middle ground between the investments of sovereign wealth funds, the promotion of good corporate governance practice and the avoidance of national security risks in the post-COVID-19 era.

Introduction

Sovereign wealth funds (SWFs) are increasingly important players in the global financial market. Many assume SWFs to be the big bad wolf at the door; this assumption is linked to their contentious sovereign nature and their lack of transparency. As a response, calls have been made to regulate and to restrict their investments in foreign financial markets in order to protect the national interests and security of recipient states. The funds themselves have reacted by investing passively to evade excessive regulation.

For publicly listed companies, the cost of SWFs' passivity is the practice of good corporate governance, whilst at the level of the host state, more macroeconomic problems occur, primarily the sudden expulsion of foreign capital which negatively affects the stability of the economic and financial system. This issue becomes more important during the concurrent COVID-19 crisis, which is distorting economies at the national and global level. The subsequent economic crisis differs from its predecessors in that it is affecting both the

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supply and the demand side of the global economy.[3] SWF investments in multiple sectors could be a way forward to alleviate the negative economic effects of the crisis. However, the COVID-19 crisis does not only have economic implications but also political ones. The political discourse strengthened by it is a nationalistic one, emphasising economic protectionism through the nation state. Thus, the ongoing battle between protectionists and free traders, exacerbated by the crisis, has created an asymmetry where a compromise regarding the role of SWFs should be reached either in favour of national security or corporate governance.

To that end, the purpose of this paper is to search for a middle ground between the investments of SWFs, the promotion of good corporate governance practice and the avoidance of national security risks. The research proposes a multilateral framework that encourages SWFs' investments in the post-COVID-19 era and their active role in corporate governance, while at the same time, limits the threat of SWFs' investments by disclosure, in other words allowing only transparent funds to invest and act as shareholders.

National Security: A Pretext for Regulations?

Host states[4] tend to investigate 'who invests in what',[5] especially when it comes to states' investments. Generally speaking, individuals or private entities investing in the foreign financial markets primarily invest to maximise profits, in return states welcome their investments and grant them incentives.[6]

Yet, unlike purely commercial and private entities, states may invest in foreign markets to intervene in the political and ideological sphere of the recipient country. The potential threat to national security is obvious. It is not uncommon for the line separating political from business interests to fade away in the case of investments driven by sovereign states. Home states can influence directly or indirectly the governments of recipient states

[3] Wahrton, 'Kings of Cash: The Impact of the Global Financial Crisis on Sovereign Wealth Funds' (11 May 2009) *University ofPennsylvania* <http://knowledge.wharton.upenn.edu/article/kings-of-cash-the-impact-of-the-global-financial-crisis-on- sovereign-wealth-funds/> Accessed 15 April 2020

[4] For the purpose of this article, "Host State" means the state receiving and hosting the investments of the SWF while "Home State" means the home state of the SWF.

[5] Jeswald Salacuse, *The Law of Investment Treaties* (2nd, Oxford University Press 2015) 33-34

[6] ibid 48

through their stakes, especially in strategic sectors and critical industries. Likewise, states can extract technology or other proprietary knowledge from investee companies.[7]

There have been multiple occasions where foreign investments have threatened the national security of recipient states. For example, China has tried achieving political and strategic gains through its African investments.[8] Such political and strategic investments elicit national security questions. In the Chinese-African case, China was accused of attaining continuous access to cheap oil from the African petrostates. Similarly, in 2005 the attempt of a state-owned company, China National Offshore Oil Company (CNOOC), to take over the US Unocal Corporation was disturbed by the Committee of Foreign Investment of the US (CFIUS) to prevent the strategic and political influence of the CNOOC .[9] However, the straw that broke the camel's back was the controversy surrounding Dubai Ports World.

The UAE state-owned company had proposed an acquisition of the UK-based Peninsula and Oriental Steam Navigation Company (P&O). On November 2005 P&O announced the acceptance of Dubai Ports' offer, but because P&O was operating in six different US ports it was subject to the scrutiny of the CFIUS, and in early 2006 the committee refused the transaction due to 'national security risks'. The Dubai case led to heated debates in the US Congress amongst republicans and democrats about securing national interests from foreign investments. It also emphasised the favoured strategy of the protectionists; intervention by preventive legislation under the pretext of securing national security and interests.

In general, all applicable laws and regulations on foreign investments are correspondingly applicable to SWFs' investments. However, scholars and commentators are asking for more restrictive SWF-tailored regulations due to their unique sovereign nature.[10] In this form of foreign investments states are themselves shareholders, SWFs lacking any kind of separate legal personality like State-Owned Enterprises (SOE). Moreover, SWFs are not conventional investors, investing only for financial purposes. As John Taylor noted, there

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[7] Benjamin Cohen, 'Sovereign Wealth Funds and National Security: The Great Tradeoff' [2008] *University of California, Santa Barbara* <http://www.polsci.ucsb.edu/faculty/cohen/working/pdfs/SWF_text.pdf> Accessed 24 April 2020

[8] Deborah Brautigam, 'Africa's Eastern Promise What the West Can Learn From Chinese Investment in Africa' [2010] *Foreign Affairs 5*

[9] Edward Graham and David Marchick, *US National Security and Foreign Direct Investments* (Peterson Institute for International Economics 2006) 128-136

[10] *See,* Ronald Gilson and Curtis Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism' [2007] Stanford Law Review, 60 p. 1345; Joel Slawotsky, 'Incipient Activism of Sovereign Wealth Funds and the Need to Update United States Securities Laws' [2015] International Review of Law http://www.qscience.com/doi/pdf/10.5339/irl.2015.swf.8;

are three main reasons why SWFs need to be regulated differently.[11] Firstly, he argues, state ownership of these funds brings national security risks to recipient countries, differentiating it from other foreign conventional investors. Secondly, he draws attention to the absence of transparency and lack of good governance in most SWFs. And finally, he underscores the political and strategic non-commercial nature of investments, which is uncommon amongst non-SWFs commercially motivated

As far as regulations are concerned, two options can be implemented by host states. The first is domestic hard law. Australia, for example, has operated a screening regime as early as 1975 when it enacted the Foreign Acquisition and Takeovers Act.[12] Thereby, every foreign investment is subject to assessment by the Australian Government, which has exclusive jurisdiction to reject or accept any foreign investment (including SWFs).

