FOR AGENDA

SM/12/318

CONFIDENTIAL

December 28, 2012

To: Members of the Executive Board

From: The Secretary

Subject: **Broadening the Fund's Investment Mandate—Proposed Rules and Regulations for the Investment Account**

Attached for consideration by the Executive Directors is a paper on broadening the Fund's investment mandate—proposed rules and regulations for the investment account. This paper, together with the paper on broadening the Fund's investment mandate—remaining strategic implementation issues (SM/12/317, 12/28/12), is tentatively scheduled for discussion on **Wednesday, January 23, 2013**. A draft decision appears on page 17.

The staff does not propose the publication of this paper as it relates to internal Fund operations. If the decision proposed in the paper is adopted, the staff proposes the publication of the Rules and Regulations included in the paper.

Questions may be referred to Mr. Steinki (ext. 38222) and Mr. Patterson (ext. 39799) in LEG, and Mr. Krueger (ext. 36854) and Mr. Steinberg (ext. 36386) in FIN.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

Broadening the Fund's Investment Mandate—Proposed Rules and Regulations for the Investment Account

Prepared by the Legal and Finance Departments
In consultation with other departments

Approved by Sean Hagan and Andrew Tweedie

December 26, 2012

Contents

I. INTRODUCTION [1]

1. **This paper proposes for Executive Board approval the new Rules and Regulations for the Investment Account (IA).** The proposed Rules and Regulations—hereinafter referred to as "the proposed Rules"—provide the legal framework for the implementation of the expanded investment authority that is authorized under the Fifth Amendment to the Articles of Agreement and is a key element of the Fund's new income model endorsed in April 2008.[2] The design of the expanded investment authority that is reflected in the proposed Rules takes into account extensive discussions by the Executive Board over the past two years on the implementation of the expanded investment authority, in particular regarding the establishment of an endowment funded with gold sales profits.[3] They also incorporate staff's proposals on the remaining strategic issues that are set forth in the companion paper *Broadening the Fund's Investment Mandate—Remaining Strategic Implementation Issues* (SM/12/317, 12/28/12) (hereinafter referred to as the "companion paper").

2. **The paper is structured as follows**: Section II provides a commentary to the proposed Rules; Section III includes the draft Board decision for the adoption of the

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[1] The paper was prepared by a staff team led by B. Steinki (LEG) and G. Steinberg (FIN), comprising C. DeLong, B. Patterson, H. Pham, and G. Rosenberg in LEG, and A. Attie, L. Cruz, T. Mattina, R. Price, and S. Sribhoga (FIN). The team worked under the direction of S. Hagan (LEG) and T. Krueger (FIN).

[2] Building on recommendations of the Committee of Eminent Persons to Study the Sustainable Long-Term Financing of the IMF, under the chairmanship of Sir Andrew Crocket (see *Report to the Managing Director by the Committee of Eminent Persons on the Sustainable Long-Term Financing of the Fund* (FO/DIS/07/8, 1/31/07)), the new income model aims to diversify the Fund's sources of income and to put the Fund's finances on a sound long-term footing. The proposal of an amendment of the Articles to expand the Fund's investment authority was an important element of this model. See *Developing a New Income Model for the Fund* (SM/07/235, 7/2/07)*; The Chairman's Summing Up—Developing a New Income Model for the Fund* (BUFF/07/115, 8/3/07); *Developing a New Income Model for the Fund—Further Considerations* (SM/07/330, 9/19/07); *The Chairman's Summing Up—Developing a New Income Model for the Fund—Further Considerations* (BUFF/07/142, 10/16/07); *Developing a New Income Model for the Fund—Additional Considerations* (SM/08/48, 2/1/08 and Sup. 1, 2/8/08); *The Chairman's Summing Up—Developing a New Income Model for the Fund—Additional Considerations* (BUFF/08/29, 2/28/08); *Developing a New Income Model for the Fund—Decisions and Report of the Executive Board to the Board of Governors* (SM/08/80, Rev. 1, Sup. 1, 4/8/08).

[3] See *Asset Allocation under a Broadened Investment Mandate- Preliminary Considerations* (SM/10/306, 12/1/10); *Implementing the Fund's Expanded Investment Authority—Overview and Work Program* (SM/10/307, 12/1/10); *The Chairman's Summing Up—Asset Allocation under a Broadened Investment Mandate—Preliminary Considerations* (BUFF/11/33, 2/17/11); *Broadening the Fund's Investment Mandate—Further Considerations* (SM/11/205, 8/5/11); *The Chairman's Summing—Broadening the Fund's Investment Mandate-Further Considerations* (BUFF/11/128, 9/14/11); *Broadening the Fund's Investment Mandate—Additional Considerations* (SM/12/111, 5/31/12); *The Chairman's Summing Up—Broadening the Fund's Investment Mandate—Additional Considerations* (BUFF/12/75, 6/27/12).

proposed Rules, the text of which is set forth in the Annex. Adoption of the decision requires a 70 percent majority of the total voting power.[4]

II. Commentary[5]

A. Objective, Sources, and Subaccounts (Section I, Paragraphs 1–5)

Objective of the Investment Account (Paragraph 1)

3. **While the Fifth Amendment modified the scope of the Fund's investment authority, it did not change the IA's objective.** The overall objective of the IA remains to provide a vehicle for the investment of a part of the Fund's assets so as to generate income that may be used to meet the expenses of conducting the business of the Fund. This objective is reflected in paragraph 1 of the proposed Rules and is identical to the current Rules and Regulations adopted in April 2006 ("current Rules"). As discussed in detail below, subaccounts will be established within the IA, each with its own specific investment objective.

Sources of Investment Account Assets (Paragraph 2)

4. **The sources of funding of the IA set forth in the proposed Rules reflect all sources permitted under the Articles, as expanded by the Fifth Amendment (*paragraph 2*).** Under the Articles, the IA can be funded by (a) transfers of currencies from the General Resources Account (GRA) (Article XII, Section 6(f)(ii)) and (b) transfers of profits from the sale of pre-Second Amendment Gold (Article V, Section 12(g)), provided that transfers from these two sources may not exceed the total amount of the general and special reserves at the time of the decision to transfer (Article XII, Section 6(f)(ii)); (c) transfers of profits from the sale of post-Second Amendment gold (Article V, Section 12(k)—introduced by the Fifth Amendment), which are not subject to the above-mentioned limit on the Fund's total reserves; and (d) any retained income from the investment of IA assets (Article XII, Section 6(f)(iv)). Sources of the current IA assets are (a), (c), and (d).

