



Client Alert

Financial Markets Developments

International Working Group of Sovereign Wealth Funds Publishes Voluntary Generally Accepted Principles and Practices

“We believe that this document will in both home and recipient countries improve the understanding of the objectives, structures, and governance arrangements of SWFs; enhance the understanding of SWFs as economically and financially oriented entities; and help maintain an open and stable investment climate. Through the implementation of the Santiago Principles, we seek to ensure that the international investment environment will remain open and our capital can continue to be put to use when it is most needed.”

—Hamad Al Hurr Al Suwaidi, *International Working Group of Sovereign Wealth Funds Co-Chair and Undersecretary of the Abu Dhabi Department of Finance, October 11, 2008*¹

The first modern sovereign wealth funds (“SWFs”)² were formed in the 1950s, and their importance within their home countries and the global financial system has grown steadily since then. Market estimates suggest that SWF assets under management currently total between US\$2 and US\$3 trillion, and these assets are projected to grow to between US\$7 and US\$11 trillion by 2013. The investment activity of SWFs has accelerated in the last several years, and their involvement in high-profile transactions across diverse asset classes has resulted in attention and scrutiny of their activities that did not exist before. Many recipient countries have expressed concerns that SWFs’ investments may be politically-motivated, raising questions of national security and transparency.

These concerns and recognition of the growing role of SWFs in the global economy led to the establishment of the International Working Group of Sovereign Wealth Funds (the “IWG”) at a meeting of countries with SWFs on April 30 – May 1, 2008, in Washington, DC. The goal of the IWG was to identify and draft a common set of voluntary principles that would promote a clearer understanding of the institutional framework, governance and investment activities of SWFs, as well as support an open and stable investment climate globally.³ On October 11, 2008, the IWG presented principles that it believes SWFs should follow with respect their governance and investment activities. The IWG intends that these “generally accepted principles and practices” (the “GAPP”) for SWFs, also known as the “Santiago Principles,” be applied by each SWF in a manner that reflects the different institutional, constitutional and legal environments in which they exist. While the GAPP may serve as a minimum standard for those SWFs that have well-established practices, adoption of some or all of the guidance provided by the GAPP will likely require a transition period for those SWFs with shorter histories. The IWG has agreed to explore establishing a standing group of SWFs to keep the GAPP under review and to enable implementation of the GAPP.



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Underlying the twenty-four voluntary principles and supporting commentary that comprise the GAPP are three key themes: (i) public disclosure; (ii) sound governance and (iii) investment and risk management. We discuss each of these themes in more detail below.

The Santiago Principles need to be assessed by each SWF in light of its unique circumstances. As a result, while there is no single set of “action items” or steps that can or should be applied universally to SWFs and their implementation of the GAPP, we have listed in Appendix A a summary of recommended actions that arise out of the possible implementation of different aspects of the GAPP. Our firm’s representation of many SWFs and sensitivity to the issues they face in their home countries and recipient countries, as well as the challenges of competing and managing diverse, complicated transactions, make White & Case uniquely well-suited to provide advice regarding appropriate implementation of the Santiago Principles.

I. Public Disclosure

“It’s all about trust,” said Mr. Al Suwaidi. “It’s about collectively doing everything in our power to ensure that trust lies in the heart of everything we do.”⁴

This quote illustrates a key theme prevalent throughout the GAPP: a call for increased public disclosure by SWFs. Recipient countries have expressed concern that SWF investments could affect national security, or that SWF investments could be based on noncommercial motives or undesirable macroeconomic policies. Regardless of whether such concerns have any basis, the risk of a protectionist response from recipient countries is real. Fear or uncertainty regarding SWF operations by recipient countries could limit SWFs’ investment opportunities, increase their investment risks and result in retaliatory measures. These potential negative ramifications would undermine the efficient flow of global capital and, at a time when the international financial and monetary system is already fragile, further diminish economic stability.

The IWG hopes that compliance with GAPP-recommended public disclosures regarding SWF financial information (such as asset allocation, benchmarks, rates of return, etc.), governance structure, operational controls, investment policies and accountability, will encourage the free flow of cross-border capital and improve understanding of SWFs as economically driven entities in home and recipient countries. It is hoped that this understanding will reduce protectionist tendencies and contribute to an open and stable investment climate.

Please refer to Appendix B for a summary of the individual items of information that SWFs are recommended to disclose publicly under the GAPP.

II. Sound Governance

Alongside the call for greater public disclosure, the Santiago Principles also emphasize the need for sound governance of SWFs. The GAPP provide that SWFs’ activities should be underpinned by a well-framed governance framework set out in either the legislation governing the SWF or in its charter, constitutive documents or management agreement.