However, the most important and relevant case can be drawn from the United States. Post-World War II, a move towards liberalising and opening up markets prevailed in the US. However, the rise of the Japanese Foreign Direct Investment (FDI) in the 1980s sparked concerns, and consequently led to the passage of the Exon-Florio amendment in 1989 to the Defence Production Act of 1950. This amendment entitled the US president to block any foreign acquisition that impaired, or even threatened to impair, US national security (also applicable to SWFs investments).[13] Additionally, as seen in the above cases, the CFIUS has authority to review any foreign transaction that could be deemed harmful to US national security.

The second option is international soft law. At the international level, OECD countries have agreed upon some guidelines for recipient countries.[14] These guidelines obligate recipient countries to be indiscriminate, treating similarly situated investors in a similar fashion. OECD principles also recognise transparency and predictability that can be shown through defined and clear legislation and codification. Lastly, the guidelines request host states to enforce propitiated regulations, thus restrictions should not be greater than needed to protect national security.

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[11] John Taylor, 'Sovereign Wealth Funds and Their Regulation' in Mario Giovanoli and Diego Devos, International Monetary and Financial Law: The Global Crisis (Oxford University Press 2010) 262-289

[12] Foreign Acquisitions and Takeovers Act 1975, No. 92, 1975 as amended

[13] Edward Graham and David Marchick, *US National Security and Foreign Direct Investments* (Peterson Institute for International Economics 2006) 128-136

[14] OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies, June 2008

Despite the voluntary friendly proposal of the OECD, apparently, SWFs respond to these fears and hard laws with passive investing. As the following subsection will show, by passive strategy SWFs try to ensure an apolitical and purely commercial investment.

Appraising restrictive regulations, observers are urged to skim through SWFs literature in order to perceive the strong positive relationship between regulating SWFs' investments and times of financial uncertainties. Prior to the 2008 crisis, academics and researchers called for protectionist responses to counter SWFs strategic investments.[15]

This approach changed dramatically in 2009. Scholars like Rolando Avendaño and Javier Santiso,[16] Paul Rose[17] and Gawdat Bahgat,[18] argued that there was no need for additional regulations to SWFs investments in an attempt to try to encourage SWFs' injection of capital. John Taylor[19] for instance, in his monograph about SWFs and their regulation following the financial crisis considered that GAPP principles were sufficient. Taylor expected that over time SWFs would embrace the GAPP principles, and states would also observe OECD guidelines, because the only alternative is domestic hard law, meaning more restrictions for SWFs, and less capital for host states. In contrast Fabio Bassan,[20] years after the financial crisis, underlined the inadequacy of such principles, being voluntary in nature, and demanded greater intervention from EU legislators to address improper political interference.

Contemporary SWFs are experiencing similar opportunities in the financial market. The Public Investment Fund (PIF), the largest Saudi fund, acquired major stakes in Boeing, Citi, Disney and Facebook. Yasir Al-Rumayyan, the governor of the fund, described such acquisitions as "opportunities arising from the economic wreckage of the crisis"[21] in times where multinational corporations were actively looking to mitigate financial exposure. In the same vein, the Turkish fund chief is expecting SWFs to play a key role in the post-

[15] *See,* Ronald Gilson and Curtis Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism' [2007] *Stanford Law Review*
[16] Rolando Avendaño and Javier Santiso, 'Are Sovereign Wealth Funds' Investments Politically Biased? A Comparison with Mutual Funds' [2009] OECD Development Centre Working Paper No. 283
[17] Paul Rose, 'Sovereigns as Shareholders' [2008] North Carolina Law Review, Vol. 87, p. 102
[18] Gawdat Bahgat, 'Sovereign Wealth Funds: Dangers and Opportunities' [2008] *International Affairs* (Royal Institute of International Affairs 1944-) Vol. 84, No. 6, pp. 1189-1204
[19] John Taylor, 'Sovereign Wealth Funds and Their Regulation' in Mario Giovanoli and Diego Devos, International Monetary and Financial Law: The Global Crisis (Oxford University Press 2010)
[20] Fabio Bassan, *The Law of Sovereign Wealth Funds* (Edward Elgar 2011)
[21] Pierre Paulden, 'Saudi Wealth Fund Buys Boeing, Citi, Disney Stakes' (15 May 2020) *Bloomberg* <https://www.bloomberg.com/news/articles/2020-05-15/saudi-arabia-wealth-fund-buys-stakes-in-disney-facebook-citi> Accessed 20 May 2020

coronavirus years,[22] as despite their present financial suffering they are likely to remain ‘kings of cash’.

The Response: Passivity by Investments and Corporate Governance Practice

SWFs have constantly marketed themselves as silent owners; they do not challenge the management or threaten it by voting or divestment. The Kuwait Investment Authority (KIA) for instance, endorses its passivity by noting that it ‘does not seek to purchase majority or controlling interests in the companies in which it invests’.[23] Passive investors can be defined as investors who buy stocks in the market with long-run stable low price-earnings ratios, without pressuring the management to make quick profits, instead favouring long-term wealth.[24]

As shown above, the reasons behind this passive strategy can be traced back to the sovereign nature of these funds. To avoid recipient states’ regulatory restrictions, monitoring and political opposition, SWFs embrace passivity and refrain from any kind of engagement that may upset the host state.[25] They want to appear to host states as a pure, financial and apolitical investment. SWFs maintain this passive stance at two levels.

