Sovereign Wealth Funds and Shareholder Democratization: A New Variable in the CFIUS Balancing Act

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I. INTRODUCTION

Sovereign Wealth Funds (SWFs) are emerging as a critical source of liquidity in the global economy. As government surpluses grow, SWFs act as conduits by which these surpluses are invested abroad to create a significant return on investment for the sponsoring country. However, governments do not always welcome foreign investment within their country. In the United States, for example, increasing foreign investment from SWFs has rekindled a debate over the tradeoff between the positive economic benefits of capital inflows and the national security concerns that accompany such investments. This debate is fueled by the fact that many of the fastest growing SWFs are sponsored by governments that are politically at odds with the United States. In the past, this has led to protectionism, which tends to create political responses disproportionate to the actual risks posed by SWFs. However, state sponsored foreign investment does provide a method by which foreign governments can gain influence...
over a domestic corporation and exert political pressure on the management, directors, and shareholders. This creates a valid national security concern that deserves a measured, rational response.

In the United States, the Treasury Department tasked the Committee on Foreign Investment in the United States (CFIUS) with identifying and reviewing investments from overseas that trigger national security concerns based on the possibility that they are politically motivated.\(^1\) CFIUS recently released new regulations and guidelines meant to provide more certainty and clarity in its review process.\(^2\) To that end, CFIUS clarified an exception to its review process which carves out passive investments that constitute ten percent or less of a target company’s equity.\(^3\) More specifically, an equity stake equal to or less than the ten percent threshold with _pro rata_ voting rights automatically falls under this exception to CFIUS review.\(^4\) However, shareholder activism is demonstrating that such a stake can create an excessive amount of influence and power while still falling short of the type of control that CFIUS is targeting.

As SWFs increase their level of investment, shareholders of U.S. companies are using new methods to gain influence and control over corporate affairs. For instance, hedge funds are finding creative ways to influence board decisions by leveraging significant ownership interests in target companies. The Securities and Exchange Commission (SEC) has also introduced a number of proposed rules that seek to enhance shareholder democratization. Even shareholders have been effective in changing a number of corporate governance rules in their favor. Examined alongside CFIUS regulations, this movement towards increased shareholder rights and influence may exacerbate national security concerns in situations where SWFs have gained a significant equity stake in a corporation.

Global economic organizations are addressing this issue through multilateral agreements rather than unilateral regulations like CFIUS. Many of the countries that sponsor the largest SWFs have joined the International Working Group of Sovereign Wealth Funds (IWG) to

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3. Id. § 800.302(b).
4. Regulations Pertaining to Mergers, Acquisitions, and Takeovers by Foreign Persons, 73 Fed. Reg. 70702, at 70710 (Nov. 21, 2008) [hereinafter Merger Regulations].
help publish accepted governance principles and best practices. For countries in which SWFs are actively investing (Recipient Countries), the Organisation for Economic Cooperation and Development (OECD) has published investment policy guidelines as part of its Freedom of Investment initiative. On the other hand, neither of these groups has established an enforcement mechanism for their best practices or policy guidelines.

Ultimately, national security concerns posed by politically motivated SWFs are being exacerbated by shareholder activism while simultaneously being offset by the activities of regulatory agencies like CFIUS and the development of international standards for governance and transparency within these state-owned funds. Many commentators believe that CFIUS has so far struck a proper balance between economic benefits and national security concerns. The issue is whether these developing movements will act as appropriate counterbalances, cancelling each other out and maintaining that proper equilibrium within the preexisting regulatory framework of Recipient Countries.

II. SOVEREIGN WEALTH FUNDS

SWFs “are special purpose investment funds or arrangements that are owned by the... government.” Due to the 2008 boom in commodity prices and an accumulation of foreign reserves, the holdings controlled by SWFs have grown to the point that the funds are now cornerstones of the global economy that facilitate the free flow of a significant amount of capital around the world. A recent study by Deutsche Bank found that the top ten SWFs control roughly three trillion USD, which amounts to eighty-five percent of total SWF assets worldwide. Furthermore, total assets under the control of

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9. STEFFEN KERN, SWFS AND FOREIGN INVESTMENT POLICIES - AN UPDATE 5
SWFs are expected to grow to ten trillion USD by 2015.\textsuperscript{10}

