Work in Progress

DRAFT Corner House Briefing Paper

Alternative Investments and Secrecy Jurisdictions:

Environmental, Social and Governance Issues

in the Context of the Financial Crisis

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Environmental Defense Fund

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Introduction

Over the past two decades, projected-affected peoples, environmentalists and human rights advocates have utilized a "follow the money" strategy to influence public multilateral financial institutions, such as the World Bank, and bilateral financial institutions, including Export Credit Agencies (ECAs) of OECD member countries. Improvements in environmental and social safeguard policies at multilateral development banks and ECAs as a result of interventions on a specific project in one country have led to improvements in human rights and environmental impacts in a range of countries and projects. Advocates have also worked to ensure the upward harmonization of environmental and social standards of private sector banks through the development of the Equator Principles. Such efforts in international finance have meant that environmental gains can be rapidly deployed across a wide range of sectors throughout the world. This is not to say, however, that the improved policies are necessarily routinely implemented.

Despite the fact that the world's leading public and private financial institutions have worked to improve accountability on environmentally sensitive investments, however, there are concerns that the increasingly significant capital flows associated with alternative investments such as hedge funds, private equity and sovereign wealth funds are playing an important role in bankrolling environmentally and socially destructive mega-projects. As of September 2008, over $2.6 trillion was invested in hedge funds, alone.[2] Unlike finance associated with traditional multilateral development banks or bilateral financial institutions, or traditional private sector financial institutions, alternative investment funds are not normally subject to significant transparency, governance, and reporting requirements. Increasingly, however, public financial institutions – with transparency and environmental safeguard requirements – are investing in private equity vehicles domiciled in secrecy jurisdictions and planning to tap into sovereign wealth funds, leading to a potentially leveraged entry point for environmentalists and human rights advocates into the otherwise opaque world of alternative finance.

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[1] The author may be contacted at stephf99@gmail.com
[2] Reuters, "Hedge funds batten down the hatches in turbulence", September 17, 2008

In addition, pension funds and university endowments have begun to invest heavily in "alternative investments", opening the door to entirely new participants in and potential victims of high risk investments which formerly were the domain of wealthy individuals. The new levels of institutional exposure for hedge funds and private equity funds lead to increased reputational risks to funds involved in projects perceived negatively by the public on environmental or social grounds or by regulatory authorities, for example, in light of relatively new anti-money laundering regulations. The entry of institutional or "retail" investors into alternative investments is likely to spur increasing pressure for regulation and transparency.

In the context of the rapidly developing global financial crisis, it would be prudent for regulatory authorities, concerned citizens, and decision-makers to focus on the implementation of strong transparency and accountability requirements for alternative investments, as well as the common use – even by public financial institutions – of secrecy jurisdictions.

Hedge Funds: Keeping the dialogue as short as possible

> *The longer you talk to [a potential investor], the more bad things that can happen before you get your money. For example, regulators come in, there's a currency crash, a stock crash. The goal is to keep the dialogue as short as possible."*
>
> -- Senior attorney, hedge fund advisor, offshore investment manager, September 2007[3]

Early investors in hedge funds were high net worth individuals and "family offices" or family funds. After the dot-com bubble burst, however, the typical investor profile shifted as pension funds and university endowments began, in an attempt to lower their risk, to seek out hedge funds in a search for assets which were not correlated with the stock market. The majority of pension funds with hedge fund exposure, however, do not invest directly in single-manager funds but rather in funds of hedge funds.[4] Government and quasigovernmental agencies also prefer funds of funds. Hedge fund managers seeking access to endowment and other institutional funding may attempt to develop connections with trustees and board members of pension funds and university endowments with a goal of convincing trustees to recommend the funds to their own institutional investment analysts.[5]

As hedge funds and private equity funds have entered the world of project and infrastructure finance, concerns have been raised about the difficulty of preventing negative environmental and social impacts linked to unregulated, untransparent, large-scale, and – in many cases – fast-

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[3] Advice presented to hedge fund managers at a training seminar held at the Tenth Annual Hedge Funds World Asia conference in Hong Kong in September 2007. The portions of this paper on hedge funds and private equity not associated with multilateral development banks and otherwise unannotated reflects information presented in lectures, speeches and interviews conducted at the Hong Kong conference which was attended by 450 managers of and investors in alternative investments, managers of funds of funds, family funds, as well as institutional investors - including pension funds and endowments - regulators, and financial news media representatives.
[4] A fund of hedge funds is a fund which invests in a portfolio of different hedge funds to diversify risks.
[5] According to a senior attorney and hedge fund manager, leading a workshop for hedge fund managers, "For foundations and endowments, you need to find out who is on the Board of Trustees. It is a powerful sales technique to have someone on the Board recommend you. …Government agencies use consultants so you must get on the consultants' lists" in order to have access to them as investors. Hedge Funds World Asia, September 2007.

moving financial flows. The world of alternative investments is difficult for outsiders to understand. The frequent use of secrecy jurisdiction domiciles and an "alternative" language of its own -- "portable alpha,"[6] "securitization,"[7] etc. – makes "alternative investment space" relatively opaque even to those well versed in standard financial instruments.

