SOVEREIGN WEALTH FUNDS REPORT

REGULATION OF SOVEREIGN WEALTH FUNDS CONTINUES TO TAKE SHAPE

As Sovereign Wealth Funds await the release of a set of voluntary best practices and guidelines prepared by the International Working Group of Sovereign Wealth Funds ("IWG"), governments around the world continue to define the role Sovereign Wealth Funds will play in their domestic economies. Even with the slowdown in Sovereign Wealth Fund investment activity due to the current economic climate, regulatory agencies have remained active in the discourse over appropriate levels of regulatory control and monitoring for Sovereign Wealth Fund investments.

Germany Takes 'Precautionary Measure'

In late August, the German government took measures to protect Sovereign Wealth Funds from gaining control of strategic assets. The new legislation – passed by the Chancellor's cabinet but yet to be approved by the legislature – is an expansion of the Foreign Economic Act, which allows the government to review deals involving the arms industry.

If passed, the government will have the power to review any investment in a German firm of 25% or more by a foreign entity not based in the European Union or who is not a member of the European Free Trade Association. As proposed, any such investment would be subject to review for up to three months following its announcement. If undertaken, a review may last for up to two months before a final decision may be taken as to whether the government will allow the investment to proceed.

The government has faced great opposition to the legislation, as it is largely viewed as protectionist; however, Michael Glos, the German Economy Minister, assured investors that the measure would be used "only in extreme cases." This news comes amidst a possible takeover by Neptune Orient Lines of Hapag-Lloyd, a German shipping line. Neptune Orient Lines is a chief rival to Hapag-Lloyd and is owned by Temasek Holdings, a Sovereign Wealth Fund based in Singapore.

No Change to U.S. Income Tax Considerations for Sovereign Wealth Fund Investments in the United States

On the positive side, the United States continues to extend certain tax benefits to Sovereign Wealth Funds. Under section 892 of the U.S. Internal Revenue Code (the "Code"), certain income received by foreign governments is exempt from U.S. income tax. A foreign government, for purposes of that section, means only the "integral parts" or "controlled entities" of a foreign sovereign. Generally, Sovereign Wealth Funds are considered as either an "integral part" or a "controlled entity" of a foreign sovereign, and are thus treated as foreign governments qualifying under this exemption.

Therefore, income of Sovereign Wealth Funds is generally exempt from U.S. taxation if it is derived from investments in the U.S. such as, (i) stocks, bonds, or "other securities" owned by such Sovereign Wealth Fund, (ii) financial instruments held in the execution of governmental financial or monetary policy, or (iii) from interest on money belonging to such Sovereign Wealth Fund from deposits in U.S. banks.

Though Sovereign Wealth Funds may find relief under this section of the Code, the exemption does not apply to income either (i) derived from conducting any commercial activity, (ii) received by or from (directly or indirectly) a controlled commercial entity, or (iii) derived from the disposition of any interest in a controlled commercial entity. Therefore, though a Sovereign Wealth Fund may be able to take advantage of certain U.S. income tax treatment on its investments in the U.S., the structuring of such investments may take a prominent role to ensure the availability of this exemption provided by section 892 of the Code.

Upcoming Policy and Guideline Release

The IWG recently met in Santiago, Chile, reaching a preliminary agreement on a set of Generally Accepted Principles and Practices ("GAPP") for Sovereign Wealth Funds. Dubbed the "Santiago Principles", GAPP is expected to cover legal, institutional and macroeconomic issues, in addition to broad recommendations for governance, accountability, investment strategies and risk management standards. The IWG, co-chaired by Hamad al Suwaidi, undersecretary of the Abu Dhabi finance department and a director of the Abu Dhabi Investment Authority, and Jaime Caruana, director of the International Monetary Fund's monetary and capital markets department, plans to present GAPP to the International Monetary and Financial Committee at the International Monetary Fund-World Bank Annual Meetings to take place on October 10-13, 2008. Additionally, a representative of the Organization for Economic Cooperation and Development ("OECD") briefed the IWG on the latest developments for a set of guidelines for recipient countries being developed by the OECD. These guidelines will supplement GAPP and are expected be released in mid-2009.

For further information, contact:

CARL A. RUGGIERO
CURTIS, MALLET-PREVOST, COLT & MOSLE LLP
101 PARK AVENUE
NEW YORK, NEW YORK 10178
E-MAIL: CRUGGIERO@CURTIS.COM
TEL: (212) 696-6116
FAX: (212) 697-1559

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OFFICES

ALMATY
The Nurly-Tau Centre
13 al-Faraby Street
Bloc 1-V, 4th Floor, Suite 5
Almaty, Kazakhstan 050059
TEL +7 727-311-1018
FAX +7 727-311-1019

HOUSTON
2 Houston Center
909 Fannin Street, Suite 3725
Houston, Texas 77010
TEL +1 713-759-9555
FAX +1 713-759-0712

MEXICO CITY
Rubén Darío 281, Piso 9
Col. Bosque de Chapultepec
Mexico, D.F. 11580, Mexico
TEL +52 55-5282-1100
FAX +52 55-5282-0061

NEW YORK
101 Park Avenue
New York, New York 10178
TEL +1 212-696-6000
FAX +1 212-697-1559

ASTANA
2 First Street
Left Bank of Ishym River
Astana, Kazakhstan 010000
TEL +7 7172-550-150
FAX +7 7172-550-151

ISTANBUL
Edin & Suner Plaza No. 2B
Meydan Sokak No. 14
Akatlar 34335
Istanbul, Turkey
TEL +90 212-351-6766
FAX +90 212-351-6646

MILAN
Corso Venezia, 5
Milano 20121, Italy
TEL +39 02-7623-2001
FAX +39 02-7600-9076

PARIS
6, avenue Vélasquez
Paris 75008, France
TEL +33-1-42-66-39-10
FAX +33-1-42-66-39-62

FRANKFURT
Neue Mainzer Strasse 28
60311 Frankfurt am Main
Germany
TEL +49 (0)69-247576-0
FAX +49 (0)69-247576-555

LONDON
53 New Broad Street
London EC2M 1BB, England
TEL +44 (0)207-011-9500
FAX +44 (0)207-011-9501

MUSCAT
Suite 48, Qurum Plaza
108 Al Wallaj Street
P.O. Box 210 Jewel Beach, Muscat 134
Sultanate of Oman
TEL +968 24-564-495
FAX +968 24-564-497

STAMFORD
Financial Centre
695 East Main Street
Stamford, Connecticut 06901
TEL +1 203-359-6200
FAX +1 203-328-2617

WEB
www.curtis.com

WASHINGTON, D.C.
1200 New Hampshire Avenue,
N.W., Suite 430
Washington, D.C. 20036
TEL +1 202-452-7373
FAX +1 202-452-7333