The recent growth of SWFs reflects a redistribution of wealth in favor of emerging economies.\textsuperscript{11} Most of these funds are used by countries as a method to invest budget surpluses created through commodity exports, currency exchange activities, or other methods. Many state-sponsored funds throughout the world vary with respect to the size of assets under control, source of funding, degree of separation between the sponsoring government, transparency and disclosures, and asset allocation.\textsuperscript{12}

Historically, these funds have invested in riskless assets and debt instruments, such as U.S. Treasury Bonds and other low-yield bonds. However, many SWFs are now seeking higher rates of return by targeting riskier assets such as equity stakes in publicly traded companies, indirect holdings through hedge funds and other financial intermediaries, and private equity.\textsuperscript{13} While the financial crisis caused widespread losses among SWFs holding these riskier investments, the largest funds have already signaled they are ready to begin searching for new investments due to depressed asset prices.\textsuperscript{14} The power and influence associated with these types of investments have caught the attention of the governments of Recipient Countries. These governments are now closely examining the benefits and risks associated with foreign investment by SWFs in search of possible responses.

Various economic benefits are associated with foreign equity investment. Most critically, SWFs allow governments with budget surpluses to boost the amount of capital available in global equity markets by diversifying billions of dollars across publicly traded

\textsuperscript{10} Id. at 6.
\textsuperscript{14} Jason Dean & Lui Li, \textit{Feeling Flush, China’s CIC Opens Wallet}, WALL ST. J., Aug. 31, 2009, at C1.
companies. Given tightening credit markets, these macroeconomic implications provide a significant incentive for governments to embrace state-controlled foreign investment. SWFs may also invest directly in certain sectors where capital and liquidity may be needed. For example, equity investment by SWFs in the depressed U.S. financial sector, directed towards banks such as Citigroup and Morgan Stanley, boosted liquidity and abated short-term market volatility in the same way that the U.S. federal government bailout of the banking sector attempted to do. Governments that inhibit foreign investment risk damaging their economies and putting their countries at a competitive disadvantage compared to those governments that encourage the free flow of capital across national boundaries.

On the other hand, links between a fund and the sponsoring state’s political establishment raise concerns that the motive to invest will be political rather than commercial. While each fund may maintain a different degree of independence from the sponsoring country’s government, SWFs are nevertheless ultimately funded by and under the direct control of a foreign state. China in particular has shown a proclivity for mixing politics and business, especially when a precious commodity is at stake. When a contractual dispute arose between the Chinese government and Rio Tinto, an Australian mining company, over benchmark iron ore prices, Chinese authorities arrested some of Rio’s employees in response. Shareholders of that company also turned down a takeover bid by Aluminum Corp. of China, a state-owned company, due to concerns that the Chinese government would use Rio to supply China with cheap iron ore. Similarly, China used an investment in Fortescue, another Australian mining company, to secure a three percent discount on the benchmark price of imported iron ore. These examples show that

15. Gilson, supra note 12, at 1360.
16. Id.
21. Id.
China is willing to employ its growing financial resources and strategically invest in target companies to accomplish political goals.\textsuperscript{22}

This concern over political investment is compounded by a noticeable lack of transparency in key aspects of many funds’ management profiles. Many SWFs do not disclose their investment objectives, assets and holdings, governance structure, or performance.\textsuperscript{23} As a result, Recipient Countries are often left with very little knowledge or understanding of SWFs and their motivations.

III. REGULATIONS AND AGREEMENTS AFFECTING SOVEREIGN WEALTH FUNDS

A. Domestic Regulations Affecting SWFs

The United States has put into place a patchwork of regulations that apply to some of the investments made by SWFs. These regulations govern securities generally, transactions in certain industries, and foreign investment specifically.

1. General Securities Regulations

Many of the regulations affecting U.S. securities generally are aimed at increasing disclosure and transparency rather than prohibiting control. For example, under the Williams Act, an investor or entity is required to disclose the number of shares beneficially owned, percent of share ownership, and voting power when it owns more than five percent of a registered class of shares.\textsuperscript{24} Further, if the intent of the purchase is to change or influence the control of the issuing company, then the acquiring entity must disclose the purpose of the acquisition, source of investment funds, number of shares it owns, voting power, and any material contracts or arrangements with respect to the securities.\textsuperscript{25} This greater disclosure is made to the SEC,

\textsuperscript{22} The U.S. Government appears to have noticed this trend as well. A Chinese government-owned company recently decided to withdraw its bid for a Nevada gold mining company after CFIUS suggested it would intervene and block the transaction due to national security concerns. Eric Lipton, Chinese Withdraw Offer for Nevada Gold Concern, N.Y. TIMES, Dec. 22, 2009, at B3.