The first and fundamental level is the design of their investment. In this regard, SWFs structure their transactions and investments without acquiring controlling stakes in strategic companies. Thus, any SWF investing in the US tries not to purchase more than 5% of the stocks; otherwise, its investment will be deemed as ‘foreign acquisition or control’, and subsequently subject to investigation by the CFIUS.[26] Failure to do so will hold the SWF liable under US laws.[27] In fact, preventing such an investigation is crucial for SWFs in order to obviate obligatory disclosures of investments demanded by the committee. In a more radical case, the Chinese Investment Corporation (“CIC”) was suspended from investing in

[22] Natasha Turak, ‘Sovereign Wealth Funds Will Play a Bigger Role in Markets Post-Coronavirus, Turkey’ (22 May 2020) *CNBC*
[23] Kuwait Investment Authority, <kia.gov.kw/about-kia> Accessed 7 May 2020
[24] Aswath Damodaran, *Investment Philosophies: Successful Strategies and the Investors Who Made Them Work* (2nd edn, John Wiley & Sons 2012) 8-9
[25] Paul Rose, ‘Sovereign Wealth Funds: Active or Passive Investors?’ [2008] *The Yale law journal pocket part* 118:104; Bernardo Bortolotti, Veljko Fotak, William Megginson and William Miracky, ‘Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity and the Value of the Firm’ [2010] *University of Oklahoma*
[26] Securities Act of 1933, Article 13(d)
[27] Mainly the Securities Act of 1933, but also Bank Holding Company Act 1956 and the Change in Bank Control Act 1978

Europe because it did not comply with the EU terms. Europeans had requested the fund to cap its stakes to a maximum of 10% and not to exercise its voting rights as a shareholder.[28]

The second level where SWFs maintain their passivity is their corporate governance practice. Certainly, this is linked to their limited engagement as purchasers of non-controlling stakes. There is strong empirical evidence of SWFs' low engagement with the corporate governance framework. Their cautiousness surrounding acquisition is paralleled with a hesitancy to secure board seats, or to vote against management or even to threaten the company by divestment. Seeking seats in the corporate board opens the possibility for interference and activism. Hence, SWFs are vigilant not to acquire them. A 2010 paper found that only 14.9% of SWFs obtain a board seat. The paper added that SWFs investing in OECD-based countries are less likely to get a board seat due to regulatory constraints.[29]

Yet, exercising the right to vote is a distinctive indicator of good corporate governance practice, where management is effectively monitored and scrutinised by shareholders; this is known as 'voice activism'. As passive investors, one may assume that SWFs are likely forgo the exercise of this right to influence management decisions and policies. In reality, it is hard to ascertain whether SWFs do or do not vote, since there is no requirement for investors to disclose their proxy votes. In this regard, the trend is changing towards more obligatory disclosures, especially in developed economies. For instance, in the US some institutional investors must disclose and publish their voting policies,[30] while in the UK, the Companies Act 2006 empowers the government with the right to ask institutional investors to report their voting shares and policies.[31]

Nevertheless, according to the accessible data, research has found that SWFs are scarcely involved in proxy voting, and, when voting, often vote in favour of the management.[32] This reaction can be understood in light of internal and external factors. The internal factors are related to their long-term investing nature; SWFs are keen to maintain and promote good

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[28] Jason Dean, 'China Wealth Fund to Boost Investments' (2009) *The Wall Street Journal* <http://online.wsj.com/article/SB124006120569931959.html> Accessed 7 May 2020

[29] Bernardo Bortolotti, Veljko Fotak, William Megginson and William Miracky, 'Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity and the Value of the Firm' [2010] *University of Oklahoma*

[30] US Securities and Exchange Commission, 'Reports and Publications' <https://www.sec.gov/investor/pubs/mfproxyvoting.htm> Accessed 7 May 2020

[31] The UK Companies Act of 2006, ss 1277 - 1280

[32] Bernardo Bortolotti, Veljko Fotak, William Megginson and William Miracky, 'Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity and the Value of the Firm' [2010] *University of Oklahoma*

long-term relations with the management. While restrictive regulations, the external factor, play more significant role in this concern. As aforementioned, host states, mainly western ones, are extremely sensitive to foreign state-owned investments; thus, they impose more laws and burdens to minimise the risk of controlling corporations.

What if SWFs Shift to Activism?

After the forgoing assessment of SWFs' passivity, it is essential to assess the potential activism of SWFs. This discussion transfers the entire study from the realm of theory to reality and practice. Before the financial crisis SWFs tended not to actively engage with investee companies, with the exception of the Norwegian GPFG.[33] The financial crisis of 2008 was the catalyst for SWFs giving up their passive standpoint.[34] Like other investors, SWFs suffered hugely from the global crisis. Middle-Eastern sovereign funds were amongst the most affected SWFs; the decline of oil prices and the attack to their counter-cyclical stocks (the banks), caused a huge loss for these funds, costing them about 30% of their portfolios in the global equity markets.[35] In the same way, Temask Holdings, the SWF of Singapore, was deeply damaged, as it was a major shareholder in the largest financial bodies and banks like Citigroup, UBS and Barclays, and as a result it started selling off its shares in these institutions.[36] It should come as no surprise that subsequently SWFs initiated profit-centric activism.