Investment Account Subaccounts (Paragraphs 3–5)

5. **The assets of the IA will be held in three subaccounts, each with its own investment objective: the Fixed-Income Subaccount, the Endowment Subaccount, and the Temporary Windfall Profits Subaccount (*paragraph 3*).** While these subaccounts will be managed in accordance with the general rules set forth under Section I of the proposed Rules, each will also be subject to its own specific rules, reflecting the different investment

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[4] See Article XII, Section 6(f)(iii) of the Articles of Agreement.

[5] References below to paragraph numbers refer to the Annex, unless indicated otherwise.

objectives of these subaccounts (Section II with respect to the Fixed-Income Subaccount, Section III with respect to the Endowment Subaccount, and Section IV with respect to the Temporary Windfall Profits Subaccount).

6. **When the proposed Rules become effective upon approval by the Executive Board, the existing IA assets will be allocated to the three subaccounts as follows (*paragraph 4*):**

- The *Fixed-Income Subaccount* will be funded with assets that are attributed to past transfers of currencies from the GRA in accordance with Article XII, Section 6(f)(ii), and any retained income attributed to these assets (about SDR 8.4 billion as of mid-December 2012);

- The *Endowment Subaccount* will be funded with (a) assets attributed to the profits from the sale of the holdings of the Fund's post-Second Amendment gold during 2009 and 2010 at an average sales price of US$ 850 per fine ounce (*i.e.*, SDR 4.4 billion); (b) any retained income attributed to these assets; and (c) retained income on SDR 0.7 billion of profits from the 2009 and 2010 gold sales at an average sales price above US$ 850 per fine ounce ("windfall profits") that have been transferred from the IA to fund the first distribution of the Fund's general reserve;[6] and

- The *Temporary Windfall Profits Subaccount* will be funded with SDR 1.75 billion of the remaining windfall profits, and any retained income attributed to these assets. After the completion of the partial distribution of the general reserve funded from this subaccount in accordance with Executive Board Decision No. 15228-(12/95), any remaining assets or retained income in the account would be transferred to the Endowment Subaccount (***paragraph 32***).

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[6] Limited gold sales to fund the endowment were conducted in 2009 and 2010 and profits in an amount equivalent to SDR 6.85 billion were placed into the IA. Of these gold profits, SDR 4.4 billion was the profits from the gold sales at an average sales price of US$850 per fine ounce assumed at the time of the adoption of the new income model in 2008, and will be used to fund an endowment. With respect to the remaining SDR 2.45 billion profits from gold sales at an average sales price above US$ 850 per fine ounce ("windfall profits"), the Executive Board has decided to use these windfall profits for the benefit of the Poverty Reduction and Growth Trust (PRGT) by funding two partial distributions of the general reserve, of SDR 0.7 billion and SDR 1.75 billion, respectively, conditional on financing assurances from the membership that new subsidy contributions equivalent of at least 90 percent of these amounts will be made to the PRGT. While the first distribution of SDR 0.7 billion was made on October 23, 2012 funded with equivalent transfers from the IA, the second distribution approved on September 28, 2012 (Executive Board Decision No.15228-(12/95)) is still awaiting the required assurances from members, and pending such assurances SDR 1.75 billion will be invested in the IA on an interim basis.

7. **Any future transfers of assets to the IA will be decided by the Executive Board in accordance with the relevant provisions of the Articles.**[7] At the time of additional transfers, the Executive Board will determine the subaccount (Fixed-Income or Endowment) into which new resources shall be placed. The proposed Rules authorize the Executive Board to transfer assets between subaccounts (***paragraph 5***).[8]

B. Fixed-Income Subaccount Investments (Section II, Paragraphs 16–19)

8. **Under the proposed Rules, the objective, investment strategy, eligible investments and investment arrangements for the Fixed-Income Subaccount follow those that are in place for the existing IA assets not attributed to gold sales profits.** The Executive Board is expected to discuss possible changes to the investment strategy for the Fixed-Income Subaccount in the future. In the interim, staff proposes that the investment strategy under the current Rules remains in place for this subaccount. For purposes of clarity and transparency, the proposed Rules specifically incorporate a number of key elements of that strategy that are not included in the current Rules but are part of the investment strategy as implemented under the current Rules.

9. **The assets in the Fixed-Income Subaccount will be invested under a strategy that continues to emphasize liquidity and limited volatility**.[9]Accordingly:

a) The investment objective for this subaccount remains to achieve investment returns that exceed the SDR interest rate over time while minimizing the frequency and extent of negative returns and underperformance over a 12-month investment horizon (***paragraph 16***)**.**[10] The assets in the subaccount will continue to be managed against the 1–3 year government bond benchmark, weighted to reflect the currency composition of the SDR basket (***paragraph 16***). While the 1–3 year government bond benchmark has been endorsed by the Executive Board outside of the current Rules, it is included in the proposed Rules as a key strategic investment decision.[11]

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7 Decisions on additional transfers of currencies from the GRA in accordance with Article XII, Section 6(f)(ii) require a 70 percent majority of the total voting power while decisions to transfer profits from pre-Second Amendment gold sales under Article V, Section 12(g) require an 85 percent majority of the total voting power.

8 A decision to move assets from one subaccount to another could be taken by a majority of the votes cast.

9 See *Establishment of the Investment Account* (EBS/06/57, 4/17/06), and Executive Board Decision No. 13711-(06/40), adopted April 28, 2006.

10 *Id*.

11 The Managing Director will continue to select the specific 1-3 year government bond benchmark index to be used by managers. For the details on the structure and customization of benchmark indexes, see *Establishment and Operation of the Investment Account, (*SM/05/317, 8/15/05), at ¶34, and *Establishment of the Investment Account*, (EBS/06/57, 4/17/06), at ¶¶14–15.

b) Eligible investments will continue to be limited to marketable obligations of members and international financial institutions that are denominated either in SDR or in currencies included in the SDR basket (***paragraph 17***). As under the current Rules, marketable obligations of a member include obligations of its official agencies, and obligations of financial institutions include without limitation deposits with the Bank for International Settlements (BIS) and Medium-Term Instruments (MTIs) issued by the BIS. Hedging would be prohibited, as would be certain investment activities and investments in specified instruments (*i.e.,* the use of forwards, futures, options and swaps, short selling or any form of financial leverage) **(*paragraph 17*)**. Building on existing practice, the proposed Rules will now specifically require that investments be limited to government and agency bonds that have a rating of A or higher (based on Standard & Poor's rating scale) by a major credit rating agency **(*paragraph 18*)**. The Managing Director will determine the specific operational modalities to implement the minimum credit rating requirements, including establishing a rule-based approach to deal with cases of split ratings between agencies. In the event that the rating threshold is breached, the proposed Rules require assets to be divested within three months (***paragraph 18***).[12]

c) Regarding investment arrangements, the assets will continue to be invested by external managers and, with respect to BIS obligations, by the Managing Director (***paragraph 19***). It is expressly recognized in the proposed Rules that, consistent with current practice, the investment mandates for external managers will provide for active management against the subaccount's 1-3 year government bond benchmark, within risk parameters established by the Managing Director (***paragraph 19***).[13] Investments by the Managing Director with the BIS will also be guided by the subaccount's 1-3 year government bond benchmark (***paragraph 19***).