The IWG believes that an appropriate governance structure separates the functions of the owner(s), the governing body(ies) and management, thereby promoting independent management and enabling the SWF to pursue investment decisions and operations based on economic and financial considerations free of political influence. The IWG believes that the role of the government should be to determine the broad policy objectives of the SWF, but not to interfere with particular investment decisions. Desirable governance structures also typically articulate clear roles, responsibilities and interrelationships between the different bodies responsible for the SWF’s administration and management, with the goal of facilitating operational independence for investment decisions.

The GAPP state that the accountability procedures for a SWF's operations should be clearly defined in the relevant legislation, charter, constitutive documents or management agreement. Such accountability procedures help ensure that actions of the owner(s), the governing body(ies) and the operational management, as applicable, are consistent with their respective defined responsibilities. In addition, appropriate evaluation methods permit more effective monitoring by owner(s) and governing body(ies) of the performance of SWF investment managers in achieving their stated objectives.

III. Investment and Risk Management

The IWG also encourages SWFs to establish clear and consistent investment and risk management frameworks. In order to harmonize the investment decisions that SWFs make within their approved investment objectives and strategies, the GAPP provide that SWF's investment policies should: (i) define objectives, risk tolerance and investment strategy (as set by the owner(s) or the governing body(ies)); (ii) be based on sound portfolio management principles; (iii) guide the SWF's financial risk exposures and the possible use of leverage and (iv) address the use, authority, and monitoring of external institutions for investment management. Further, in keeping with its recurring themes of transparency and politically-free investment decisions, the GAPP call for public disclosure of a SWF's investment policy and investment decisions to show a commitment to a disciplined investment plan and provide a benchmark to judge compliance and success.

The GAPP also provide that SWFs should establish a publicly disclosed risk management framework that identifies, assesses and manages the risks of its operations. The IWG believes that a well-defined and implemented risk management framework will enable SWFs to: (i) protect their assets; (ii) operate within the tolerance levels set forth in the investment policy; (iii) preserve financial stability and (iv) maintain a stable investment environment. Moreover, with reliable information and regular reporting, the SWFs should be able to effectively monitor and manage relevant risks within acceptable levels. The adoption of a clear investment policy is a vital part of risk management, enabling a SWF to match its strategy with its appetite for risk. For example, stabilization funds are more likely to invest conservatively and have shorter investment horizons. Conversely, savings funds often have longer investment horizons and may invest in more risky asset classes.

IV. Looking Forward

The Santiago Principles were developed due to concern about a lack of information and openness expressed by home countries of SWFs, recipient countries and the wider international financial community. The IWG has attempted to address these concerns by adopting the GAPP, which address the broad themes of: (i) public disclosure; (ii) sound governance and (iii) investment and risk management. The IWG acknowledges that this initial framework has limitations and will require a transition period, further discussion and review and, of course, voluntary compliance by SWFs.

Appendix A

Summary of Recommended Actions Arising Out of Possible Implementation of Different Aspects of the GAPP

GAPP Principle	Recommended Actions
<p>Legal basis and form (Principle 1)</p>	<ul style="list-style-type: none"> ■ Ensure that the SWF’s legal framework clearly: (i) authorizes the SWF’s formation under domestic law; (ii) grants the investment manager control over the SWF’s assets; (iii) delineates responsibilities among the SWF and other governmental entities (such as the central bank, development banks, other state-owned corporations and enterprises); (iv) identifies the beneficial and legal owners of the SWF’s assets and (v) specifies the SWF’s roles, objectives and responsibilities.
<p>Objectives and macroeconomic linkages (Principles 2 – 3)</p>	<ul style="list-style-type: none"> ■ Define and redefine, where necessary, the policy purpose of the SWF. This may include issues pertaining to: (i) how public monies are to be incorporated into the SWF’s investment activities; (ii) the use and distribution of earnings and/or principal and (iii) where the responsibilities of management lie (e.g., meeting, to the extent possible, the cost to the state of social welfare and public service pensions to be paid from 2025 until 2055).* ■ Develop and implement procedures for coordinating and consulting with domestic authorities where a SWF transaction may result in significant macroeconomic implications.
<p>Funding and withdrawal rules (Principle 4)</p>	<ul style="list-style-type: none"> ■ Develop and implement in the relevant legislation, or other constitutive documents procedures detailing the SWF’s general approach to funding, withdrawal and spending activities on behalf of the government.
<p>Statistics compilation and reporting (Principle 5)</p>	<ul style="list-style-type: none"> ■ Report regularly relevant statistical data regarding the SWF to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.
<p>Governance framework (Principles 6 – 9)</p>	<ul style="list-style-type: none"> ■ Establish a governance framework that enables the SWF’s operational management to be conducted on an independent basis. This framework should: (i) clearly define the role of government in setting the investment strategy and the role of managers in executing that strategy and (ii) ensure appropriate and effective division of oversight, decision making and operational responsibilities (e.g., establishing a set of ethical guidelines restricting investments which constitute an unacceptable risk that the SWF may contribute to unethical acts or omissions). ■ Establish a compliance mechanism that ensures that the governance framework is being properly followed.*