The novel coronavirus is rerunning the grim scenario of the global financial crisis. SWFs lost substantial wealth due to the downturn caused by the unprecedented plummet of oil prices as well as the countercyclical recession.[37] Nonetheless, larger SWFs are actively purchasing shares at publicly traded companies, as mentioned above. The global financial crisis also provoked a change in the behaviour of recipient states, as western economies began to

[33] GPFG's activism at this very time was ethics-based. After intense debates in the Norwegian parliament between the years 1996-2004, the government decided to encircle two ethical norms: the first was sustainable investment benefiting future generations of Norway; the second was abstaining from investments in companies which violate the fundamentals of human rights and international law, or those companies having gross corruption and severe environmental impacts.
[34] Veljko Fotak, Jie Gao and William Megginson, 'The Financial Role of Sovereign Wealth Funds' in Mike Wright, Donald Siegel, Kevin Keasy and Igor Filatotchev, *The Oxford Handbook of Corporate Governance* (Oxford University Press 2013) 581-604
[35] Wahrton, 'Kings of Cash: The Impact of the Global Financial Crisis on Sovereign Wealth Funds' (11 May 2009) *University ofPennsylvania* <http://knowledge.wharton.upenn.edu/article/kings-of-cash-the-impact-of-the-global-financial-crisis-on- sovereign-wealth-funds/> Accessed 15 April 2020
[36] Alberto Curzio and Valeria Miceli, *Sovereign Wealth Funds: A Complete Guide to State-Owned Investment Funds* (Petersfield Hampshire 2010) 72
[37] Tom Arnold, 'Largest Sovereign Funds Suffer $67 Billion Paper Loss from Stock Market Rout' (17 April 2020) *Reuter* <https://www.reuters.com/article/us-health-coronavirus-swf/largest-sovereign-funds-suffer-67-billion-paper-loss-from-stock- market-rout-idUSKBN21Z31Y> Accessed 7 May 2020

approach SWFs and welcome their investments as critical providers of liquidity in an increasingly illiquid world.[38]
How are we to make sense of this change? Did the contingent need for capital outweigh the usual protectionist concern for national security?

Obviously, states justify restrictions in foreign financial engagement under the pretext of protecting the national economy and security.[39] But in this case there were two apparently secure guarantees: the 2008 GAPP and the OECD principles. The GAPP principles were signed and adopted by the largest SWFs. GAPP principles primarily focused on pursuing good governance and transparent investments to maintain a stable global financial system. Evidently, SWFs were also cautious not to upset host states. The Chinese Investment Corporation (CIC) reassured in its annual report of 2009 its commitment to invest passively.[40]
While the GAPP principles encourage transparent investments and good fund governance, they also recognise the practice of SWFs' ownership rights. Principle 21 of the GAPP reads:

"[*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."*[41]

SWFs are no different from any other institutional and individual investors in exercising their fundamental legal right of activism. SWFs are now more and more expected, like public pension funds and hedge funds,[42] to commence activism.
The Qatari sovereign fund, QIA, was an early innovator in this regard. In 2012 Glencore, an Anglo–Swiss multinational commodity trading and mining company, entered into an agreement of all-share merger with Xstrata, another Anglo–Swiss multinational mining company, in which Glencore held 40% of the shares. Glencore offered 2.8 shares in its stock in return to every Xstrata share. QIA actively started building its shares in Xstrata, increasing

[38] Alberto Curzio and Valeria Miceli, *Sovereign Wealth Funds: A Complete Guide to State-Owned Investment Funds* (Petersfield Hampshire 2010) 72
[39] ibid
[40] Bernardo Bortolotti, Veljko Fotak, William Megginson and William Miracky, 'Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity and the Value of the Firm' [2010] *University of Oklahoma*
[41] Sovereign Wealth Funds: Generally Accepted Principles and Practices "Santiago Principles" of October 2008; Principle 21
[42] *See*, Michael Smith, 'Shareholder Activism by Institutional Investors: Evidence from CalPERS' [1996] The Journal of Finance vol. li, no. 1; Mihaela Butu, *Shareholder Activism by Hedge Funds* (Hamburg: Diplomica Verlag 2013) 18-21

its stake from 5% to11% in only 3 months, which consequently allowed the fund to veto the merger. Upon the voting of shareholders, Qatar demanded a better deal from Glencore asking for 3.25 shares for a share.
After long negotiations between QIA and Glencore, a settlement was reached granting 3.05 shares for an Xstrata share.[43] The Qatari activism in this very case underlined the potential of these previously quiet investors to speak out through profit-based activism. The Glencore-Xstrata merger has created a domino effect, inspiring other, sleepier SWFs to wake up and raise their voice by initiating profit-centric activism, like the GPFG's lawsuit against the German automaker (Volkswagen)[44] and the recent 'financial' battle between the Chinese and the Singaporean sovereign funds[45].

However, the central question is what SWFs' activism can offer to portfolio companies,[46] which forces a return to the cost of passivism. Interestingly, the available literature provides two conflicting pieces of evidence regarding the target of SWFs, hence similarly contradictory findings in relation to corporate performance after the investment. Jason Kotter and Ugur Lel have conducted a cross-sectional study and a longitudinal observation to assess the characteristics of SWFs' target firms. They have found that SWFs target large yet poor performing corporations. Their analysis concludes that SWFs hunt for those large firms with financial difficulties and provides them liquidity; however, the research points out that SWFs' investments do not improve the firm value and its governance in the long run.[47]

Conversely, another empirical research indicates that SWFs invest "in large, highly leveraged, growing and profitable firms- likely, the most visible and high-profile growth firms".[48] The research does not only agree that SWFs' investments do not increase firm

[43] Lianna Brinded, 'Timeline and Factbox: Glencore and Xstrata Merger' (3 May 2013) *The International Business Times* <http://www.ibtimes.co.uk/glencore-xstrata-merger-shares-trading-qatar-sovereign-464122> Accessed 7 May 2020
[44] AFP, 'Norway Sovereign Wealth Fund to Sue Volkswagen: Report' (16 May 2016) *Auto.Economics* < http://auto.economictimes.indiatimes.com/news/industry/norway-sovereign-wealth-fund-to-sue-volkswagen- report/52286120> Accessed 7 May 2020
[45] Andy Mukherjee, 'Knocking at a Singapore Landlord's Door' (7 January 2017) *Bloomberg* < https://www.bloomberg.com/gadfly/articles/2017-01-06/glp-takes-too-long-to-open-its-repository-of-value> Accessed 7 May 2020
[46] companies that private equity firms hold an interest in
[47] Jason Kotter and Ugur Lel, 'Friends or Foes? Target Selection Decisions of Sovereign Wealth Funds and Their Consequences'[2011] Journal of Financial Economics, 101 (2) pp. 360–381
[48] Bernardo Bortolotti, Veljko Fotak, William Megginson and William Miracky, 'Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity and the Value of the Firm' [2010] *University of Oklahoma*

performance, but also provides that these sovereign investments have negative financial and managerial impacts on corporations in the long-term.[49]