\textsuperscript{23} Amy D. Keller, Sovereign Wealth Funds Trustworthy Investors or Vehicles of Strategic Ambition?, 7 GEO. J.L. & PUB. POL’Y 333, 342 (2009).


the issuing company, and the exchange on which the securities are traded. In addition, Section 16 of the Securities Exchange Act requires a shareholder with a beneficial ownership of more than ten percent to disclose to the SEC the amount of its holding and to notify the SEC when there is a transaction that affects ownership of this share.

2. Transactions Affecting National Security

In 1988, Congress passed the Exon-Florio Amendment, which amended the Defense Production Act of 1950 in response to the increasing number of acquisitions of U.S. assets by Japanese companies. Exon-Florio allows the President to block certain transactions to prevent foreign acquisition of U.S. companies in industries critical to national security. The clause granting this power uses broad language that allows the executive branch significant discretion when determining what transactions to investigate. With the Byrd Amendment of 1993, Congress specifically ordered the executive branch to review transactions involving a foreign government-controlled acquirer that affect the national security of the United States. Congress recently overhauled the Exon-Florio Amendment with the passage of the Foreign Investment and National Security Act of 2007 (FINSA). This Act sets out the most current framework by which foreign acquisitions and investments within the U.S. are reviewed, including equity investments by SWFs.

The President’s powers under the Exon-Florio Amendments are delegated to CFIUS, an inter-agency body composed of the heads of various agencies. Currently, any CFIUS member may unilaterally

26. Id.
31. Id. at 338.
33. Id. § 837(n)(2).
35. The twelve present members of CFIUS include:
trigger the review process upon suspicion that the transaction might affect national security.\textsuperscript{36} This rarely occurs though, as companies are encouraged to voluntarily provide notice of a pending transaction. If voluntary notice is given and no action is taken, CFIUS will not subsequently reverse this decision and review the transaction,\textsuperscript{37} meaning that the regulations create a safe harbor that rewards foreign companies that voluntarily notify CFIUS of a proposed transaction.

CFIUS has the authority to review only “covered transactions,” defined as any transaction “by or with a foreign person and [that] could result in control by a foreign person of a U.S. person or persons engaged in interstate commerce in the United States.”\textsuperscript{38} The regulations further state that “[t]he term ‘control’ means the power, direct or indirect, whether or not exercised, . . . to determine, direct, or decide important matters affecting an entity.”\textsuperscript{39} This broad definition of “control” allows CFIUS wide discretion in determining whether a transaction meets the required “covered transaction” threshold.

However, to create certainty for foreign investors, the regulations provide that a transaction is not covered if it results in a foreign person holding ten percent or less of the outstanding voting interest in a U.S. business, but only if the transaction is solely for the purpose of passive investment.\textsuperscript{40} At first glance, “solely for the purpose of passive investment” seems to be a provision that allows CFIUS broad discretion to review any transaction it wishes. Indeed, the word “passive” was implemented in the most recent rule changes made by CFIUS in response to calls from Congress to address a perceived loophole.\textsuperscript{41} However, in its accompanying discussion, CFIUS states

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\textsuperscript{36} Georgiev, supra note 5, at 127. For a more complete history of CFIUS, see Scagg, supra note 30.
\textsuperscript{37} Id.
\textsuperscript{39} Id. § 800.204.
\textsuperscript{40} Id. § 800.302(d)(1).
\textsuperscript{41} See Implications of Sovereign Wealth Fund Investments for National Security: Hearing Before the U.S. - China Economic and Security Review
\end{flushright}
that a passive investment only includes an ownership stake less than ten percent with the ability to vote those shares *pro rata*. Thus, if an SWF acquires an equity stake with *pro rata* voting rights that comprises ten percent or less of ownership in a U.S. company, the transaction would not qualify as a “covered transaction” and therefore would fall outside of the purview of CFIUS. As later discussion shows, equity stakes of this nature may fall short of providing absolute control of a domestic entity to a foreign investor, but they do allow a significant amount of influence over target entities.