Given the general goal of "minimizing dialogue" even with potential investors, proper due diligence for alternative investments requires substantial effort. According to an official at a major Asian stock exchange,

> *"The central problem for many pension funds and endowments is their governance capacity. The rule of thumb is simple, don't play with asset classes you don't understand and, if they have governance gaps, you must be prepared to fill them at the pension fund management level in order to fulfill your fiduciary responsibilities to your beneficiaries. This is why the more mature pension funds look at environmental, social and governance issues, not just as they relate to straight equity, but as they relate to all asset classes."*

The increasing exposure of pension funds and university endowments to asset classes that few -- if any – understand, subjects beneficiaries to significant risks. Environmental, social, and governance problems often translate directly into financial risks. Despite the value and importance of proper due diligence, however, regulatory authorities continue to come up with a host of strange reasons for not requiring access to data. For example, at the 2007 Hedge Funds World Asia meeting in Hong Kong, Michael Ainley, the Head of Wholesale Banks and Investment Firms for Britain's Financial Services Authority (FSA) explained to the crowd of hedge fund managers and investors that, in the UK, it had been suggested that regulators be provided with "real-time data" on hedge fund positions. According to Ainley, however, the FSA "can't yet accept this kind of proposal" because such data would be "difficult to collect." How would we use it? The fact that we have it would create a false sense of security."[8] There are some signs that massive economic crisis, however, may change the playing field in terms of the willingness of regulatory authorities continue to look the other way.[9]

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6 "Alpha" refers to so-called "excess return" on an investment - i.e. in excess of stock market returns. It is a "common measure of assessing an active manager's performance." "Portable alpha" refers to a "skill-based, distinguishable, consistent return" in excess of stock market returns." http://www.hedgefund-index.com/d_alpha.asp, http://www.hedgefundintelligence.com /ih/Article.aspx?Task=Report&IssueID=52262&ArticleID=1098182

7 Securitization can be defined as "the pooling of assets and the issuance of securities to finance the carrying of the pooled assets." Introduction to Securitization, Jason Kravitt, Mayer, Brown & Platt, 1998, http://www.securitization.net/knowledge/transactions/introduction.asp

8 Michael Ainley, Head of Wholesale Banks and Investment Firms, Financial Services Authority, U.K., Panel discussion titled, "Examining hedge funds : Financial stability and market development," Hedge Funds World Asia, September 2007.

9 Stephen Labaton, New York Times, " S.E.C. Concedes Oversight Flaws Fueled Collapse," 9/27/08, "The chairman of the Securities and Exchange Commission, a longtime proponent of deregulation, acknowledged on Friday that failures in a voluntary supervision program for Wall Street's largest investment banks had contributed to the global financial crisis, and he abruptly shut the program down. "The last six months have made it abundantly clear that voluntary regulation does not work," said [Christopher Cox, Chairman of the S.E.C.] in a statement. The program "was fundamentally flawed from the beginning, because investment banks could opt in or out of supervision voluntarily. The fact that investment bank holding companies could withdraw from this voluntary supervision at their discretion diminished the perceived mandate" of the program, and "weakened its effectiveness," he added. The

The Quant Quake, crowded trades, and swimming naked

"Stay away from crowded trades, or if you are in a crowded trade, be aware of who's running for the exit door first."

- Kurt Winkelmann, Managing Director, Head of Global Investment Strategies, Goldman Sachs, September 2007[10]

"After all, you only find out who is swimming naked when the tide goes out."

- Warren Buffet , 2002[11]

"Hedge funds are sold, not bought."

- Managing Director, fund of hedge funds, September 2007

Hedge fund managers charge exceedingly high fees - often 2% of net assets under management (AUM) and 20% of profits. As a result, there is a continual flood of individuals wishing to try their luck at fund management and there are significant incentives to achieve high short-term yields.

Investors hunt for hedge fund "alpha", seeking "highly skilled managers operating in inefficient markets."[12] According to analysts, Asia is "not yet oversaturated" and presents a "great opportunity" for "skilled managers" given the inefficiencies in new and developing Asian markets and the plethora of new instruments and new strategies.[13]

Hedge funds, in theory, provide returns which are uncorrelated to traditional debt and equity markets. Some use computer-generated or "quantitative" models to identify investments which are thought to be uncorrelated with the market. Investments driven by "quant" models with similar assumptions, however, may end up highly correlated with each other. As the August 2007 "quant quake" demonstrated, many of the quant funds "underestimated the magnitude and the speed with which danger could strike" and suffered "shockingly bad" losses.[14] Managers

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program Mr. Cox abolished was unanimously approved in 2004 by the commission under his predecessor, William H. Donaldson. The commission created the program after heavy lobbying for the plan from all five big investment banks. At the time, Mr. Paulson was the head of Goldman Sachs. He left two years later to become the Treasury secretary and has been the architect of the administration's bailout plan. The investment banks favored the S.E.C. as their umbrella regulator because that let them avoid regulation of their fast-growing European operations by the European Union."

