

**“The Shareholder Voting Rights and Sovereign
Wealth Funds:
Perspectives from Investors”**

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I Introduction

While the recent global financial crisis has certainly made Sovereign Wealth Funds (SWFs) more risk averse in their investment allocations toward equity or equity related alternative investments, they will remain as the major investment instruments for maximizing risk adjusted long-term return. The implications of equity investments by government controlled SWFs, especially the direct investments in U.S. and European public companies by SWFs from the oil rich and export-led Asian economies, have created much fear that these foreign equity investments may seek strategic, technological, and other non-financial benefits compromising recipient countries' interests. It was suggested that the voting rights of SWFs in U.S. companies above a certain threshold, even for non-controlling stakes, be restricted in the form of "vote suspension." This approach, which apparently would not discourage pure financial investments by SWFs, nevertheless should be considered as fundamentally discriminatory and protectionist in nature.

After reviewing the present status of voting rights and proxy rules in U.S., we reexamine the voting rights issue from the perspectives of small SWFs investors, particularly from the viewpoint of

relatively small export-led Asian economies like Korea. The current decision making process and governance structure of Korean SWF (Korea Investment Corp.) is taken as a case study with the relatively small portfolio size and the limited resources of small started-up SWFs. In terms of accountability, reporting requirements, and its associated costs when faced with exercise of voting rights, we identify certain issues appropriate for direct exercise of voting rights or proxy, while delegating the voting rights to an independent trustee or proxy advisory firm would be more suitable based on the cost/benefit analysis of issues. Furthermore, a regional strategic alliance among small SWFs is also proposed for the effective exercise of votes to achieve universally accepted common goals of responsible international investors.

II Shareholder Voting Rights and SWFs

The status of shareholder voting rights and proxy rules constitute the central issue in the discussion of corporate governance system. There indeed exist widely different viewpoints on the role and value of shareholder voting rights ranging from simply referring them as the nominal power having no real value or significance to providing an important means of accountability for directors and executives.

To some extent, these differing viewpoints on the value of shareholder voting rights and the extent to which shareholders should be able to exert control over major corporate decisions can be traced back to more fundamental issues of corporate governance system in general. Depending on whether one takes “director/managerial primacy-based system” of corporate governance or “shareholder primacy-based system”¹, the role of shareholder voting rights thus could be defined as either irrelevant nuisance or final arbitrator to restore and maintain “shareholder primacy-based system.”

While there is an on-going debate about what should be the proper role of shareholder voting rights between these two different lines of thoughts, it looks like for most of practical purposes that the advocates for the limited shareholder voting rights including SEC are gaining at the expense of advocates for increased shareholder role. However, the present conservative regulatory stance held by SEC may be challenged more vigorously by the recent events

¹ “The Case for Limited Shareholder Voting Right” by Stephen M. Bainbridge, UCLA Law Review, Vol.53, 2006, argues for maintaining the limited shareholder voting rights currently provided by corporation law under the director/managerial primacy-based system.

during financial crisis.² It would be interesting to see whether advocates for increasing shareholder power would gain, and any meaningful reforms would come out from the current review of financial regulatory frameworks going on in U.S.

Having briefly reviewed the current status of shareholder voting rights in general, we now turn to the issue of SWF as shareholders in particular.

The direct investments by SWFS affiliated with foreign governments has invoked the fears of foreign entities potential to influence a company's actions seeking investing country's national interests ranging from economic, political, technological and other strategic benefits.

There is of course CFIUS³ review process already in effect which

² Recently, SEC (Rule 14a-8) has approved the new proxy rule denying shareholders access to the management proxy for the nomination of corporate directors.

³ In the U.S, all inbound foreign investment is governed by the Exon-Florio statute, which was most recently amended in 2007. Under the Exon-Florio regime, the inter-agency Committee on Foreign Investment in the United States (known as "CFIUS") reviews all notices of pending foreign acquisitions of control over U.S. companies and can recommend to the President that specific transactions be blocked because they pose a threat to national security. The definition of "control" in the CFIUS regulations is quite broad. The regulations provide that there is no control when voting securities are held "solely for purposes of investment," which mean that the acquirer "has no intention

should provide more than adequate protections against these unlikely events yet to be materialized. But even for the acquisitions of significant but non-controlling stakes by portfolio investors, some suggest consideration of restriction on the voting rights of SWFS above a certain threshold. That is, the equity acquired by SWFS would lose its voting rights but would regain them when transferred to non-SWFS owners.⁴

According to this “Minimalist Approach”, these restrictions of voting rights would not discourage pure form of financial portfolio investments as SWFs with pure incentive of final portfolio investments will invest regardless of existence of voting rights, while SWFS investments with certain non-financial motives will stay away from the investment.