B. *International Organizations Provide Voluntary Guidelines to Regulate SWFs*

Many industrialized countries have in place a review process similar to that of the U.S. However, many of these same countries are now encouraging a multilateral approach to the difficult questions posed by SWFs. Backed by the U.S., European Union, and others, the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) have set out to establish a best practices guide for both SWFs and countries receiving investment from SWFs.

1. **Best Practices for SWFs**

   In response to the growing importance of SWFs, the IMF helped to establish the International Working Group of Sovereign Wealth Funds (IWG). This group, consisting of twenty-six SWFs created by member countries of the IMF, sought to develop a list of voluntary best practices to be adopted by SWFs worldwide. The IWG produced the Generally Accepted Principles and Practices for Sovereign Wealth Funds (GAPP), consisting of twenty-six principles based on a survey completed by its members. GAPP acts as “a framework of..."
generally accepted principles and practices that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis.”\textsuperscript{48} GAPP addresses three main underlying characteristics of SWFs: (1) legal framework, objectives, and coordination with macroeconomic policy, (2) institutional framework and governance structure, and (3) investment and risk management framework.\textsuperscript{49}

The first two characteristics focus on creating a governance structure that encourages the separation of political and commercial interests of a fund.\textsuperscript{50} Politically motivated investment is the crux of national security concerns under regimes such as CFIUS. Recipient Countries would rather see a mandated fund structure that requires commercial interests to take precedence over political interests. However, GAPP does not lay out a specific structure to be instituted by every SWF. Instead, the guidelines outline the broad goals that such a structure would seek to accomplish.\textsuperscript{51} The underlying rationale is that the structure needs to be adapted to the size, objectives, and roles of the SWF, as well as the regulatory regimes within which it is investing.\textsuperscript{52} The downside to this approach is that much of the discretion is left to the SWF, which may not be as interested in accomplishing the same goals as the Recipient Country.

Furthermore, as stated above, compliance with GAPP is completely voluntary and the IWF does not plan to develop an enforcement mechanism.\textsuperscript{53} Instead, the IWG hopes to establish a standing group of SWFs, which will assist funds with the practical matters of implementing GAPP.\textsuperscript{54} The standing group will periodically review the principles so that they accurately reflect modern best practices. However, it remains to be seen how effective peer pressure within the international community will be in accomplishing widespread adherence to GAPP among countries

\textsuperscript{48} SWF INT’L WORKING GROUP, supra note 6, at 4.
\textsuperscript{49} Id.
\textsuperscript{50} Id. at 5.
\textsuperscript{52} Id.
\textsuperscript{54} SWF INT’L WORKING GROUP, supra note 6, at 6.
hosting SWFs.

While GAPP provides a signal of multilateral cooperation and support for unified action toward the emergence of SWFs, it also represents a negotiated compromise. The principles explicitly address concerns over politically motivated investments, but they are less ambitious concerning public disclosure and transparency.\(^{55}\) Some SWFs stand as examples of transparency and good governance,\(^{56}\) but others have objected to greater public disclosure for a variety of reasons, including privacy and competitive advantage.\(^{57}\) For example, the heads of both the China Investment Corporation and the Kuwait Investment Authority have publicly stated that increased transparency will compromise their first-mover advantage and inflate asset prices before they can establish their fund’s position.\(^{58}\) However, the regulatory systems of many western countries are built upon transparency and disclosure, and many governments have objected to the idea of inviting nontransparent investors to invest, at their discretion, large sums of money into the marketplace on the basis of market stability and investor protection.\(^{59}\) Still, the international community has tried to prevent these sorts of reactions by also developing a set of guidelines that countries should follow in response to receiving investments by SWFs.

