



**Promoting Good
Internal Governance
Tips for Sovereign Actors**



Introduction

Sovereign actors, such as sovereign wealth funds (“**SWFs**”) and national development banks (“**NDBs**”), are an increasing presence in the global financial landscape. These actors are responsible for managing a significant amount of assets and making investment and lending decisions using money generated and/or received by governments. It is therefore essential for sovereigns to be the model of good governance and sound investment strategy.

What constitutes good governance for sovereign actors will depend on a number of factors, including any regulations in the countries in which they operate, the investment policy and risk profile. There is no “one-size-fits-all” approach to good governance - it is a journey of continuous improvement to meet and shape the context in which the SWF or NDB operates, as well as the associated opportunities and responsibilities that are placed upon it, both internally and externally.

External governance is important to ensuring that the SWFs and NDBs are making sound investment and lending decisions, and preserving (or improving) the value of the assets. However, while not as visible, internal governance is just as important to ensuring the sovereign can manage their investment risk, attract appropriate funding partnerships and respond to increasing public scrutiny. When internal governance fails, the results can be catastrophic and very public, and will likely have significant financial and reputational consequences.

In this article, we explore what constitutes good internal governance for sovereign actors (with a focus on SWFs and NDBs). We also look at the key areas of risk, particularly given the urgency of some investments and lending arising out of the pandemic, and best practices for having proper internal governance in place as an integral part of managing risk.

What constitutes “good governance” for sovereign actors?

Sovereign actors need to abide by the laws and regulations of the land in which they are operating or investing. There are some jurisdictions which provide guidance on what steps are required to ensure good governance. To complement this, sovereign actors have been proactive in putting together frameworks to improve and ensure good governance. Such examples include for SWFs the Santiago Principles and for NDBs, the Corporate Governance Development Framework:

Santiago Principles

- The International Working Group of SWFs (the precursor to the International Forum of Sovereign Wealth Funds) in discussion with other international financial institutions created the Santiago Principles, a series of generally accepted principles and practices (“GAPP”) designed to establish objectives and best practices for SWFs.¹ One of their four stated objectives is to ensure that SWFs have in place a transparent and sound governance structure that provides adequate operational controls, risk management and accountability.
- Principle 22 of GAPP states that the SWF should have a framework that identifies, assesses, and manages the risks of its operations. These include two subprinciples:
 - The risk management framework should include reliable information and timely reporting systems, which should enable the adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function.
 - The general approach to the SWF’s risk management framework should be publicly disclosed.

Corporate Governance Development Framework

- The Corporate Governance Development Framework (“**Framework**”) was the result of extensive collaboration amongst members of the Development Finance Institutions’ Corporate Governance Working Group, which consists of representatives of several international finance institutions.² The signatories of the Framework are working together to improve the governance of the companies they work with.
- The Framework includes requirements to: (i) ensure internal responsibility by identifying and assigning an internal function that is responsible for the implementation of the Framework; and (ii) provide or procure training to build capacity and knowledge transfer to staff for the implementation and further development of the Framework.
- The Framework espouses a methodology which requires the company’s internal control system, internal audit function, risk management system (including an environmental and social management system), and compliance function to be sufficient to ensure sound stewardship of the company’s assets, effectiveness of operations, accuracy in reporting, and compliance with policies, procedures, laws, and regulations.³

The Santiago Principles and the Framework are not mandatory. It is for the relevant SWF and NDB to confirm that they will endorse and follow these principles. However, the recent exponential growth in environmental, social and governance (“**ESG**”) value and recognition has brought increased pressure on financial institutions from regulators, investors, employees and consumers, to adopt and enforce proper governance. Now, a failure in proper governance can have a material impact on the sovereign actor’s reputation as well as its bottom line.

1 https://www.ifswf.org/sites/default/files/santiagoprinciples_0_0.pdf

2 <https://cgdevelopmentframework.com>

3 https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/investment+services/corporate+governance+methodology

What does good internal governance look like in practice?

The above principles highlight the need for proper controls and processes, but they do not provide a guidebook for what this looks like in practice. Again, there is no “one-size-fits-all” list of requirements to ensure good internal governance – it will be up to the SWF or NDB to design and implement.

It is clear that a strong ethical culture and adequate controls and processes are at the heart of good governance. Effective internal governance can be broadly distilled into five essential elements: leadership, risk assessment, standards and controls, training and communication, and monitoring and response.