This “self selection” equilibrium state introduced by “vote suspension” would have several problems. The first problem is, of

of determining or directing the basic business decisions of the issuer.” CFIUS is explicitly charged with considering “whether the covered transaction is a foreign government-controlled transaction.”

Foreign-government controlled transactions trigger an automatic 45-day investigation and are subject to various congressional oversights.

⁴ “Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism” by Ronald J. Gilson & Curtis J. Milhaupt, Stanford Law and Economics Olin Working Paper No. 355, Feb., 2008

course, related to the complete negation of shareholder voting rights such that these voting rights serve no meaningful role in the corporate governance system.

The second problem would be more serious such that this complete “passivity” compelled by the “vote suspension” would attract only SWFs who is not only disinterested in control but is also unwilling to engage with management in any activities that may affect firm behavior or decision making. In this way, SWFs can not encourage much needed reforms and changes within a company, as might other active investors such as pension funds, hedge funds, or private equity funds may try to do so. Given the relatively small size of private equity firms and hedge fund compared to SWFs⁵, this complete absence of large, stable shareholder base like SWFs to the corporate governance structure could affect the long-term financial returns performance produced by the company negatively by undermining the effective corporate governance because good financial returns tend to follow the good corporate governance practices in the long-run.

The third problem is that there may be other ways besides voting

⁵ It is estimated that the total size of SWFs well exceeds the sum of both private equity funds and hedge funds combined.

rights if shareholders with a significant equity portion really want to exercise some kind of subtle “influence.”⁶

The fourth problem is of issues involving the principle of “reciprocity.” Many western funds⁷, though not formally affiliated with government, have exercised their voting rights directly or indirectly through proxy to have their views on certain issues let known as responsible investors. These issues may comprise environmental, social, and governance issues (“ESG” issues) which was incorporated into UN’s “Principle for Responsible Investment (PRI).” These issues now have become the legitimate concerns for any socially responsible global investors and could be extended to include universally accepted norm and standards of corporate governance, climate change, and sustainable development.

While western shareholder activism is permitted to play an increasingly activist role in developing countries, the imposition of restrictions on shareholder voting rights by western countries

⁶ U.S. Treasury Department’s new CFIUS rule may constitute this as “control.”

⁷ For example, Norway’s SWF (Government Pension Fund Global) has signed on to the UN’s “Principle for Responsible Investments” as a set of non-binding best practices. Other similar moves are attempted by entities including CalPERS (California Public Employee Retirement System), Alaska Permanent Revenue Fund and Singapore’s Temasek Fund which could serve as role models.

should be considered basically against the principle of “reciprocity” and “protectionist” in nature.

III Shareholder Voting Rights in the Santiago Principles

While most of SWFS are not expected to try to emulate western funds as active ESG investors as stipulated in the UN’S PRI in the near future, the “Voluntary Best Practices” as adopted in the “Santiago principles” provide us with at least a good starting point to discuss the role of SWFS in terms of shareholder voting.

On the one hand, GAPP19 of Santiago Principles stipulates the financial objective of SWFS emphasizing the role of passive financial investor in which it sets out the investment policy of ultimate share value maximization or investment on economic grounds.⁸

⁸ GAPP19. Principle.

The SWF’s investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.

GAPP19-1. Sub-principle.

If investment decisions are subject to other than economic and financial decisions, these should be clearly set out in the investment policy be and publicly disclosed.

GAPP19-2. Sub-principle.

The management of an SWF’s assets should be consistent with what is generally accepted as sound asset management principles.

On the other hand, GAPP21 stipulates shareholder ownership rights as a fundamental element of their equity investment value assuming SWFs will exercise their voting rights. At the same time, SWFs also should publish a “Voting List” on regular basis as some institutional investors do in the case of mutual funds in U.S. and unit trusts in U.K. which is consistent with universally accepted norm and principles of global investing community.⁹

It shows the ambivalent views of Santiago Principles. While emphasizing the main objectives of SWFs being the passive financial ones, the underlying shareholder ownership also cannot be denied, albeit it requires that this exercise of ownership rights be exercised in a publicly disclosed and transparent manner consistent with its investment policy.

IV A Case of Korea Investment Corporation (KIC)

⁹ GAPP 21. Principle

SWFs view shareholder ownership rights as a fundamental element of their equity investments’ value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding the exercise of ownership rights.

Having reviewed the SWF's general investment policy and principles, we now turn to a specific example of SWF in Korea as a specific case study in order to reexamine the issues from the perspectives of relatively small export-led Asian economies.

