FOREIGN DIRECT AND PORTFOLIO INVESTMENT, DIFFERENCES & SIMILARITIES

Definitions

I. Foreign Direct Investment (FDI)

According to Jones and Wren in *Foreign Direct Investment and the Regional Economy* (2012):

The standard definition of foreign direct investment is given by the Organization for Economic Cooperation and Development (OECD, 1996). A key aspect of this is that it represents the notion of one enterprise in a particular country having a degree of control over another enterprise in a different country, as opposed to just the provision of financial capital. It is classed as, "investment that adds to, deducts from or acquires a lasting interest in an enterprise operating in an economy" arising from outside the country in order to "have an *effective voice* in the management of the enterprise" (OECD, 1996, p. 7). In the event that a foreign investor does not have an effective voice in the management of the company, then the investment is classified as 'portfolio investment' (*emphasis added*).

II. Portfolio investment

In his book '*The International Law on Foreign Investment'* (2004), M. Somarajah explains the differences between the FDI and the portfolio investment more clearly:

The distinguishing element is that, in portfolio investment, there is a divorce between management and control of the company and the share of ownership in it.

In other words, the main difference between the FDI and portfolio investment is that in the first one, the share of ownership in a company resulting from an investment in the company accompanies effective management and control in it while in the latter, these two elements do not move hand in hand.

To understand the subject of this report, therefore, we need to learn more about legal control of companies.

III. Corporate control

The following elements may result in having control of a corporation:

a. The right to a majority of the votes in the election of the Board of Directors;

b. Control by management, if management is not under complete control of the Board of Directors; and

c. *De facto* control by one or more shareholders, whether they hold a majority of shares or not.

IV. Types of corporate control

Corporate control has two main forms: legal and factual.

A. Legal (de jure) control

As mentioned before, the main factor for determining who is in control of a corporation is to look at the composition of the board of directors. Those who control the board of directors control the corporation. The mechanism of voting to elect the board members, therefore, is the mechanism to control the corporation. The last part of Article 88 of the Joint Stock Companies Act of Iran defines the modality of electing the board members:

> In the case of election of the directors, the number of votes of each voter shall be multiplied by the number of directors intended to be elected and the voting rights of each voter shall be the result gained from such multiplication. The voter may assign all his votes to one person or divide the same between a number of persons. The articles of association may not include provisions contradictory to the above arrangement.

The formulae to be applied shall look like this:

Voting rights of each voter = number of votes X number of directors to be elected.

It is evident that where number of votes increase, voting rights also increase. What does happen where the number of directors increases? For example, let us accept that two shareholders called A and B each have 30 and 50 shares out of 100 shares of a company. It is also accepted that their numbers of votes are 30 and 50. The company is going to elect five directors. By applying the above formulae, voting rights of A and B shall be calculated in the following manner:

Voting rights of A = 30 X 5 = 150
Voting rights of B = 50 X 5 = 250

The total number of the voting rights is equal to 500 = 100 X 5. It must be kept in mind that under Article 88 of the Joint Stock Companies Act, each voter may assign all his votes to one board candidate or divide the same between the candidates suitable to his plan to exert control over the corporation. In our example, if A uses his voting rights to elect only one board member, it will be certain that A’s candidate shall be elected. B, on the other hand, shall focus on the remaining four candidates. In competition with the third shareholder, C, who owns the remaining 100 voting rights, B shall elect three board directors while C shall elect the last one.

In our second example, the number of directors is 10. The voting rights shall be as follows:

Voting rights of A = 30 X 10 = 300
Voting rights of B = 50 X 10 = 500
Voting rights of C = 20 X 10 = 200

In the above situation, if A uses his voting rights to elect 3 board members, B may focus his attention on electing five members and the remaining two members shall be elected by C. Contrary to the first example in which the composition of the board members was 1 for A, 3 for B, and 1 for C, in the second example, by doubling the number of the directors without changing the number of shares of the three shareholders, the composition of the board members shall be changed to 3 for A, 5 for B, and 2 for C. It is clear that the number of board members for each of the shareholders is not doubled.

It goes without saying that *de jure* control is not limited to electing the board directors. It can be applied to the functions carried out by the board directors. It can also influence the decision to put an end to their activities.

Further, shareholders of a company may enter into different alliances in order to ensure that another shareholder will have or will not have the possibility of electing certain number of the board members. We may study positive and negative control in another News & Analysis report.

B. Factual control

The following elements may be defined as factual control:

1. The controlling person has any direct or indirect influence that would result in factual control, if that influence is exercised.

2. Factual control, or operational control, exists where a person other than the directors has the ability to manage the business and affairs of the corporation.

3. Factual control also exists where a person or group of persons may influence decisions, powers, or changes in the board of directors or in the meetings of the shareholders in order to influence managerial decisions of the corporation.

Corporate control through shareholding

In the case of *British American Tobacco Co v. I.R.C.* [1943] 1 A.E.R. 13, Viscount Simon L.C., at page 15, stated: "The owners of the majority of the voting power in a company are the persons who are in effective control of its affairs and fortunes."