Leadership

Successful governance must consist not only of well-articulated internal policies and procedures, but must also be built on a solid foundation of ethics endorsed by the board. There must be investment and accountability – the people responsible for ensuring internal governance must be provided adequate authority and resources, and have the ear of those ultimately responsible for corporate conduct, including the board.

Risk assessment

An awareness of the nature and extent of risks associated with who, where and how the SWF and NDB does business is a critical first step in implementing adequate internal governance. Enforcement authorities now expect parties to have formal processes for assessing the risks to which they are exposed. Without such a process it is difficult to credibly claim to have a robust and risk-based program.

Standard & Controls

Authorities are looking for clear evidence that an organization's governance is more than words on paper. Parties should not only have detailed written policies, but also clear procedures and protocols for ensuring those policies are implemented.

Training & Communications

Authorities place a great deal of emphasis on ensuring that training programs are reaching key employees and will look closely at who the entity trains, how the training was conducted and how often training occurs. The way in which the party communicates the importance of good governance, and its expectations both internally and externally, will also be an important consideration.

Monitoring, Auditing & Response

Three essential activities – monitoring, auditing and responding – are how enforcement authorities expect parties to maintain continuous oversight of their internal governance programs. In addition to establishing a monitoring system to identify problems and address them promptly, it is also critical that managers in each country of operation report on governance issues, establish protocols and conduct credible investigations with appropriate disciplinary consequences for infractions.

Key areas of focus for SWFs and NDBs

Implementing a good governance program will require an assessment of the specific risks and profile of the relevant sovereign actor. Although each one of the above elements will need to be addressed, there are certain areas which should be of particular focus for SWFs and NDBs.

Good governance starts with the tone from the top

Unfortunately, governance failures often stem from a poor “tone at the top” or lack of attention and resources from management. Top-level management should be heavily involved in espousing, implementing and enforcing good internal governance, and the ultimate responsibility for effective governance should lie with them. For example, the Framework requires an internal function to be responsible for the implementation of the Framework. Having an adequately resourced function is important, but that function needs to report to and be supported by senior management.

SWFs and NDBs must implement effective standards and controls

Most funds and institutions will have in place written policies and procedures, to address certain high-risk areas such as bribery and corruption, money laundering and other financial misconduct. However, written policies and procedures without proper controls will be ineffective for implementing good internal governance.

- **Review high-risk transactions and irregularities.** There are certain areas that carry a higher degree of risk when dealing with financial investments or lending. Financial institutions in particular need to be aware of these areas and take steps to actively monitor them, and a requirement for audit appears in both the Framework and the Santiago Principles. In order to ensure this function works, SWFs and NDBs should implement governance procedures which hold responsible personnel accountable to review transactions and records in a manner that is commensurate to the risk.

- **Review the existing set of policies and procedures, particularly in relation to corporate governance, anti-corruption and money laundering.** The program should adequately cover the risks faced by the SWF or NDB, and should include a robust procedure (e.g., effective whistleblowing program and internal reporting mechanism) for escalating issues to top or senior level management. We have seen ineffective whistleblowing programs in many jurisdictions where local language is a must or where reports are directed to someone within the whistle-blower’s reporting line or to legal counsel. If the whistle-blower is concerned with retaliation, or does not feel comfortable reporting, it is unlikely that the whistle-blower will make the report.
- **Address any gaps in the program.** The current environment may give rise to additional anti-corruption or money laundering risks that need to be addressed. For example, are the due diligence / background check procedures effective to deal with risks associated with engaging new or unfamiliar third parties or in high-risk jurisdictions (e.g., KYC procedures, managing interactions between agents and third parties)? Our experience in assessing these procedures is that many are scoped incorrectly or the red flags are not followed up with appropriate action.

Make sure to monitor and investigate compliance

Investigations are an essential tool to ensure that a party is “walking the talk” in relation to its governance procedures. It is not enough to introduce controls and processes and expect they will be adhered to, or to just fix the problem without first investigating what actually happened, how the misconduct occurred, who was involved and how can it be prevented in the future. Regulators, financiers, stakeholders, employees and investors all expect the entity – its board and management – to conduct an independent and robust investigation and undertake appropriate remediation. A number of multilateral development banks have jointly endorsed common principles and guidelines for investigating potential issues, highlighting the importance of independent and effective investigations to good and ethical governance.

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