2. Principle Guidelines for Recipient Countries

The OECD has released a best practices guide for Recipient Countries, which will supplement the work done by the IWG.\(^{60}\) There are four underlying philosophies that drive these guidelines in regard

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55. MINDING THE GAPP, supra note 53, at 14.
56. CalPERS, in the U.S., and the Norwegian Oil Fund are generally held up as examples of SWFs that demonstrate these characteristics. See Delia Velculescu, Norway’s Oil Fund Shows the Way for Wealth Funds, IMF SURVEY MAGAZINE, July 9, 2008, at 110, available at http://www.imf.org/external/pubs/ft/survey/2008/073108.pdf.
58. Rose, supra note 51, at 141.
to national security. First, Recipient Countries should avoid discrimination by treating similarly situated investors in a consistent manner through generally applied principles. When general principles are not adequate to address national security concerns, the restrictive measures should be tailored to the specific investment causing concern and not to all investments from a particular country. Second, regulations that govern foreign investment should be made as transparent as required confidentiality will allow so that they create predictable outcomes and encourage investment. This includes publication and codification of applicable regulations, notification of changes in investment policy, procedural certainty and predictability, and disclosure of policy actions to reinforce government accountability. Third, the level of restrictions that regulations place on certain investments should be proportional to the national security risk posed by those investments. Finally, procedures for high-level government oversight should exist in order to create accountability in the implementing agency. Accountability should also allow some sort of recourse through efficient administrative mechanisms when a Recipient Country takes action against a foreign SWF.

The principles promulgated by the IWG and the OECD are founded upon the solid ideals of free, fair, and transparent financial markets. For purposes of this discussion, the CFIUS review process satisfies most, if not all, of the OECD Recipient Country Guidelines. The greater concern is that the IWG guidelines for SWFs lack an enforcement mechanism needed to protect market participants lacking financial leverage or market information. Thus, these guidelines will most likely serve as a strong basis for future action in this area, but they do not ultimately protect Recipient Countries from politically motivated investments. This is especially noteworthy when viewed in conjunction with the increasing ability of

61. Id. at 4.
62. Id. at 5.
63. Id.
64. Id.
65. OECD SWF REPORT, supra note 60, at 5.
66. Id.
67. Id.
68. Id.
69. See, e.g., Georgiev, supra note 5, at 134.
shareholders of U.S. companies to affect corporate affairs.

IV. SHAREHOLDER ACTIVISM

Currently, shareholders in publicly traded U.S. companies are gaining more power and influence over the board of directors and thus, indirectly, over management. Many contend that this trend towards shareholder democratization will blur the separate, well-established spheres of management and shareholder rights. Historically, the rise of institutional investors, such as mutual funds and pension funds, was widely expected to have the same result but generally failed to live up to expectations. However, proposed regulations, changes in corporate governance aimed at increasing shareholder power within the corporation, and the success of aggressive hedge funds promise to push the trend towards corporate democratization to new levels.

A. Proposed Changes in Regulations

The SEC recently reviewed new rules that would increase shareholders' influence over management. For example, the often-debated proxy access rule would allow shareholders to add their choices of candidates for the board of directors. Currently, a board has exclusive discretion in choosing candidates to fill board seats under Rule 14a-8 of the Securities Exchange Act of 1934.

Commentators believe that changing this rule is critical to empowering shareholders. The SEC also considered rules that would effectively allow shareholders with a five percent stake in a

72. Anabtawi & Stout, supra note 70, at 1278.
73. Id. at 1307–08.
company to use corporate funds to pay for proxy contests. Access to corporate funds is one of the incumbent board’s most potent weapons against proxy fights, as it requires activists to spend significant personal resources. The SEC also reviewed rules that would eliminate “broker voting.” Current rules now allow brokers to vote their client’s shares on routine matters of the corporation, including director elections. Because brokers consistently vote with management, this provides a sizeable chunk of shares in the incumbent’s favor. If the proposal is successful in removing director elections from the definition of routine matters, incumbents would almost certainly face more pressure from challengers.

While proposed rules favoring shareholder participation in corporate governance have suffered a number of setbacks in the past, the financial crisis has made these changes much more politically attractive. For instance, Chairman Schapiro recently gave a speech strongly supporting the proposed changes. Congress also introduced a bill that would provide shareholders with a right to include their own director nominees in proxy statements. The intense debate taking place over corporate governance, within both the SEC and the corporate community, signals a broader movement towards challenging the status quo and increasing shareholder involvement in corporate affairs.