The corporate law of Iran is familiar with this form of corporate control. This matter is discussed in detail in the book on *Foreign Investment Law of Iran* (1994). Therefore, we do not feel the need to repeat the same discussions in this report. Instead, it would be useful to mention that corporate control through shareholding must not be confused with another form of corporate control that is applied through the managing structure of a corporation, especially through the board of directors. The latter results from the first one, in general, but they are not the same concepts.

The Draft Commercial Code of Iran combines these two forms of corporate control in its article 226:

> A company in which more than 50% of the capital, either directly or indirectly, belongs to another company, as well as a company that is under control of another company either through the ways prescribed in its articles of association or through any other way such as obtaining majority in the board of directors, shall be considered as a subsidiary (*far'ii*) company even if less that 50% of its capital belongs to the controlling company. The company that holds the controlling position is called the mother company. A company that is under substantial influence of another company in any way, such as having at least one manager in that company or through substantial shareholding, shall be called affiliated (*va'abasteh*) company (*emphasis added*).

In the above article, certain terms such as “controlling position” and “substantial shareholding” are not defined clearly. Further, by using the term “less than 50%”, drafters of the Draft Code have opened the way for serious misunderstandings because the limit for “less than 50%” is 0%.

The history of corporate law of Iran shows that from the beginning, the concept of ‘subsidiary company’ was not fully dependent on the concept of owning controlling number of shares in a corporation. Annexed article of the Regulations of the Corporate Registry Act (1931) is clear in this respect: “Concerning the subsidiary companies established by the mother company, if the majority of the subsidiary company’s shares belong to the mother company, then as far as registration is concerned, the subsidiary company shall be considered as a branch of the mother company.”

It must also be noted that the term ‘subsidiary company’ does not mean the same in all of the laws of Iran. For instance, article 5(a) of the Act on the Charter of the National Iranian Oil Company defines ‘subsidiary company’ as a legal entity whose shares belong completely to the National Iranian Oil Corporation.

Consequences of corporate control

Another misunderstanding that is present in some legal analyses is the confusion between corporate control and whether a corporation is Iranian or foreign. Under article 6(c) of the “Regulations of Foreign Investment in and out of Stock Exchange Offices”, a juridical person that is incorporated in Iran in which more than 50% of its shares belong to a foreign individual or to a juridical person that is incorporated out of Iran shall be considered as a foreign juridical person until shares of the foreign person fall to less than 40%. This means that in certain circumstances, to become an Iranian corporation, it shall not be sufficient to incorporate a juridical person in Iran. Ownership of more than 60% of its shares by Iranian persons would also be required.

What if the corporation is a TNC with tens or hundreds of thousands of shares owned by shareholders of different nationalities? Would it be possible to determine who controls such corporations? It must immediately be added that these questions are not theoretical. Under the Iranian law, it is prohibited to get into transactions with corporations that are of certain nationality. Recently, serious questions were raised about whether any ship belonging to American shipping lines have harbored in the Iranian ports. The main response given by the authorities was that although through controlling the place of incorporation of shipping lines and registering the ships, it was possible to control whether a shipping line or a ship is American or not but in the case of transnational corporations, such a control would practically be impossible.

Practically speaking, in case of transnational corporations, the following elements must be taken into consideration in order to determine who exerts *de jure* or *de facto* control over the corporation:

1. The transnational corporations are interrelated and interconnected in different ways. As explained by Vitali, Glattfelder and Battiston in "*The network of global corporate control*":

> The computation of control requires a prior analysis of the topology. In terms of connectivity, the network consists of many small connected components, but the largest one (3/4 of all nodes) contains all the top TNCs by economic value, accounting for 94.2% of the total TNC operating revenue.

2. They also add that financial institutions effectively exert control over corporations:

> According to some theoretical arguments, in general, financial institutions do not invest in equity shares in order to exert control. However, there is also empirical evidence of the opposite. Our results show that, globally, top holders are at least in the position to exert considerable control, either formally (e.g., voting in shareholder and board meetings) or via informal negotiations (*emphasis added*).

3. Control of transnational corporations, like many other similar issues, is influenced by both the domestic and the international trade law of each country, as well as the interactions between these two legal systems. Where domestic law of a country is a *sui generis* system, as it is the case in Iran, then it becomes even more difficult and complicated to predict the result of legal discussions on corporate control issues.

Conclusion

The main factor that creates a distinction between FDI and portfolio investments is control. The concept of control is fuzzy because it is heavily influenced by the social and economic contexts present in each country. Further, two issues of corporate control and "citizenship" of a corporation overlap. As a result, under the Iranian law a corporation that is effectively controlled, for example, by American shareholders is considered as an "American corporation". The complex structure of transnational corporations has made it even more difficult to determine who controls them. Another difficult issue is to distinguish between *de jure* and factual control. Once more, the criteria used to make the distinction are fluid and murky. The Iranian legislator has not paid enough attention to this subject. A properly developed foreign investment law requires specific provisions to shed enough light on two frequently misunderstood concepts of FDI and portfolio investments.

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