More astonishing, it is empirically evident that poor performing corporations and managements blithely welcome SWFs' investments.[50] At first glance, this corporate attitude looks odd because there seems to be no benefit from such investments in the long run, but looking at the situation through a broader, more generalized perspective could justify such approaches. Corporations and states are eager to attract foreign investments, especially state investment, due to their financial capabilities (liquidity). Consequently, firms welcome SWFs to assist and help in mitigating financial risks and difficulties, as, for instance, the gigantic investments of Qatar were greeted in post-Brexit Britain.[51]

The negative impact of SWFs in publicly traded companies in the long-term is traceable to their passive strategy. Incorporating passive investing does not imply absence of shareholders' impact on corporate governance. Quite the contrary, passive investors procure potential to impact all corporate actors. Numerous scholars argue that these silent investors are in fact active, by contending that passive investing does not equate with passive ownership.[52] The passive strategy of SWFs has high costs in terms of corporate governance; it primarily creates agent-principal and principal-principal conflicts. Yet, the central question is whether activism can be an alternative which alleviates these conflicts and stimulates a better corporate governance practice.

An 'Agent-Principal' Conflict

Agency cost[53] is the main corporate governance problem that passivity can generate; management which neglects effective scrutiny is very likely to misuse its power and serve its

[49] ibid
[50] ibid
[51] Jennifer Thompson, Javier Espinoza and Henry Mance, 'Qatar pledges £5bn investment in UK after Brexit' (27 March 2017) *Financial Times* < https://www.ft.com/content/ac7a13b6-12e1-11e7-80f4-13e067d5072c> Accessed 7 May 2020
[52] *See,* Ian Appel, Todd Gormley and Donald Keim, 'Passive Investors, not Passive Owners' [2016] Journal of Financial Economics 121 111–141; Asjylyn Loder and Inyoung Hwang, ''Passive' Investing Can Be a Lot More Active Than You Think' (19 October 2016) *The Wall Street Journal* < https://www.wsj.com/articles/passive-investing-can-be-a-lot-more-active-than-you-think- 1476882001> Accessed 8 May 2020; Mike Scott, 'Passive Investment, Active Ownership' (16 April 2014) *Financial Times* < https://www.ft.com/content/7c5f8d60-ba91-11e3-b391-00144feabdc0> Accessed 8 May 2020; Jeff Sommer, 'Challenging Management (but not the Market)' (16 March 2013) *The New York Times* < http://www.nytimes.com/2013/03/17/your- money/david-booth-of-dfa-using-the-chicago-schools-theory.html> Accessed 8 May 2020
[53] *See,* Christine Mallin, *Corporate Governance* (5th edn, Oxford University Press 2016) p8

own interests rather than those of its principals. As far as SWFs are concerned, agency costs are likely to occur due to two different factors.

Firstly, the sovereign nature of the fund must be considered once again. It follows in this context that many SWFs are attacked by corruption and bureaucratic institutions that have little concern about good fund governance. Consequently, SWFs' corruption creeps to directors, as SWFs (the shareholders) lack the incentives and willingness to monitor and challenge the management. By the same token, Paul Rose revealed a close link between low monitoring and directors' attitude regarding SWFs' investments; management often benefits from SWFs' long-term and non-active investments, because simply they are not questioned and chased every now and then.[54]

In this regard, activism may be more detrimental than beneficial. Hypothetically speaking, if a non-transparent fund conducts proactive activism, so that it participates in proxy voting or even acquires a seat in the board, there is no guarantee that it will mitigate the risk of agency costs due to the corruption of the fund and the lack of economic motives. Conversely, it is possible to pursue strategic and political gains, making use of its activism and position in the company. For the same reason,Yaron Nili deems proactive activism as a threat to corporate governance of investee companies.[55]

Nonetheless, assuming so is unfair to the totality of SWFs. These arguments overlook another important factor of SWFs reluctance to screen the management.
In reality, the excessive restriction on SWFs' stake acquisition is another factor prompting agency conflict. The passive investments of SWFs consists of small stakes in listed companies, making it quite hard, as well as expensive and ineffective, to monitor every single investee company. Silence here is not so much a choice but necessity. Therefore, in the absence of these fears and restrictions, SWFs will be able to take part in the governance of listed companies in a proactive manner; they can participate actively in proxy voting, shareholders' proposals, board seats, and board nominations.

A 'Principal-Principal' Conflict

[54] Paul Rose, 'Sovereign Wealth Funds: Active or Passive Investors?' [2008] *The Yale law journal pocket part* 118:104; Bernardo Bortolotti, Veljko Fotak, William Megginson and William Miracky, 'Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity and the Value of the Firm' [2010] *University of Oklahoma*

[55] Yaron Nili, 'The Corporate Governance of Sovereign Wealth Funds' [2014] *Harvard Law School Forum on Corporate Governance and Financial Regulation* < https://corpgov.law.harvard.edu/2014/08/07/the-corporate-governance-of-sovereign- wealth-funds/> Accessed 8 May 2020

Due to their non-economic motives, SWFs do not pressure the company to perform better, as suggested empirically by the studies cited above.[56] They are of course investors, and every investor aims to make profits, but many SWFs merely search for a benchmark performance over a relatively long period of time. In addition to a company's financial loss, other shareholders suffer also from benchmarking as the price of their shares will not increase.

Another corporate governance related matter arises from SWFs' passivity; though this time a 'principal-principal' conflict, where one shareholder acts to the detriment of other shareholders by reducing their share's value. Interestingly, whereas in the case of hedge funds, where shareholder activism may cause principal-principal conflict,[57] with SWFs passivity causes the same conflict. Actually, in the case of hedge funds the very reason is short-termism. Hedge funds are short-term institutional investors, which pressure companies to produce quick profits.[58] In the short run, this is absolutely beneficial to all shareholders as it increases the value of the shares. Nonetheless, in the long run it damages the performance of the corporations and consequently othershareholders.