B. Shareholder Influence over Corporate Governance Rules

Shareholder activists have used their growing voice to champion changes to business practices and corporate by-laws. Shareholders of U.S. corporations have a fundamental right to vote on the election of directors and certain extraordinary transactions, such as mergers or

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77. Anabtawi & Stout, supra note 70, at 1282.
78. Id.
dissolutions.\textsuperscript{82} Out of practical concerns for efficiency, voting may be done by proxy. Under federal proxy rules, a proxy solicitation and statement containing a list of proposals is sent to each shareholder, who then casts a vote on each issue and returns the forms to the corporation.\textsuperscript{83} Shareholders have been using their right, under federal law,\textsuperscript{84} to add proposals to proxy statements to garner support from other shareholders. Increasingly, shareholders are using this process to introduce resolutions and proposals that are causing real changes to their corporation’s governance rules.\textsuperscript{85}

For instance shareholders in many corporations have proposed and achieved majority voting of directors. Compared to plurality voting, which is the default rule in many jurisdictions including Delaware, majority voting increases the power of each shareholder vote\textsuperscript{86} by requiring a potential director to receive the majority of votes in order to be successfully nominated to the board.\textsuperscript{87} On the other hand, plurality voting rules only require a director to receive more votes than other candidates.\textsuperscript{88} Thus, unlike plurality voting, majority voting rules count withheld votes as “no votes” and make votes against a director meaningful.\textsuperscript{89} A study of various corporate boards demonstrates this trend, finding that sixty percent of respondents’ boards had adopted majority voting or will be considering the issue within a year.\textsuperscript{90}

Shareholders are also attacking the popular system of staggered terms for corporate board members. Under this system, only a certain number of board members are eligible for reelection each year. This prevents shareholders from replacing the board during proxy fights or

\begin{itemize}
\item \textsuperscript{82} Fairfax, \textit{supra} note 74, at 59–60.
\item \textsuperscript{83} 17 C.F.R. § 240.14a-3 (2008).
\item \textsuperscript{84} \textit{Id.} § 240.14a-8 (2008).
\item \textsuperscript{85} Fairfax, \textit{supra} note 74, at 68. But activist shareholders may also use their influence to pursue personal agendas. Paula Tkac, \textit{One Proxy at a Time: Pursuing Social Change through Shareholder Proposals}, 91 FED. RES. BANK ATLANTA ECON. REV. 1, 5 (2008).
\item \textsuperscript{87} Fairfax, \textit{supra} note 74, at 64.
\item \textsuperscript{88} \textit{Id.} at 63.
\item \textsuperscript{89} \textit{Id.} at 64.
\item \textsuperscript{90} THE KORN/FERRY INSTITUTE, \textit{34TH ANNUAL BOARD OF DIRECTORS STUDY} 31 (2008), http://www.kornferry.com/Publication/9955.
\end{itemize}
takeover battles.\textsuperscript{91} While proposals for majority voting rights receive much more attention, attacks on the staggered term system have also enjoyed widespread support among shareholders. As a result, some corporations recently abandoned staggered terms and others may follow.\textsuperscript{92}

Under each of these corporate governance changes, shareholders with \textit{pro rata} voting rights are using their rights under federal proxy laws to add proposals to proxy statements and attempting to bring about changes in corporate governance. These changes are increasing the shareholders’ control over the corporation and blurring the previously well-defined line between shareholders and stakeholders. With the financial crisis pushing more shareholders to participate in shareholder meetings, activists should find it easier to win additional measures.\textsuperscript{93} This broad movement towards corporate democratization and increased shareholder rights is exemplified by the increasing number and size of aggressive, activist hedge funds.

\textbf{C. Hedge Funds Demonstrate New Methods of Influence}

Historically, individual and institutional investors’ attempts at activism were generally hindered by the need to diversify their assets.\textsuperscript{94} Investors’ relatively small stakes in publicly traded companies prevented them from seeking any real influence. Hedge funds, on the other hand, acquire large stakes in target companies for the purpose of becoming actively involved in their affairs.\textsuperscript{95} Diversification poses less of a problem due to the fact that investors in hedge funds are usually wealthy and sophisticated and have already achieved broad diversification.\textsuperscript{96}