	<ul style="list-style-type: none"> ■ Implement appropriate controls to ensure that: (i) persons with operational and oversight responsibilities, including the governing body, act in accordance with the SWF’s policy purpose; (ii) the governing body cannot absolve itself of its responsibilities by delegating certain core functions to external service providers and (iii) managers’ investment decisions are insulated from political interference. ■ Set minimum standards of competency and suitability for governing body members (e.g., substantial expertise and experience at a senior level). ■ Establish guidelines with respect to management that address the scale and rapidity with which the SWF adjusts its portfolio.*
<p>Accountability (Principles 10 – 12)</p>	<ul style="list-style-type: none"> ■ Clearly define in the relevant legislation, charter, constitutive documents or management agreement the accountability framework for the SWF’s operations. ■ Furnish quarterly* and / or annual report(s) and accompanying financial statements on the SWF’s operations, assets and liabilities and performance in accordance with recognized international or national accounting standards (e.g., publishing quarterly reports on the SWF’s financial position in major newspapers of the country / publishing annual reports on SWF’s website in multiple languages). ■ Conduct an annual external audit of the SWF’s financial statements (e.g., auditing accounts by a recognized leading accounting firm). ■ Conduct on a regular basis an internal audit of the SWF’s activities, finances, accounting and operational systems and controls. Such an internal audit may include: (i) an assessment of the performance of those persons involved in operation and oversight of the fund; (ii) a review of compensation mechanisms; (iii) a review of information processes, operational software systems and accounting and financial reporting systems; (iv) mechanisms to sanction the improper use of privileged information and (v) an assessment of regulatory compliance systems.*

<p>Assurances of integrity of operations (Principles 13 – 17)</p>	<ul style="list-style-type: none"> ■ Implement training and guidelines for corporate and ethical responsibility (such as a code of conduct and conflicts of interest guidelines). ■ Establish clear rules and procedures for dealing with third parties (such as commercial fund managers and custodians, or external service providers). ■ Comply with applicable local laws, including tax and antimonopoly laws. ■ Comply with disclosure requirements and market integrity rules addressing insider trading and market manipulation. ■ Provide disclosure to local regulators, upon request, of financial and non-financial information when required by applicable law. ■ Cooperate with investigations and regulatory actions when required by applicable law. ■ Adopt good disclosure practices (<i>see</i> Appendix B).
<p>Investment policy (Principles 18 – 21)</p>	<ul style="list-style-type: none"> ■ Establish a clear and consistent investment policy that defines the SWF's objectives, strategic asset allocation, risk tolerance and investment strategy, and addresses the extent to which internal and/or external investment managers are used, the breadth of their activities and authority, and the process by which they are selected and their performance monitored (e.g., investment policies that a reasonable and prudent person would apply in respect of a portfolio of investments to avoid undue risk of loss and obtain a reasonable return). ■ The investment policy should include: (i) a discussion on risk exposure (including geographic, sectoral and overall concentration); (ii) any limits on the size of the SWF's stakes and whether it will take controlling stakes;* and (iii) the use of leverage and/or derivatives. ■ Establish a general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights. ■ Consider publishing regular reports on the investments by the SWF that include information regarding: (i) the size of the fund; (ii) its returns; (iii) the geographic location of investments; (iv) its specific investments; (v) the currency composition of its investments and (vi) the categories of its investment.*

<p>Risk management and performance measurement (Principles 22 – 23)</p>	<ul style="list-style-type: none"> ■ Establish a framework that identifies, assesses and manages the risks of the SWF's operations and provides reliable information on a timely basis to owners (e.g., a risk management unit that is responsible for conducting performance and risk analysis, identifying and communicating performance and risk issues to senior management, developing an understanding of performance and risk within the SWF's investment sectors, and investigating data irregularities). ■ Subject the risk management framework to a regular, independent audit.
<p>Implementation (Principle 24)</p>	<ul style="list-style-type: none"> ■ Consider using the GAPP to review the SWF's existing governance arrangements and provide reports to the owner or governing bodies. This can be done by means of a self-assessment or through third-party verification.