In SWFs case, the problem is deeply interlinked with the attitude of those funds. If the fund aims at non-financial benefits, then it is unlikely to ask for a better performance. More problematic is if these funds acquire a controlling passive stake where they do not ask for share price enhancement. The totality of shareholders will suffer from having a large block-holder preventing the increase of share value. Unfortunately, the principal-principal conflict is hardly remediated by activism, there should be a financial motive for these funds so to enhance the value of the shares. Thus, preventing non-commercial SWFs from investing – as they are detrimental either way – and enforcing SWFs may ensure a more transparent and responsible investing behaviour.

Finding the Middle Ground for the Post-COVID-19 World:

The paper has clearly demonstrated a problem within SWFs' investments and behaviours in publicly listed companies. This part aims to resolve this conflict especially in the post-COVID 19 world, that is, to suggest a "Proposal" where states and corporations can benefit from

[56] Bernardo Bortolotti, Veljko Fotak, William Megginson and William Miracky, 'Quiet Leviathans: Sovereign Wealth Fund Investment, Passivity and the Value of the Firm' [2010] *University of Oklahoma*
[57] Marguerite Schneider and Lori Ryan, 'A Review of Hedge Funds and their Investor Activism: Do they Help or Hurt other Equity Investors?' [2011] Volume 15, Issue 3, pp 349–374
[58] Mihaela Butu, *Shareholder Activism by Hedge Funds* (Hamburg : Diplomica Verlag 2013) 18-21

SWFs' high financial capabilities as well as their potential beneficial activism, whilst also preventing national security risks through political and strategic investments.

In short, it is a question of balance; the literature surrounding SWFs' tends to suggest a compromise favouring either national security or corporate governance. The paper will discuss the various proposals suggested by scholars, whilst searching for – and proposing – the middle ground. The Proposal calls for commitment from the states and SWFs as well as the international community.

The Proposal is a hard international law, which necessarily fulfils the following five interrelated requirements:

1) Multilateral agreement: Harmonisation

In the first place, this paper suggests a global multilateral agreement between recipient states and home states exhibiting *equally* the commercial interests of both parties. A multilateral framework can solve two major problems: the regulation and its possible circumvention by SWFs.
A similar approach has been suggested, yet on a bilateral level.[59] Indeed, any bilateral agreement that regulates SWFs investments should be welcomed, however there is a need for harmonisation to avoid uncertainty and promote better interstate economic relations. The divided approaches to CIC investments support the point clearly. CIC investments were unwelcomed by the EU in 2007,[60] conversely, the UK did not take the same approach.[61]

Multilateral agreements tend to harmonise the applicable laws and regulations in different jurisdictions, hence providing more certainty. The starting point should be adopting a clear definition of SWFs. The absence of a harmonised definition allows, on one hand, recipient states to treat different SWFs unequally, and on the other hand, allows SWFs to circumvent the laws and rules by disqualifying themselves from the term 'sovereign wealth fund' under the understanding of IMF definition. Therefore, a harmonised and sufficiently broad definition and measures should be undertaken multilaterally.

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[59] Fabio Bassan, *The Law of Sovereign Wealth Funds* (Edward Elgar 2011)

[60] Jason Dean, 'China Wealth Fund to Boost Investments' (2009) *The Wall Street Journal* <http://online.wsj.com/article/SB124006120569931959.html> Accessed 7 May 2020
[61] George Parker, 'Brown Urges Chinese Fund to Use City as Hub' (18 January 2008) *Financial Times* < https://www.ft.com/content/ce9e1bea-c575-11dc-811a-0000779fd2ac> Accessed 15 May 2020

2) Hard law

At the international level, there is nothing to supersede the decisions and actions of a state unless it is a binding multilateral or bilateral agreement. In the case of SWFs, there are currently two codes to the investments of SWFs; the GAPP Principles and the OECD guidelines. John Taylor assumes their voluntary nature is a promising opportunity,[62] although simultaneously permitting non-adherence. Unexpectedly, any SWF will ‘kindly’ and ‘voluntarily’ adhere to anon-binding framework.

In view of that, a hard legal instrument can force SWFs to invest transparently and in accordance with acceptable measures and rules. The very consequence of hard law is enforceability should any SWF infringe the law. Yet, this brings up the question of jurisdiction.

The Proposal attempts to avoid unilateral approaches and excessive restrictions to foreign capital flows; thus, recipient states should not have jurisdiction. It can be argued that in this regard only the recipient state should rule, as it is exclusively the affected party. Yet, not uncommonly, states may exercise extremely unnecessary measures, harming indirectly corporations and the practice of corporate governance, not to mention bringing uncertainty and unfair treatment to SWFs. Therefore, in consideration of both standpoints, an international independent governing body can have exclusive jurisdiction reflecting the interests and fears of host states.

In that case, two questions arise. The first is: who should be that governing body? Indeed, addressing this question requires a separate study. The governing body might be a new SWFs-tailored one, or an existing body such as the World Trade Organization.

The second question needing further investigation is how sanctions, or rulings are implemented. One scholar suggests sanctioning SWFs through taxation.[63] Unfortunately this would discourage investments as it entails a greater financial burden. Yet, even before considering sanctions design, an examination into the prospective judicial system is vital. Unlike domestic judicial systems, international law must grapple more thoroughly with the problem of enforcement.