[12] The requirement of a minimum A rating from one major credit rating agency has been applied to the IA for government bond investments since the establishment of the IA in 2006. See *Establishment of the Investment Account* (EBS/06/57, 4/17/2006), at ¶21.

[13] External managers of the IA bond portfolio currently conduct active management mainly through adjusting the duration of the portfolio relative to the 1-3 year government bond benchmark. See *id.* at ¶¶12 and 24. They are currently allowed to deviate from the benchmark within the ±6 month range of duration. See *Establishment and Operation of the Investment Account* (SM/05/317, 8/15/ 05), at ¶34. External managers may also exercise active management through the investment in securities issued by eligible international financial institutions and certain national agencies. These instruments typically provide higher *ex ante* yields than comparable government securities included in the 1–3 year government bond benchmark. See *Establishment of the Investment Account* (EBS/06/57, 04/17/06), at ¶12.

C. Endowment Subaccount Investments (Section III, Paragraphs 20–30)

Investment Objective and Base Currency (Paragraph 20)

10. **The investment objective of the Endowment Subaccount is to achieve a real return of 3 percent in U.S. dollar terms over the long term (*paragraph 20*).** This objective aims to provide a meaningful contribution to the Fund's administrative expenditures. The 3 percent target is a long-term objective, and such returns may be difficult to achieve in the near- to medium-term, given current market valuations,[14] and also in view of the phasing of investments over a three-year period (see below). As the Fund's administrative expenditures are driven by U.S. dollar denominated developments, the proposed Rules establish the U.S. dollar as the base currency for measuring performance of the Endowment Subaccount, even though the SDR remains the base currency of the Fixed-Income Subaccount.[15] As discussed in the companion paper, assessing the Endowment Subaccount's performance *vis-à-vis* a real return target requires the choice of an appropriate deflator. Accordingly, the proposed Rules require that the Endowment Subaccount's real return for each period be calculated using the deflator used for purposes of the Fund's administrative budget the Global External Deflator (GED) for the same period, provided that the U.S. consumer price index (US CPI) element of the deflator is modified to use the *actual* US CPI for that period instead of the *projected* US CPI.[16]

Investment Strategy—Passively-Managed Portion (Paragraphs 21, 22, and 25)

11. **Under the proposed Rules, no less than 90 percent of the Endowment Subaccount assets will be managed passively.** Upon the effectiveness of the proposed Rules, 95 percent of the Endowment Subaccount assets will be allocated to the passively-managed portion. For this portion of the subaccount, external managers will be required to track benchmark indices for the relevant asset classes selected by the Managing Director (***paragraph 21***).[17] As discussed in previous papers and endorsed by the Executive Board, the Managing Director is expected to select broad and widely used/widely available benchmark indices, *i.e.,* indices that are maintained by recognized providers (e.g., JP Morgan, Barclays Capital, or MSCI), widely used by institutional investors, and that are broad in terms of

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[14] See *The Acting Chair's Summing Up—Broadening the Fund's Investment Mandate—Additional Considerations* (BUFF/12/75, 06/27/12).

[15] For a detailed discussion of the choice of the U.S. dollar as base currency, see the companion paper, at ¶¶11–16.

[16] The GED is comprised of the Board approved structure adjustment to capture personnel cost increases (70 percent weight), and the projected US CPI for the non-personnel component (30 percent weight). *Id.* at ¶16 and n. 20.

[17] For a more detailed discussion of passive index replication, see *Broadening the Fund's Investment Mandate—Additional Considerations* (SM/12/111, 5/31/12), at ¶¶28–40.

country and sector coverage.[18] Appropriate customization would be done by the index provider to take into account the Fund's investment policies, such as the minimum credit rating requirements, and other relevant considerations.[19]

12. **Consistent with the objective of achieving a real return of 3 percent over the long term, the passively-managed assets in the Endowment Subaccount will be invested according to a Strategic Asset Allocation (SAA) benchmark *(paragraph 22)*.** This benchmark consists of: developed market sovereign bonds (20 percent), developed market corporate bonds (15 percent), developed markets inflation-linked bonds (20 percent), developed market equities (25 percent), emerging market equities (5 percent), emerging market bonds (10 percent), and real estate investment trusts (REITs) (5 percent). For purposes of the SAA benchmark, the categorization of bonds as sovereign bonds is determined by the specific benchmark index selected by the Managing Director, and could include government bonds, government-agency bonds, and bonds of international financial institutions. Respective weights would be benchmark-driven.[20] Temporary holdings of cash, bank deposits or short-term investments in cash instruments are also authorized ***(paragraph 24)***. Since the SAA is designed to constitute a long-term investment strategy, it is expected that it will be reviewed only infrequently, at least every 5 years.[21]

13. **For the passively-managed portion, there will be an annual rebalancing to the SAA benchmark, and intra-year rebalancing when policy bands are breached (*paragraph 25*).** Policy bands of +/-8 percentage points will be established for the larger asset classes (*i.e.,* developed market sovereign bonds, developed market corporate bonds, developed markets inflation-linked bonds, and developed market equities) and bands of +/-4 percentage points for the smaller asset classes (*i.e.,* emerging market equities, emerging

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[18] See *Developing a New Income Model for the Fund—Decisions and Report of the Executive Board to the Board of Governors* (SM/08/80, Rev. 1, Sup. 1, 4/8/08), at ¶4(a) of Annex I; *Developing a New Income Model for the Fund—Additional Considerations* (SM/08/48, 2/1/08 and Sup. 1, 2/8/08), at n. 16; and *The Chairman's Summing Up—Developing a New Income Model for the Fund—Additional Considerations* (BUFF/08/29, 2/28/08). See also *Broadening the Fund's Investment Mandate—Additional Considerations* (SM/12/111, 5/31/12); *The Chairman's Summing Up—Broadening the Fund's Investment Mandate—Additional Considerations* (BUFF/12/75, 6/27/12); and the companion paper, at n. 5.