While a large stake in a target company does not provide a hedge fund with control over that company, it does provide the fund with a significant amount of influence. Hedge funds leverage this influence using different techniques, such as public pressure and the threat of proxy contests and litigation against management to change the

\begin{itemize}
  \item \textsuperscript{91} Fairfax, \textit{supra} note 74, at 70.
  \item \textsuperscript{92} \textit{Id}.
  \item \textsuperscript{94} Anabtawi & Stout, \textit{supra} note 70, at 1278.
  \item \textsuperscript{95} \textit{Id}. at 1279.
  \item \textsuperscript{96} \textit{Id}.
\end{itemize}
business’s strategy.\textsuperscript{97}

An institutional shareholder owning a large equity stake can put significant public pressure on a company’s management by signifying dissatisfaction with current management. Such dissatisfaction is usually followed by sale of the investor’s equity stake rather than proactive remedies.\textsuperscript{98} In order to align shareholder and management interests, the officers of a corporation are often paid with common equity, stock options, and bonuses triggered by stock performance.\textsuperscript{99} By depressing the price of the stock through the sale of a large equity stake, the institutional investor can both lower the market value of the company and significantly decrease the management’s compensation.\textsuperscript{100} A 2008 study supports this theory, finding that CEO turnover rates are higher and more new directors are appointed at companies with activist investors.\textsuperscript{101} Other shareholders may also be convinced to sell their stakes by the institutional investor’s actions, compounding the detrimental effect of the sale on the stock price. For these reasons, the directors and management of a company tend to heed statements made by institutional investors holding a large equity stake in their company, even if it represents less than ten percent ownership.

For example, in 2005, a hedge fund named Third Point used public pressure to force the resignation of the CEO of Star Gas Partner LP.\textsuperscript{102} Holding a six percent stake in the company, Third Point emphasized its position as the largest stakeholder in a press release that criticized a number of management blunders.\textsuperscript{103} CEO Irik Sevin stepped down from his position shortly thereafter.\textsuperscript{104} The hedge fund did not use any formal powers granted by corporate governance rules or rights pursuant to a preferred ownership interest. Instead, Third Point used

\begin{footnotesize}
\begin{enumerate}
\item \textit{Id.} at 1065.
\item Kahan & Rock, \textit{supra} note 97, at 1029.
\item \textit{Id.} at 1030.
\end{enumerate}
\end{footnotesize}
the “soft power” associated with large equity stakes, which can carry great influence without any sort of formal legal right or power.

The ouster of Citigroup CEO Charles Prince also demonstrated the sort of influence that an equity stake of a certain size can bestow upon a shareholder. In November 2007, Prince Walid Bin Talal, a wealthy Saudi investor with an investment portfolio that surpasses most hedge funds, recommended that the CEO of Citigroup be fired. Prince Bin Talal did not hold a seat on the board of directors, which would have provided him with this sort of authority. Rather, he controlled a 3.9% equity stake in the company. Nonetheless, Citigroup’s board decided to heed his advice based on the “soft power” created by the size of the Prince’s pro rata voting share.

These strategies can effect substantial change in a target company despite the fact that hedge funds almost never acquire a controlling equity stake. Instead, one study of activist hedge funds found that the “overwhelming majority” of funds took between a five and ten percent pro rata ownership share, with a median of six percent. In other words, hedge funds implement their activist strategies while holding positions that would qualify as mere influence, rather than control, under CFIUS regulations.

V. SHAREHOLDER ACTIVISM WILL INCREASE THE POTENTIAL INFLUENCE AND RISKS OF SWFS

Due to the objectives given to CFIUS by Congress, as well as the need to encourage foreign investment within the U.S., current regulations offer few restrictions on SWFs that are sophisticated enough to structure their investment to avoid attention. While not an immediate concern, risks posed by excessive influence from foreign governments will be exacerbated by the movement towards greater shareholder rights and activism. However, CFIUS must avoid unilateral regulation that could cause extensive damage to the

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108. Id.
economy and international standing of the U.S. in the midst of an existing economic crisis.