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[62] John Taylor, ‘Sovereign Wealth Funds and Their Regulation’ in Mario Giovanoli and Diego Devos, International Monetary and Financial Law: The Global Crisis (Oxford University Press 2010)
[63] Victor Fleischer, ‘Should We Tax Sovereign Wealth Funds?’ [2008] The Yale Law Journal 118 Pocket Part 93
<http://www.yalelawjournal.org/forum/should-we-tax-sovereign-wealth-funds> Accessed 15 May 2020

More problematic is the case of SWFs; the decision or ruling will be directly enforced on the state (due to SWFs' lack of legal personality), which may shake relations between states.
However, the idea is not new in the international field. The case of the World Trade Organisation (WTO) can be beneficial in this regard, as the WTO is a unique international organisation with around 160 signatory states; the organisation regulates trade matters between its members, and, relevantly, has its own dispute settlement mechanism. WTO's decisions are legally binding and subsequently enforceable.[64] This mechanism is worth considering as a leading example where states cooperate in a freer and more transparent global market. Having said that, these two questions with many other practical and theoretical questions request a dedicated and profound study.

In a post-COVID-19 world, legal regulations aiming at softening hard laws and forging global multilateral agreements concerning SWFs could be eased because of the existence of two conflictual dominant realities. These are the increasing global prevalence of a dominant right wing protectionist discourse on one hand, and the excessive need for foreign capital and investment by governments and national economies on the other. Indeed, these two conflicting realities may constitute the necessary conditions for enforcing a middle ground framework such as the one suggested in this paper since governments and national economies will be looking for both attracting foreign investments after the expected recession whilst protecting their national economy in accordance with the dominant political discourse.

3) Promoting open borders to foreign capital and equal treatment

As discussed earlier, SWFs' investments are highly beneficial to the macroeconomics of recipient states. They are providers of high amounts of capital and can fight short-termism (especially in outsider markets). Therefore, any proposal considering the investments of SWFs should try to encourage rather than discourage their activities. To that end, SWFs must be treated equally like any other foreign investor, without any kind of discrimination. While this is compatible with OECD guidelines for recipient states, there is a strong argument that SWFs' unique nature necessitates counter equivalent strategies and policies.

[64] World Trade Organisation, *The WTO* <https://www.wto.org/english/thewto_e/thewto_e.htm> Accessed 15 May 2020

As a result, protectionists demand a restrictive treatment to SWFs' investments. One suggestion is capping the stake that an SWF can acquire in a listed company; practically speaking the EU undertook this measure with the CIC; the result was losing the financial injections of this huge SWF.[65] In contrast, the Proposal pushes for a more liberal and open market.

In fact, this requirement can be a broad heading resulting on other requisites. Specifically, the promotion of equal treatment, can be translated to equal rights as shareholders (the fourth requirement). Nevertheless, to avoid being too liberal, a balanced framework is needed. Joel Slawotsky proposed a somewhat moderate structure.[66] His general idea is to ask for more disclosure when an SWF acquires a controlling stake. This requirement is essential to ensure apolitical investment and stands as a separate prerequisite (the fifth requirement).

4) Promoting the good practice of corporate governance

SWFs are capable of redefining the practice of corporate governance, as seen above. The beneficiaries here are not merely SWFs; corporations and their shareholders suffer from large passive block-holders. The aim is to enhance the practice of corporate governance in listed companies and to fight and replace short- term activists. Thus, first, SWFs should not be threatened by regulatory restrictions. In point of fact, activism and engagement in corporate governance is hugely attributable to the size of the acquired stake, which again compels more relaxed measures towards SWFs investments.

Secondly, SWFs should also be treated equally like any other shareholders. The ownership of a share empowers the shareholder to vote and pressure the management to prioritise shareholders' value. SWFs are not different in this respect. However, a more radical suggestion proposed by scholars as a viable solution,[67] is vote suspension.

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65 Jason Dean, 'China Wealth Fund to Boost Investments' (2009) *The Wall Street Journal* <http://online.wsj.com/article/SB124006120569931959.html> Accessed 7 May 2020

66 Joel Slawotsky, 'Incipient Activism of Sovereign Wealth Funds and the Need to Update United States Securities Laws' [2015] *International Review of Law* <http://www.qscience.com/doi/pdf/10.5339/irl.2015.swf.8> Accessed 15 May 2020

67 Ronald Gilson and Curtis Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism' [2007] *Stanford Law Review*

Despite the varying regulation of voting rights from one jurisdiction to another, it remains a fundamental power recognised internationally to any shareowner.[68] Vote suspension causes discrimination, forming two classes of shareholders, damaging shareholders' democracy.[69] This suggestion seems almost deigned to discourage SWF investment. Indeed, Ronald Gilson and Curtis Milhaupt propose vote suspension to expel the investments of SWFs. They suggest that SWFs can only regain their voting rights when their shares are owned by another non-governmental body.[70] Eventually, SWFs should not invest, or perhaps not exist. Certainly, that measure contradicts the aim of the Proposal, wherein neither corporations nor states should be looking after SWFs divestments.

Notwithstanding the viewpoint of the current Proposal, vote suspension is not the right measure for protecting sovereign activists from manipulating the national interests and security of recipient states. Not uncommonly, shareholders conduct activism in locked rooms and behind the scenes, or even publicly to pressure the company through the media and so on. Similarly, SWFs can form coalitions with other investors to push their strategies and policies, meaning that companies should also suspend these investors also from voting.

Under these circumstances, internal policies seem powerless to avert political and strategical influences. The Proposal suggests no restrictions to the practice of corporate governance, as the recommended norms do not prove to mitigate the risks of national security but to create other problems, namely passivity (which causes agency and principal conflicts), unfair treatment, corporations' underperformance and divestment of SWFs. Instead, the Proposal asks for less restrictive measures so that SWFs can acquire larger stakes and perform actively providing long-termism, socially responsible investments and good corporate governance practice. Nonetheless, the Proposal does not seek to compromise the national security of recipient states, so on top of the hard law, in the case of strategic or political intrusion, the Proposal obliges SWFs to disclose their actions and policies.