[19] See the companion paper, at n. 5. For further discussion on the appropriately customized benchmark indices, see also *Broadening the Fund's Investment Mandate—Additional Considerations* (SM/12/111, 5/31/12), at ¶¶30, 31, 34, 37 and 41.

[20] See the companion paper, at n. 47.

[21] For more detail on the SAA, see *Broadening the Fund's Investment Mandate—Additional Considerations* (SM/12/111, 5/31/12), at ¶¶12–26. See also *Asset Allocation under a Broadened Investment Mandate—Preliminary Considerations* (SM/10/306, 12/01/10), at ¶¶24–29; *Broadening the Fund's Investment Mandate—Further Considerations* (SM/11/205, 08/05/11), at ¶¶13–22; and *The Acting Chairman's Summing Up— Broadening the Fund's Investment Mandate—Further Considerations* (BUFF/11/128, 09/14/11).

market bonds, and REITs).[22] The rebalancing framework for the passively-managed portion of the Endowment Subaccount is designed to be mechanistic, thereby eliminating the need for discretion and reducing the risk for perceived conflicts of interest. Rebalancing to the SAA benchmark will take place: (i) annually, either in the context of the implementation of the Fund's annual income disposition decisions if they involve transfers to or from the IA or, absent such operations affecting the Endowment Subaccount, at end-July of each year; and (ii) whenever the policy band for any of the asset classes is breached. No annual rebalancing would take place if the subaccount was already rebalanced within three months prior to that scheduled annual rebalancing. The Managing Director will determine the specific modalities for the rebalancing.

Investment Strategy—Actively-Managed Portion (Paragraph 23)

14. **No more that 10 percent of the assets in the Endowment Subaccount will be managed actively, with an allocation of 5 percent at the time of the effectiveness of the proposed Rules (*paragraph 23*).** As discussed in the companion paper, staff proposes to allocate an amount equivalent to 5 percent of the total assets of the Endowment Subaccount at the time of the effectiveness of the proposed Rules (about SDR 0.2 billion) for the actively-managed portion. The actively-managed portion may be invested only in the same asset classes as the SAA benchmark for the passively-managed portion, with a 65 percent share of fixed-income instruments and a 35 percent share for equities (including REITs), but no specific allocation requirements for each asset class within these two categories. The Managing Director, in consultation with the Executive Board and prior to the initiation of such investment of the actively-managed portion of the Endowment Subaccount, will design the investment strategy and investment arrangements for the actively-managed portion, including the selection criteria and risk parameters for external managers, benchmark indices, policy bands and rebalancing procedures (both for the 65 percent bonds/35 percent equities SAA and the 10 percent limit for the actively-managed portion), the scope and instruments for currency hedging, the phasing, and additional key measures to avoid actual or perceived conflicts of interest specific to the actively-managed portion.[23] As discussed in the companion paper, further staff work is needed on these issues (see below).

Permissible and Prohibited Investment Activities (Paragraph 26)

15. **The asset classes of the SAA benchmark for the passively-managed portion determine the scope for permissible investments for the Endowment Subaccount.** The delineation between developed markets and emerging markets is determined by the specific benchmark index selected by the Managing Director for the relevant asset class. The selection of broad and widely-used/widely available benchmarks will ensure that the

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[22] For more detail on the policy bands and portfolio rebalancing, see the companion paper, at ¶¶30–36.

[23] See *id.* at ¶10.

delineation is based on considerations that are widely accepted in the institutional investment industry. Investments in collective investment vehicles for the assets covered by the asset classes, including Exchange Traded Funds and mutual funds, are permitted. In order to mitigate risks and to safeguard against actual or perceived conflicts of interest, the proposed Rules preclude certain investment activities and instruments. In particular, short selling and any form of financial leverage as well as direct investments in gold are not permitted. Investment in derivative instruments is prohibited, unless they are being used for currency hedging as authorized under the proposed Rules or to minimize transaction costs in the context of rebalancing or benchmark replication (***paragraph 27***).

Currency Hedging (Paragraph 27)

16. **To limit the foreign exchange rate risk *vis-à-vis* the base currency, the proposed Rules require hedging for fixed-income instruments in the passively-managed portion that are denominated in developed market currencies *vis-à-vis* the U.S. dollar** (***paragraph 27***). Permitted currency hedging instruments include, but are not limited to, currency forwards, futures, swaps and options. No currency hedging is permitted for other assets of the passively-managed portion. For the actively-managed portion, currency hedging by external managers is permitted but not required, with the scope and instruments to be determined by the Managing Director as part of the investment strategy for this portion of the Endowment Subaccount in consultation with the Executive Board (***paragraphs 23 and 27***).[24]

Minimum Credit Ratings and Divestment (Paragraph 28)

17. **The proposed Rules establish minimum credit rating requirements for sovereign and corporate bonds (*paragraph 28*).** As discussed in the companion paper, a minimum credit rating for sovereign bonds from a major credit rating agency equivalent to BBB+ (based on Standard & Poor's rating scale) is designed to allow for sufficiently broad portfolio diversification, while at the same time containing the risks of actual or perceived conflicts of interest, including risks of perceived impairment of the Fund's surveillance and lending decisions as a result of Fund investment holdings.[25] In addition, and to limit credit risk, a minimum credit rating equivalent to BBB-, the lowest investment grade rating, applies for corporate bonds. In the event that a rating threshold is breached, the proposed Rules require assets to be divested within three months from the rating downgrade. The Managing Director will decide the specific operational modalities to implement the minimum credit

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[24] For a more detailed discussion of the underlying considerations for the proposed approach on hedging, see *id.* at ¶¶17–23.

[25] For a more detailed discussion on the implications of BBB+ rating for investments in government bonds of members with Fund supported programs, see the companion paper at ¶¶42–46. For a discussion of the conflicts of interest considerations regarding impairment of Fund decisions, see *Broadening the Fund's Investment Mandate—Additional Considerations* (SM/12/111, 5/31/12), at ¶¶6 and 9.

ratings requirements, including establishing a rule-based approach to deal with cases of split ratings between agencies.[26]

Investment Management Arrangements (Paragraphs 10 and 29)

18. **The assets of the Endowment Subaccount will be managed by external managers (*paragraph 29*).** The Managing Director is only authorized to manage Endowment Subaccount assets pending their investment according to the SAA benchmark and where interim investment becomes necessary following the termination of a manager and before a new manager is appointed. The proposed Rules establish broad guidance for the selection of external managers, both in terms of their general qualifications, and more specific requirements depending on whether managers are selected for the passive or the active portion of the Endowment Subaccount (***paragraph 10***).[27]

Phasing of Investments (Paragraph 30)

19. **The proposed Rules provide for a rule-based approach to the phasing of the passively-managed portion of the Endowment Subaccount (*paragraph 30*).** The investment of the passively-managed portion in accordance with the SAA benchmark will be phased over a three-year period, in equal quarterly installments, following the selection of the external managers. In exceptional market conditions, the Managing Director is authorized to temporarily suspend the phasing of investments, or to extend the phase-in period by up to one year. [28] The investment of the actively-managed portion will take place after strategies and managers are identified and, as noted above, following further consultation with the Executive Board. Pending investment in accordance with the SAA benchmark for the passively-managed portion and the investment strategy for the actively-managed portion, Endowment Subaccount assets will be invested in the same manner as the assets of the Fixed-Income Subaccount, provided that the investment objective for these amounts is nominal capital preservation while generating income.[29] As for the Fixed-Income Subaccount, investments may also be made by the Managing Director in BIS deposits, MTIs, or other BIS obligations.