The KIC (Korea Investment Corporation) was established in July 2005 under the KIC Act with USD 17 bn from the Bank of Korea (Foreign Exchange Reserve) and USD 3 bn from Korea's Ministry of Strategy and Finance (KMSF). During 4Q, 2007, additional commitment of USD 10 bn by KMSF was brought in with the total committed assets of USD 30 bn.

The first investment was launched in Nov. 2006 and currently its asset size under management is estimated to be around USD 27.8 bn. The overall investment objectives as provided in the investment policy are "long-term attainment of consistent and sustainable financial returns within an appropriate level of risk by implementing a diversified global portfolio comprising both the fixed income and equity asset classes." For the actual investment management operations, KIC is outsourcing (Indirect investments by re-entrusting assets to Korean and overseas financial institutions) a major portion of its assets to external fund managers (EFMS), while developing its own internal management resources for the future. Currently it is also working on the investment

process and framework to increase allocation toward the new equities investments or alternative investments away from the fixed income securities.

In KIC Investment Policy Statement, general investment objectives are defined as to “achieve a stable and continuous return exceeding the benchmark within an appropriate level of risk through portfolio diversification and exercising proper flexibility, while pursuing sustainable increase in return.”¹⁰ In terms of other considerations such as “voting issue,” KIC investment policy requires that the corporation shall act as a prudent manager when exercising the voting rights. In the case of indirect investment, the voting right may be delegated to EFMs as long as it is not in breach of the fiduciary duty of the corporation, but the results of exercise of the voting rights should be reported to Board of Directors and the Steering Committee on a regular basis.

The current descriptions regarding the exercise of voting rights are quite sketchy, thus most of voting rights are delegated to EFMs. The disclosure requirements and its associated costs of preparing for voting list of many stocks in the equity portfolio far outweigh the benefits of enhanced corporate governance given the limited equity portions held by KIC in a well diversified equity portfolio.

¹⁰ Annual Reports, Investment Policy Statements, 2008, Korea Investment Corporation

Therefore, it would be appropriate to distinguish the voting rights issues between the “firm-specific issue” and the “fundamental corporate governance issue.” The firm specific issues, i.e., selecting a new CEO or CFO, or investing in a new investment project, are not likely to be an effective corporate governance mechanism for SWFs. In this case, these issues can be delegated or outsourced to outside independent trustee organization, EFM, or proxy advisory firms without significant consequences on the ultimate financial returns.

On the other hand, “fundamental governance issues,” e.g., takeovers or introduction of anti-takeover device such as poison pills, which are likely to affect the fundamental value of the company thus affecting the financial returns, should be taken up by the SWFs and voted upon directly. For a certain “fundamental governance issues” facing the SWFs, the equity portion of small export led Asian SWFs may not be big enough to become an effective determining factor.

In this regards, one potentially interesting idea to pursue further is that these small SWFs holding each small portions of a company could combine its voting rights by setting up or by establishing a regional special purpose trustee organization or proxy advisory firm. This outsourcing firm can conduct the professional proxy

monitoring services for the small SWFs on more cost-effective basis and then authorized to vote on an issue as a coalition group.

This strategic alliance among regional small Asian SWFs should dissipate the recipient country's concerns that one specific country's national interests could be manifested on the exercise of voting rights, while at the same time this should help to enhance the transparency and governance structure thus increasing the potential financial returns and unlocking the inherent investment value of a invested company.

In the future, one could certainly imagine these alliances among small SWFs be extended to cover wider range of issues such as other universally accepted common goals of responsible international investors community.¹¹

V Conclusion

Typical equity investments by SWFs usually involve a long-term investment horizon. Thus, the existence of underlying shareholder

¹¹ Recent strategic alliance MOU signed between SWFS of Australia, Malaysia, Kuwait and KIC in 2009 provides an initial starting point towards the co-operations among small SWFs in this field.

voting rights and its exercises simply cannot be assumed away as irrelevant as in the case of short-term equity investors. This issue will come year after year as long as they hold the equity investments. At the same time, exercises of shareholder voting rights represent some serious concerns for the recipient countries' government and management due to the sovereign nature of investments, despite the fact that it would be utterly difficult to contradict the underlying voting rights attached to equity investments. The investment objective of SWFs is to maximize the financial returns subject to a tolerable level of risk, but the financial returns realized are sometimes significantly affected by the changes in the corporate governance structure, which in turn call for the proper exercise of voting rights directly or through proxy to maintain or restore the original investment value.

We have examined these issues from the perspectives of small recently started-up SWFs with limited resources and investment size. Given a cost/benefit structure of SWFs, we identified certain fundamental governance issues considered necessary for the direct exercise of voting rights, whereas other issues can be safely and more cost effectively delegated to outside proxy services. Furthermore, a proposal of possible co-operations among small SWFs was suggested as an approach to participate in the globally accepted best investment practices in a meaningful way.