In a post-COVID-19 world, promoting good practice of corporate governance by SWFs is especially important. This is because companies will be looking for both high, short term

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[68] *See,* Andreas Cahn and David Donald*, Comparative Company Law: Texts and Cases in the Laws Governing Corporations in Germany, the UK and the USA* (Cambridge University Press 2010) 467-510

[69] David Masse, 'Why Shareholder Democracy Matters?' (5 October 2011) *Corporate Secretary* < https://www.corporatesecretary.com/articles/proxy-voting-shareholder-actions/12018/why-shareholder-democracy-matters/> Accessed 15 May 2020

[70] Ronald Gilson and Curtis Milhaupt, 'Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Merchantilism' [2007] *Stanford Law Review*

returns as well as maintaining stable and consistent long run profits. Further, governments will be aiming at positively shocking their domestic economies in the short run, being deeply affected by the negative economic shock the pandemic entailed, as well as instigating the economy on a stable and consistent long run growth path. Promoting good practice of corporate governance by SWFs might impel the realisation the aforementioned short and long-term economic and financial goals of the private and public sectors.

5) Obligating SWFs to disclose their actions and policies

The sovereign nature of SWFs has been a subject of intense debate over the last decade. Indeed, it is the very reason why all these calls and schemes have been brought forward. Put simply, sovereignty is capable of introducing non-transparent investments. To fight this threat protectionists typically argue for hard laws in host nations. In contrast, those scholars who do not demand more restrictive regulations from recipient states chiefly rely on the code of the IMF, the GAPP Principles, assuming that SWFs will comply voluntarily and willingly. Unfortunately, it is hard, if not impossible, to ask a dictatorship or a non-transparent regime to become suddenly and voluntarily democratic and transparent. Given these circumstances, the Proposal will not ask SWFs to adhere to GAPP principles and become more transparent; alternatively, it demands obligatory disclosures of all activities and policies to an independent body.

This viable proposal was brought by Joel Slawotsky, but while his proposal was focused on the case of the US, the paper attempts to apply it on the international level.[71] Slawotsky's general idea is to ask for more disclosures when an SWF acquires a stake. His plan only encourages purely commercial SWFs to invest, as thereis no reason why financially motivated SWFs would fear disclosing their activities and policies. Still, his suggestion needs further discussion; he requests SWFs' disclosures if they acquire 2.5% of the total shares (which is not a controlling stake under US laws), and even less if SWFs are from the same country, or if two or more SWFs collaborate together or with other investors in a company (a recent example is the 26% collective acquisition of Thames Water by KIA and other Canadian pension funds).[72] There is certainly a logic to this opinion, as SWFs are able to

[71] Joel Slawotsky 'Incipient Activism of Sovereign Wealth Funds and the Need toUpdate United States Securities Laws' [2015] *International Review of Law* <http://www.qscience.com/doi/pdf/10.5339/irl.2015.swf.8> Accessed 15 May 2020

[72] Simon Jessop, 'Canadian, Kuwaiti investors take stake in UK's Thames Water' (15 March 2017) *Reuters*

implement their strategies through their allies; nevertheless, this may incur unfair treatment to SWF compared to other investors.

As a solution, the Proposal suggests that an independent international body, rather than a recipient state, plays this role. The disclosure of activities should be compulsory when acquiring a controlling stake only (otherwise this will be deemed as excessively restrictive) in the following possible cases:

- An SWF acquiring a controlling stake in a listed company.
- An SWF acquiring a controlling stake with other investors (alliance) collectively.
- Two SWFs from the same country acquiring collectively a controlling stake in alisted company.

To that end, the Proposal confronts protectionism for stake acquisition, yet stresses the disclosure of SWFs' activities. Disclosures would include the purposes, objectives, institutional arrangements and all necessary financial information. This norm can treat two key SWFs' problems; primarily it will expel non-commercial investments; moreover, it will mitigate the principal-principal conflict.

Conclusion

In summary, the post-COVID-19 world will prompt states to pursue policies paving the path for foreign entities to inject sovereign capital into national economies. Conversely, the prevalent protectionist political discourse, as well as fears over national security risks may impel building borders and walls preventing the flow offoreign sovereign investments.

Starting from this particular concern, this paper has studied the implications of excessive protectionism on the investments of SWFs. The outcome is often detrimental, on one hand, to the practice of corporate governance, as SWFs adopt a passive silent strategy performing no effective monitoring and causing agent-agent and principal-principal conflict. And on the other hand, it proves to be harmful to the economy of host states as these large providers of liquidity will be expelled.

<http://mobile.reuters.com/article/innovationNewsIndustryMaterialsAndUtilities/idUSKBN16L0W3>
Accessed 15 May 2020

The paper has also confirmed that encouraging SWFs' investments and activism will necessarily mitigate corporate-governance conflicts. Moreover, due to their unique long-term horizon, SWFs are able to offset the avarice of short-term investors, promoting long-term success of listed companies and the economy at large with instant capital injections.
These advantages that SWFs' activism and investments bring about, still, do not ensure an apolitical and non-strategic investment. As a solution,the paper proposes a middle ground to secure commercial investments, whilst also pushing SWFs to fully practise their legal rights as shareholders.

This study proposes a 'moderate protectionist role' to be played by an independent international body satisfying five requirements. The international body aims, first, at harmonising the treatment of SWFs in different countries, making no room for discrimination. Second, it is a hard law; compliance is obligatory not optional. In addition, the Proposal demands one commitment from SWFs, which is an obligatory disclosure of their activities to boost transparency and accountability. Meanwhile, it requests recipient states to promote a liberal open market, with no restrictions on the practice of corporate governance.

Yet, the major limitation of this Proposal is its applicability. Greater efforts are needed to assess the practical and theoretical aspects of the Proposal. For instance, the notion of having an independent international body ruling on national security issues of a sovereign state absolutely demand a dedicated theoretical study. In the same way, the practical implications of the Proposal require more investigation and assessment. Further research could usefully explore the possibility of transforming the GAPP principles and OECD guidelines into hard laws rather than voluntary recommendations. In summary, the Proposal is merely an attempt to balance the different facets of SWFs' investments, and its viability is highly subject to further studies.

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