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[26] See the companion paper, at ¶46.

[27] See *id.* at ¶9.

[28] See *id.* at ¶29.

[29] See *id.*

D. Temporary Windfall Profits Subaccount Investments (Section IV, Paragraphs 31and 32)

20. **The Temporary Windfall Profits Subaccount is an interim subaccount for the investment of the remaining gold sales windfall profits, pending their use to fund the partial distribution of the Fund's general reserve approved by the Executive Board on September 28, 2012.**[30] The permitted instruments for investment and investment arrangements are the same as for the assets of the Fixed-Income Subaccount (***paragraph 31***), provided that the investment strategy aims at nominal capital preservation while also generating income. The assets will be managed by the external managers or invested by the Managing Director in BIS obligations.

E. Governance Framework and Conflict of Interest Safeguards

21. **The proposed Rules reflect the underlying principles for an effective governance framework that has been discussed and supported by Executive Directors.**[31] As discussed in previous papers, the key principles are (i) clarity of the purpose of the funds with specific performance objectives; (ii) clear separation of responsibilities, in particular for formulation of investment strategy and oversight on the one hand and operational implementation on the other, and suitability and accountability of bodies entrusted to discharge responsibilities; (iii) effective internal and external controls, including robust risk management; (iv) transparent and regular reporting to oversight bodies and stakeholders; and (v) policies and procedures to manage actual and perceived conflicts of interest. The Executive Board's discussions were informed by an opinion from the law firm Wilmer Hale on the conflicts and governance arrangements for the Fund's IA.[32] As discussed below, the governance arrangements established under these proposed Rules effectively implement these principles.

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[30] See *Proposal to Distribute Remaining Windfall Gold Sales Profits and Strategy to Make the Poverty Reduction and Growth Trust Sustainable* (SM/12/244, 9/17/12), and Executive Board Decision No. 15228-(12/95), adopted September 28, 2012.

[31] See *Broadening the Fund's Investment Mandate—Additional Considerations* (SM/12/111, 5/31/12), at ¶42 and *The Chairman's Summing—Broadening the Fund's Investment Mandate—Additional Considerations* (BUFF/12/75, 6/27/12).

[32] See *Report on Conflicts of Interest Considerations Related to the Proposed Expanded Investment Authority for the Investment Account of the International Monetary Fund* (January 24, 2008), which was discussed in *Developing a New Income Model for the Fund—Additional Considerations* (SM/08/48, 2/01/08), and circulated to the Executive Board in Supplement 1 to SM/08/48, 02/08/08. The review concluded that the key measures that the Fund currently has in place are generally adequate to address the increased risk of actual and perceived conflicts of interest that reasonably can be expected to result from the expanded investment authority, subject to certain recommended enhancements, especially in relation to the Fund's investment in certain asset classes that have an increased risk of actual or perceived conflicts of interest (*i.e.*, specialized asset classes).

22. **The proposed Rules establish a clear separation of responsibilities between the Executive Board, the Managing Director, and external managers.** The Executive Board establishes the strategic investment policies—through the adoption of the proposed Rules—and is responsible to oversee the implementation of such policies, while the Managing Director is responsible for implementing the investment strategies for the IA within the parameters established by the Executive Board (***paragraph 6***). The responsibilities of the Managing Director include hiring and terminating external managers and custodians, selecting specific benchmark indices for the various asset classes, developing an investment strategy and investment arrangements for the actively-managed portion of the Endowment Subaccount (***paragraph 23***), implementing the phasing of investments and the rebalancing of subaccounts, determining the modalities for implementing the credit rating requirements, reporting on the investment operations and initiating reviews of the Rules. External managers take decisions on the purchase and sale of specific assets, except for investments with the BIS, as described above, within the mandates established by the Managing Director.

23. **Implementing the strategic investment policies requires the Managing Director to establish arrangements to support effective decision-making and oversight (*paragraph 7*).** The envisaged arrangements set out in SM/12/111 and broadly endorsed by the Executive Board include the establishment of a new Investment Oversight Committee (IOC), consisting of a small group of senior staff members, with delegated responsibilities for some of the key implementation issues, and the continued responsibility of FIN's Investment Unit, under the supervision of the Director of FIN, for the day-to-day management of the resources, including contacts with external managers and custodians, BIS investments, implementation of the risk controls, and preparation of periodic reports.[33]

24. **The proposed Rules require the Managing Director to adopt conflict of interest policies and take other measures to mitigate conflicts of interest (*paragraph 7*).** The Managing Director is responsible for some of the general conflict of interest policies applying to all staff such as the Staff Code of Conduct and the specific conflict of interest policies and procedures for staff in the Investment Unit in FIN.[34] As indicated in SM/12/111, additional measures are envisaged to strengthen the information barriers for staff in FIN's Investment Unit, both with respect to access to Fund documents and physical barriers, and to include a clause in external manager contracts requiring them to report to Fund management if they believe that any Fund staff member has communicated or attempted to communicate material non-public information. The recommendation by Wilmer Hale on strengthening the

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[33] See Box 1 of the companion paper; see also *Broadening the Fund's Investment Mandate—Additional Considerations* (SM/12/111, 5/31/12), and *The Chairman's Summing Up—Broadening the Fund's Investment Mandate—Additional Considerations* (BUFF/12/75, 6/27/12).