A. Limitations on CFIUS Review

As noted above, the newest regulations promulgated by CFIUS carve out an exception to the committee’s jurisdiction when an acquiring entity owns an equity stake of ten percent or less with pro rata voting rights.\(^ {110} \) This exception represents the committee’s policy of concentrating on “control” rather than mere “influence.” CFIUS makes clear that influence falling short of the definition of control does not fall within the purview of the regulations.\(^ {111} \)

The ten percent exception is rare in the sense that the rest of the regulations generally eschew bright-line rules in favor of broad definitions that provide members of CFIUS with a good degree of discretion when determining which transactions to review.\(^ {112} \) While CFIUS maintains that the newest promulgation of the rules blurs this bright line standard and expands the scope of its scrutiny by adding the term “passive” to describe exempted investments, the accompanying guidance reaffirms a carve out for certain investments.\(^ {113} \) This half-measure could be a means to pacify calls from Congress and the public relating to legitimate national security concerns while recognizing that uncertainty in the regulatory process might discourage foreign investment at a time when liquidity is so badly needed.

B. Hedge Funds as Predictors

SWFs have an advantage similar to hedge funds. As stated above, hedge funds mitigate the problems of diversification through their sophisticated clients.\(^ {114} \) While SWFs do seek to diversify their assets in most cases, the sheer size of the assets under their control allows SWFs to take significant equity stakes in even the largest publicly traded companies while still remaining relatively diversified.\(^ {115} \) For example, some SWFs have invested billions of dollars into the risk-laden equity of U.S. financials to take advantage of extremely

\(^ {110} \) See supra Part III.A.2.
\(^ {111} \) Merger Regulations, supra note 4, at 70704.
\(^ {112} \) See supra Part III.A.2.
\(^ {113} \) See supra Part III.A.2.
\(^ {114} \) See supra Part IV.C.
\(^ {115} \) Moshirian, supra note 17.
depressed prices.\textsuperscript{116} However, the percentage of the SWF’s overall assets that these investments represent is small enough that the equity stakes do not have a material impact on the fund’s risk profile. In other words, many of the investments made by hedge funds in target corporations, if governed by CFIUS regulations, would fall under the ten percent or less exception in the regulations. The size and type of investments taken by SWFs are often similar to the size and type of investment taken by hedge funds and institutional investors.\textsuperscript{117} Thus, activist hedge funds show that SWFs may leverage these investments to influence corporate affairs. As a result, foreign governments may use their influence to effect politically motivated changes in target corporations.

C. The Balancing Act

This risk is compounded by the fact that many of the tools that hedge funds, and thus SWFs, can use to gain influence over corporations are being bolstered by the general movement towards shareholder democratization. For instance, current trends toward proxy access and majority voting and away from staggered director elections will only make voting rights associated with equity stakes more influential.\textsuperscript{118} Instead of adjusting the regulations to account for the changing landscape, CFIUS chooses to keep in place an old framework, which was created before these significant changes in corporate governance occurred.

As the democratization of corporate governance advances, the potential influence and power of SWFs that hold equity stakes will grow while, under the newest regulations, the ten percent exception prevents CFIUS from reviewing those investments. GAPP attempts to address the main concern of industrialized countries, namely politically, rather than commercially, motivated investments.\textsuperscript{119} In fact, the Treasury Department strongly supports GAPP to supplement the regulations designed by CFIUS.\textsuperscript{120} However, this international response, crafted by the very SWFs it seeks to govern, is careful to use softer, nonbinding language throughout. Further, it is unclear to


\textsuperscript{117} See supra Part IV.C.

\textsuperscript{118} See supra Part IV.B.1.

\textsuperscript{119} See supra Part II.A.

\textsuperscript{120} See supra Part II.A.
what extent GAPP will be implemented by most SWFs and there is no foreseeable enforcement mechanism. These facts suggest no change in one side of a previously balanced equation while, on the other side, shareholder activism is materially changing in favor of increased corporate democratization.

VI. CONCLUSION

It appears the current U.S. policy towards foreign investment by SWFs is to wait and see whether multilateral agreements will be strong enough to prevent politically motivated investments. To be fair, it is unclear to what extent the IWG’s guidelines will be accepted and implemented by the international community of SWFs. However, this uncertainty speaks to the weakness of those agreements as an effective check against politically motivated foreign investment.

On the other side of the equation, the evidence cited above provides little doubt that shareholders are seizing increasing power throughout the U.S. The opportunities to influence and control corporate affairs inherent in the positions taken by hedge funds can also be expected in the positions taken by many SWFs. As a result, CFIUS regulations leave open the possibility for foreign governments to gain more influence and control over American businesses through equity investment as shareholder democratization advances.

121. MINDING THE GAPP, supra note 53, at 15.