* Not required under the GAPP, but considered a good governance practice by the Organization for Economic Cooperation and Development and other industry participants.

Appendix B

Summary of GAPP Recommended Public Disclosure Framework

Type of Disclosure	GAPP Reference(s)	Recommended Item of Disclosure	Purpose(s) of Disclosure
Legal	GAPP 1.2. Subprinciple	Key features of legal basis and structure.	<ul style="list-style-type: none"> Enhances public understanding and confidence in the management of public monies.
	GAPP 1.2. Subprinciple	Legal relationship between SWF and other state bodies.	<ul style="list-style-type: none"> Contributes to a better understanding of the responsibilities of the SWFs and of the SWF's institutional organization and structures.
Financial	GAPP 4.1. Subprinciple	Source of SWFs' funding (e.g., mineral royalties).	<ul style="list-style-type: none"> Facilitates a better understanding of the uses of public monies to fund the SWF.
	GAPP 4.2. Subprinciple	Withdrawals from the SWF to the national budget and spending on behalf of the government.	<ul style="list-style-type: none"> Ensures consistency with the home country's macroeconomic policies.
	GAPP 17. Principle	Relevant financial information, which includes: (i) asset allocation, benchmarks where relevant and (ii) rates of return over appropriate historical periods consistent with investment horizons.	<ul style="list-style-type: none"> Provides guidance on appetite for risk. Contributes to stability in international financial markets because recipient countries will have greater access to information regarding the financial health of SWFs. Enhances trust in recipient countries.
Policy/ Governance	GAPP 2. Principle	Policy purpose of the SWF (e.g., stabilization fund, savings fund and/or reserve investment corporations).	<ul style="list-style-type: none"> Facilitates development of suitable investment strategies based on economic objectives. Ensures that the SWF undertakes investments without any intention of facilitating any geopolitical agenda of the government.
	GAPP 4. Principle	Policies, rules, procedures, or arrangements in relation to SWFs' general approach to funding, withdrawal and spending operations on behalf of the government.	<ul style="list-style-type: none"> Provides a clear basis for deriving the expected time horizon and efficient investment policy for the savings. Promotes macroeconomic stability and accountability.

GAPP 16. Principle	Governance framework, objectives and manner in which the SWF's management is operationally independent from the owner.	<ul style="list-style-type: none"> ■ Promotes a clear understanding of what the SWF seeks to achieve. ■ Provides assurance that investment decisions are made on an independent basis free of political interference.
GAPP 18.3. Subprinciple/ GAPP 19.1. Subprinciple	Description of investment policy, including those decisions that are subject to other than economic and financial considerations (e.g., social, environmental or other factors).	<ul style="list-style-type: none"> ■ Indicates appetite for risk and exposure.
GAPP 21. Principle	General approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.	<ul style="list-style-type: none"> ■ Demonstrates that voting decisions are based on economic criteria.
GAPP 22.2. Subprinciple	General approach to risk management policies and key actions related to governance.	<ul style="list-style-type: none"> ■ Provides reassurance that the SWF adheres to a high standard of managing operational, regulatory and reputational risks.
GAPP 24. Principle	Results of any self-assessment or third-party verification regarding implementation of the GAPP.	<ul style="list-style-type: none"> ■ May contribute to stability in international markets and enhance trust in recipient countries.

1 See Simon Willson, *Wealth Funds Group Publishes 24-Point Voluntary Principles*, October 15, 2008 (available at <http://www.imf.org/external/pubs/ft/survey/so/2008/NEW101508B.htm>).

2 SWFs are defined in the report by the International Working Group of Sovereign Wealth Funds on the Santiago Principles, dated October 2008, as special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports (available at <http://www.iwg-swf.org/pubs/santiagoprinciples.pdf>).

3 Facilitated and coordinated by the International Monetary Fund (the "IMF"), the IWG consists of Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Islamic Republic of Iran, Ireland, Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad and Tobago, the United Arab Emirates and the United States. Permanent observers of the IWG are Oman, Saudi Arabia, Vietnam, the Organization for Economic Cooperation and Development and the World Bank.

4 See Tom Barkley and Maya Jackson Randall, *Sovereign Wealth Funds Unveil Best Practices*, October 12, 2008 (available at http://www.beurs.nl/nieuws/artikel.php?id=273904&taal=US&titel=UPDATE:Sovereign_Wealth_Funds_Unveil_Be_).

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