[34] Important general conflicts of interest policies applying to all staff are set out in the N-Rules of the Rules and Regulations.

role of senior management in the Fund's policies for mitigating conflicts of interest will be taken up in the ongoing review of the Fund's broader risk management framework.[35]

25. **While the Managing Director is given broad authority to implement the investment policies of the IA, the proposed Rules require consultation of the Executive Board in two areas (*paragraph 8*).** These are (i) conflict of interest policies and other key conflict of interest mitigating measures adopted by the Managing Director and (ii) the investment strategy and investment arrangements for the actively-managed portion of the Endowment Subaccount. With respect to the additional conflict of interest measures discussed above, these have been broadly endorsed by the Executive Board,[36] and it is understood that no further consultation of the Executive Board would be required to implement these measures. Under the consultation clause, the Managing Director would be required to consult with the Executive Board on any significant changes to these arrangements going forward. With respect to the investment strategy and investment arrangements for the actively-managed portion of the Endowment Subaccount, the Managing Director would be required to consult with the Executive Board prior to the initiation of such investment operations, and on any significant changes thereafter.

26. **The risk of conflicts of interest is mitigated by the investment strategy and investment arrangements set out in the proposed Rules.** In particular, the limits on asset classes and investment activities exclude many specialized asset classes and investment techniques that give rise to increased risks of actual or perceived conflicts of interest.[37] The largely passive investment strategy for the Endowment Subaccount, the credit rating and divestment requirements for sovereign bonds, the envisaged use of broad and widely-used/widely available benchmarks, and the reliance on external managers for purchase and sale of IA assets all mitigate the risk of actual or perceived conflicts of interest.

27. **The IA will be subject to a number of investment-related risks, which will in part be mitigated by the proposed investment strategy and investment arrangements.** Some of these risks will inevitably rise with the broader investment opportunities permitted under the proposed Rules; however, these Rules also put in place a strong risk mitigation framework, with further details to be established by the Managing Director. Specific risks include the following:

- *Market risk* is limited in the Fixed-Income and Temporary Windfall Subaccounts. In the Endowment Subaccount, it would be mitigated partly through asset class

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[35] See *Broadening the Fund's Investment Mandate—Additional Considerations* (SM/12/111, 5/31/12).

[36] See *id*.

[37] *Id.* at n. 6.

diversification under the SAA, and within asset classes through broad security selection.

- *Currency risk* in the SDR-denominated Fixed-Income Subaccount is limited through the regular rebalancing of the portfolio to the SDR basket. For the Endowment Subaccount, a large portion of the fixed-income assets will be hedged to the U.S. dollar.

- *Counterparty risk* arising from hedging operations in the Endowment Subaccount will be managed through close monitoring and controls over credit.

- *Interest rate risk* for fixed-income assets in the Endowment Subaccount will reflect benchmark indices, and in the case of the Fixed-Income Subaccount and the Temporary Windfall Profits Subaccount will be limited by the short durations of the holdings.

- *Liquidity risk* is judged to be small given the low likelihood of an unanticipated call on the IA's assets and the inherently liquid nature of the portfolio holdings.

- *Credit risks* for fixed-income assets will be contained by application of minimum credit thresholds. For non-fixed income obligations, including equities and REITs held in the Endowment Subaccount are also subject to risks that, some losses on specific securities will experience losses are expected from time-to-time, though these risks will be mitigated through diversification within the benchmark indexes.

28. **The Managing Director will establish specific risk controls covering both investment and operational risks and put in place mechanisms to monitor their observance by staff and asset managers (*paragraph 7*).** Operational risk arising from errors or compliance failures will be controlled by carefully structured due diligence reviews of external managers and custodians, the checks and balances provided by the reconciliation of external managers and the custodians, stringent performance measurement and reporting requirements, and internal controls on the Fund's operations. The governance framework also mitigates operational risks from actual or perceived conflicts of interest associated with the Fund's investment activities. Finance Department staff responsible for investments is guided by a set of policies and procedures that complement the Fund's Staff Code of Conduct.

29. **The Managing Director will be required to report semi-annually on the operations of the IA (*paragraph 9*).** Such reports will include information on the valuation and performance of IA assets, the selection of managers, the investment guidelines and benchmarks for asset managers, the applicable controls and evaluation of the adequacy of established risk control procedures, and such assessment of market conditions that may affect the valuation of IA assets.

F. Other Issues (Section I, Paragraphs 11–15)

Custody Arrangements (Paragraph 11)

30. **The proposed Rules provide that the assets of the IA shall be held in safekeeping by one or more custodian banks or the BIS.** As under current practice, all assets of the IA are expected to continue to be held by custodian banks or the BIS. The custodian provides independent valuation and safekeeping of the IA assets, and holds and invests the IA's short-term residual cash balances. The custodian also monitors the subaccounts to ensure that the external managers conform to their investment mandates. Assets of the Fund held by the custodian generally are protected by the privileges and immunities from judicial action and from search, seizure or other form of executive or legislative action.[38]

Use of Income—Payout Policy (Paragraph 12)

31. **The proposed Rules reflect the proposal in the companion paper that there would be no payouts from the Endowment Subaccount during the phasing of the passively-managed portion of the Endowment Subaccount (*paragraph 12*)**. Under the Articles of Agreement, the Fund can use IA income to meet the expenses of the Fund, to hold it in the IA, or to invest it (Article XII, Section 6(f)(iv)), and this is reflected in paragraph 12 of the proposed Rules. Decisions on the use of IA income for meeting the expenses of the Fund can be taken by a majority of the votes cast. The Executive Board will continue to take decisions on the use of IA income at the time of the annual decisions on Fund income. With respect to the Endowment Subaccount, the proposed Rules reflect the proposal in the companion paper that no income from that subaccount should be used for meeting the expenses of the Fund during the phasing period of the passively-managed portion (***paragraph 12)***. The proposed Rules further reflect the provisions in the Articles on termination of the IA and reductions in investment (***paragraph 13***).[39]

Audits (Paragraph 14)

32. The proposed Rules reflect the requirements under Section 20 of the Fund's By-Laws regarding the audit of the accounts of the General Department, which includes the IA**.**

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38 In circumstances when the custodian, on the Fund's direction, gives up legal title to an asset in exchange for a claim against the counterparty, thereby assuming the status of a general creditor of the counterparty, the Fund's immunities apply to the claim but the underlying asset normally would not be protected by immunities.

39 Where one subaccount has income but the IA as a whole has no income, for example as a result of losses in another subaccount, transfers of IA resources to the GRA could only be made on the basis of the provision on reduction of the amount of investment, which requires a 70 percent majority of the total voting power (Article XII, Section 6(f)(vi)).

Review (Paragraph 15)

33. The Executive Board will review the proposed Rules at least every 5 years. The Managing Director will initiate these reviews as part of the responsibility to implement the proposed Rules.

III. Proposed Decision

The following decision, which may be adopted by a 70 percent majority of the total voting power, is proposed for adoption by the Executive Board:

"1. The Rules and Regulations for the Investment Account adopted under Executive Board Decision No. 13711-(06/40), April 28, 2006 are repealed.

2. Pursuant to Article XII, Section 6(f)(iii), the Fund adopts the Rules and Regulations for the Investment Account that are set forth in the Annex of SM/12/318 (12/28/12)."

Annex: Rules and Regulations for the Investment Account

I. GENERAL PROVISIONS

Objective of the Investment Account

1. The objective of the Investment Account (IA) is to provide a vehicle for the investment of a part of the Fund's assets so as to generate income that may be used to meet the expenses of conducting the business of the Fund.

Sources of Investment Account Assets

2. The IA may be funded with (a) currencies transferred from the General Resources Account (GRA) in accordance with Article XII, Section 6(f)(ii) of the Articles and (b) the placement of profits from the sale of pre-Second Amendment gold in accordance with Article V, Section 12(g) of the Articles, in amounts up to the total amount of the Fund's general and special reserves at the time of any decision authorizing such transfers; (c) the transfer of profits from the sale of post-Second Amendment gold in accordance with Article V, Section 12(k) of the Articles; and (d) income from the IA investment that is not transferred to the General Resources Account to meet the expenses of the Fund (Article XII, Section 6(f)(iv)).

Investment Account Subaccounts and Allocation of Assets

3. The IA shall have a Fixed-Income Subaccount, an Endowment Subaccount, and a Temporary Windfall Profits Subaccount, each of which has its own investment objective and shall be managed in accordance with Sections I and II, I and III, and I and IV, respectively, of these Rules and Regulations.

4. The assets of the IA in existence at the time of the effectiveness of these Rules and Regulations shall be allocated to the subaccounts as follows: (a) the Fixed-Income Subaccount shall be funded with the IA assets that are attributed to past transfers of currencies in accordance with Article XII, Section 6(f)(ii) of the Articles, and any retained income attributed to these assets; (b) the Endowment Subaccount shall be funded with (i) the IA assets attributed to profits from the sale of the holdings of the Fund's post-Second Amendment gold during 2009 and 2010 equivalent to an average sales price of US dollar 850 per fine ounce, (ii) any retained income attributed to these assets, and (iii) the retained income attributed to the SDR 0.7 billion of gold sales profits from the 2009 and 2010 gold sales at an average sales price above US dollar 850 per fine ounce that were transferred from the IA to the GRA on October 23, 2012 to fund a distribution of the Fund's general reserve; and (c) the Temporary Windfall Profits Subaccount shall be funded with IA assets attributed to profits of SDR 1.75 billion from the sale of the holdings of the Fund's post-Second

Amendment gold during 2009 and 2010 at an average sales price above US dollar 850 per fine ounce, and any retained income attributed to these assets.

5. Transfers of assets between subaccounts may be made with the approval of the Executive Board.

Responsibilities of the Managing Director

6. The Managing Director is responsible for implementing the investment policies for the IA set out in these Rules and Regulations.

7. In carrying out the Managing Director's responsibilities, the Managing Director shall (a) establish effective decision-making and oversight arrangements; (b) take the necessary measures, including the adoption of policies and procedures, that seek to avoid actual or perceived conflicts of interest; and (c) establish specific risk control measures and put in place mechanisms to monitor their observance by asset managers.

8. The Managing Director shall consult with the Executive Board regarding (a) the key conflict of interest policies and arrangements in the Managing Director's responsibility referred to in paragraph 7 and (b) the key aspects of the investment strategy for the actively-managed portion of the Endowment Subaccount referred to in paragraph 23 of these Rules and Regulations.

9. The Managing Director shall provide semi-annual reports to the Executive Board on the investment activities of the IA. Ad hoc reports shall be prepared as warranted by market or other developments.

External Managers

10. All assets of the IA shall be managed by external managers, except as otherwise set forth in these Rules and Regulations. The Managing Director shall only select external managers of the highest professional standards, in particular excellent compliance records, strong market reputation, and with sound investment processes. In selecting managers for passively-managed assets, the Managing Director shall take into account their ability to replicate selected benchmarks with minimal tracking error and cost, and in selecting managers for actively-managed assets, their proven skills and track record in generating excess returns after fees.

Custody Arrangements

11. The assets of the IA shall be held in safekeeping by one or more custodian banks or the Bank for International Settlements (BIS). The custodian(s) shall hold the assets of the IA in safekeeping, periodically value the assets held, and hold and invest short-term residual cash balances.

Use of Investment Account Income

12. The income from investment shall be invested, retained in the IA or used to meet the expenses of conducting the business of the Fund. The Fund shall decide on the use of the IA's income for each financial year, including whether any portion of such income will be transferred to the GRA for use in meeting the expenses of conducting the business of the Fund, provided that income generated from the Endowment Subaccount shall not be used in meeting the expenses of conducting the business of the Fund pending the completion of the phasing period for the passively-managed portion of the Endowment Subaccount specified in paragraph 30.

Termination or Reduction of the Investment Account

13. The IA shall be terminated in the event of a liquidation of the Fund and may be terminated, or the amount of the investment may be reduced, prior to the liquidation by the Fund by a 70 percent majority of the total voting power. The procedures specified in Article XII, Sections 6(f)(vii), (viii) and (ix) of the Articles will apply in the event of the termination of the IA or a reduction in its assets. The Fund's decision to reduce investments in the IA shall specify the subaccount from which assets shall be used to fund a reduction in investments.

Audit

14. The assets of the IA shall be audited by the Fund's external auditors and included in the Fund's annual financial statements.

Review of the Rules and Regulations and Conflict of Interest Policies

15. The Executive Board shall review these Rules and Regulations at least every 5 years.

II. FIXED-INCOME SUBACCOUNT

Investment Objective

16. The investment objective of the Fixed-Income Subaccount is to achieve investment returns that exceed the SDR interest rate over time while minimizing the frequency and extent of negative returns and underperformance over a 12-month investment horizon. The assets in the Fixed-Income Subaccount shall be managed against the 1-3 year government bond benchmark, weighted to reflect the currency composition of the SDR basket.

Eligible Investments

17. The assets of the Fixed-Income Subaccount may be invested only in marketable obligations of members or in marketable obligations of international financial institutions. Marketable obligations of a member shall include the obligations of its central bank and

official agencies. Marketable obligations of international financial organizations shall include without limitation deposits with the BIS and Medium-Term Instruments (MTIs) issued by the BIS. IA investments in the instruments specified above may only be made directly in the cash markets. Hedging is prohibited, as is the use of derivative instruments (including forwards, future, options and swaps), short selling, or any form of financial leverage. Investments are limited to eligible investments that are denominated in SDRs or in the currencies included in the SDR basket.

18. Government and government agency bonds in which the Fixed-Income Subaccount invests shall be subject to a minimum credit rating by a major credit rating agency equivalent to A (based on Standard & Poor's rating scale). If the respective rating threshold is breached, assets shall be divested within three months from the rating downgrade.

Investment Arrangements

19. The assets of the Fixed-Income Subaccount shall be managed by external managers, provided that assets may also be invested by the Managing Director in marketable obligations of the BIS. The investment mandates for external mangers shall provide for active management against the 1-3 year government bond benchmark within risk parameters established by the Managing Director. Investments in BIS obligations shall be guided by the 1-3 year government bond benchmark.

III. ENDOWMENT SUBACCOUNT

Investment Objective

20. The investment objective of the Endowment Subaccount is to achieve a long-term real return target of 3 percent in U.S. dollar terms. The subaccount's real return shall be calculated by using the deflator that is used for purposes of the Fund's administrative budget, the Global External Deflator (GED), provided that the U.S. consumer price index (US CPI) component of the GED shall be adjusted to use the actual US CPI instead of the projected US CPI.

Strategic Asset Allocation and Investment Strategy

21. No less than 90 percent of the Endowment Subaccount assets shall be managed passively (the "passively-managed portion") under mandates that require the external managers to closely track benchmark indices selected by the Managing Director, with up to 10 percent of the Endowment Subaccount assets managed actively in accordance with paragraph 23 below (the "actively-managed portion"). Upon effectiveness of these Rules and Regulations, an amount equivalent to 95 percent of the Endowment Account assets shall be allocated to the passively-managed portion and an amount equivalent to 5 percent to the actively-managed portion.

22. The passively-managed portion shall be invested pursuant to the following strategic asset allocation (SAA) benchmark: 20 percent in developed market sovereign bonds; 20 percent in developed market inflation-linked bonds; 15 percent in developed market corporate bonds; 10 percent in emerging market bonds; 25 percent in developed market equities; 5 percent in emerging market equities; and 5 percent in real estate investment trusts (REITs).

23. The actively-managed portion may be invested only in the same asset classes as the SAA benchmark for the passively-managed portion, with a 65 percent share of fixed-income instruments and a 35 percent share for equities (including REITs) but no specific allocation requirements for each asset class within these two categories. The Managing Director, in consultation with the Executive Board, shall determine the investment strategy and investment arrangements for the actively-managed portion of the Endowment Subaccount, including the selection criteria and risk parameters for external managers, benchmark indices, the scope and instruments for currency hedging, the phasing of the actively-managed portion of the Endowment Subaccount, policy bands and rebalancing procedures, and additional key measures to avoid actual or perceived conflicts of interest.

24. The asset allocation benchmarks for both the passively- and actively-managed portions above shall not apply to temporary holdings of cash, bank deposits or short-term investments in cash instruments.

Rebalancing of the Passively-Managed Portion

25. The passively-managed portion of the Endowment Subaccount shall be rebalanced to the SAA benchmark (a) annually, either in the context of implementing the Fund's annual income disposition decisions or, absent such disposition decisions affecting the Endowment Subaccount, at end-July of each year, and (b) when the actual weight of any of the asset classes of developed market sovereign bonds, developed market corporate bonds, developed market inflation-linked bonds or developed market equities deviates by more than 8 percentage points from the SAA benchmark, or by more than 4 percentage points for any of the asset classes of emerging market bonds, emerging market equities, and REITs. A scheduled annual rebalancing under (a) shall not take place if a rebalancing under (b) is completed within three months prior to that scheduled annual rebalancing.

Prohibited Investment Activities

26. Short selling and any form of financial leverage as well as direct investments in gold are not permitted for the Endowment Subaccount. Derivative instruments, including options, forwards, futures and swaps, are only allowed for hedging operations authorized under these Rules and Regulations or to minimize transaction costs in the context of subaccount rebalancing and benchmark replication.

Currency Hedging

27. The exchange rate risk for fixed-income instruments denominated in developed market currencies *vis-à-vis* the U.S. dollar shall be hedged for the passively-managed portion of the Endowment Subaccount. Permitted hedging instruments include, but are not limited to, currency forwards, futures, swaps, and options. Currency hedging is not permitted for other assets of the passively-managed portion of the Endowment Subaccount. Hedging by external managers of the actively-managed portion of the subaccount is permitted, but not required, as determined by the Managing Director in accordance with paragraph 23 above.

Minimum Credit Ratings for Bonds and Divestment

28. The Endowment Subaccount shall only invest in bonds that have the following minimum credit ratings by a major credit rating agency: for sovereign bonds, a rating equivalent to BBB+ (based on Standard & Poor's rating scale); and, for corporate bonds, a rating equivalent to BBB- (based on Standard & Poor's rating scale). If the respective rating threshold is breached, assets shall be divested within three months from the rating downgrade.

Investment Management Arrangements

29. The assets of the Endowment Subaccount shall be managed by external managers within mandates established by the Managing Director in accordance with these Rules and Regulations. The Managing Director is authorized to manage Endowment Subaccount assets (a) during the phasing of the Endowment Subaccount in accordance with paragraph 30 of these Rules and Regulations, and (b) on an interim basis where this is necessary following the termination of a manager and pending the transfer of the assets to a new manager.

Phasing of Initial Investments

30. The investment of the passively-managed portion of the Endowment Subaccount shall be phased over a three-year period, with equal amounts to be made available to external managers for investment at quarterly intervals. In case of exceptional market conditions, the Managing Director may decide to suspend the phasing or extend this period by up to one year, and to adjust the quarterly installments accordingly. With respect to the actively-managed portion, the phasing of investments shall be decided in the context of the investment strategy in accordance with paragraph 23 of these Rules and Regulations. Pending investment in accordance with the rules for the passively- and actively-managed portions of the Endowment Subaccount, the assets of the Endowment Subaccount shall be invested in accordance with paragraphs 17 to 19 of these Rules and Regulations, provided that the investment objective for these amounts shall be nominal capital preservation while generating income.

IV. TEMPORARY WINDFALL PROFITS SUBACCOUNT

31. The assets of the Temporary Windfall Profits Subaccount shall be invested, pending their use in accordance with Executive Board Decision No. 15228-(12/95), adopted September 28, 2012, in accordance with paragraphs 17 to 19 of these Rules and Regulations, provided that the investment objective of this subaccount shall be nominal capital preservation while generating income.

32. The Temporary Windfall Profits Subaccount shall be terminated after the transfer in accordance with Executive Board Decision No. 15228-(12/95) has been completed. Any remaining assets, including any retained income, shall be transferred to the Endowment Subaccount for investment.