[10] Kurt Winkelmann, Hedge Funds World Asia, Keynote Address: "The future outlook of managing Asian institutional assets." Kurt Winkelmann's powerpoint presentation was delivered by a Goldman Sachs representative from Singapore. Hong Kong, September 2007.

[11]Warren Buffet, Chairman's Letter, Berkshire Annual Report, February 28, 2002

[12] Sam Riter, Keynote Address: "Asian opportunities: Risks and Rewards", Hedge Funds World Asia, Hong Kong, September 2007

[13] Sam Riter, Keynote Address: "Asian opportunities: Risks and Rewards", Hedge Funds World Asia, Hong Kong, September 2007. "In Asia there are still many inefficiencies that managers can take advantage of. They can capture the inefficiencies before they dissolve."

[14] Alistair Barr, "Quant quake shakes hedge-fund giants: Goldman, Renaissance, AQR see losses, but also sense opportunity,"MarketWatch, Aug. 13, 2007. For example, see Mark Hines, "Four Opportunities for 2008": "As another example, many of the big quant funds thought they were diversified by holding large portfolios diversified across various markets. However, in August they learned their specific quantitative strategies were not diversified

claimed that their strategy had gotten "too crowded" and the losses occurred when "too many tr(ied) to get out the same door."[15]

One month after the "quant quake," Sam Riter, Managing Director of BlackRock, the largest publicly traded asset management company in the United States, remarked on the "low barriers to entry" into hedge fund management given the attractiveness of high management fees and the resulting large numbers of individuals of varying capacities and backgrounds entering the industry. [16]

According to a fund of funds manager for a $1.3 billion family office, "The hardest part of our job is separating the lucky from the truly skilled. We believe that a lot of track records are based on luck. You could just go to Las Vegas and put 1% of your portfolio on black on the roulette table. You could do this each month. You can do it, statistically speaking, for seven years before getting a string of reds that wipe you out."[17]

Hedge fund managers employ various strategies to seek investors. New managers are often advised to aim for funds of funds and family offices which generally make decisions much more quickly than institutional investors. Since only a handful of pension funds invest directly in single manager hedge funds, funds of hedge funds provide most hedge fund managers with access to institutional investors.[18]

As complex as it may seem to identify potential investors for hedge funds in Singapore or Hong Kong, in reality, the universe of significant investors is well defined and not very large. In Hong Kong, for example, there are a small number of universities with endowments likely to invest in hedge funds, between 15 to 20 family offices and half a dozen funds of funds potentially likely to provide investments. Most of the financial institutions in Hong Kong are global in nature with decision-making occurring in New York or London.[19] In Singapore, by contrast, government and institutional investors are more aggressive than their Hong Kong counterparts and actively aim at alternative investments. There are significant university endowments and three large Singapore banks which handle hedge funds through asset managers but only a handful of family offices and

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enough, and the high concentration of funds using the exact same quantitative factors caused many of them to get wiped out in the quant quake." December 21, 2007, http://seekingalpha.com/article/58095-four-opportunities-for-2008

[15] ibid

[16] Sam Riter, Keynote Address: "Asian opportunities: Risks and Rewards", Hedge Funds World Asia, Hong Kong, September 2007. As of June 2008, BlackRock's assets under management totaled US$1.428 trillion. At that time, the company provided various investment services to clients with portfolios totaling more than US$7 trillion. http://www2.blackrock.com/global/home/AboutUs/index.htm BlackRock was recently called on by the Federal Reserve to manage $30 billion of hard-to-sell assets from Bear Stearns, leading to questions from Congressman Henry Waxman about how BlackRock won the assignment without an open bidding process. Michael de la Merced, "BlackRock: the Mr. Fix-it of Wall Street," New York Times, 5/8/08

[17] Statement made during a training session for hedge fund managers, Hedge Funds World Asia, Hong Kong, September 2007.

[18] "Funds of funds are the easiest money for early stage managers," according to the managing director of a family office holding funds of funds, Training session for hedge fund managers, Hedge Funds World Asia, Hong Kong, September 2007

[19] Training session for hedge fund managers, Hedge Funds World Asia, Hong Kong, September 2007.

funds of funds.[20] As non-governmental organizations concerned about environmental and social impacts of hedge funds are discovering, what earlier seemed like an impenetrable maze of potential hedge fund investors is actually a "knowable universe"of parties who may not be difficult to contact and who may well be interested in understanding risks associated with environmental, social, and governance issues.

"Thirty Hours by Plane": The Offshore Approach

"The largest investor in China is Hong Kong - that is, money routed through Hong Kong. The second largest investor is British Virgin Islands, and the third largest is Japan."

> – Senior attorney and advisor to hedge funds and private equity funds for a large international offshore services provider. 2007.

"British Virgin Islands supposedly checks with your on-shore regulators to show that you're regulated on-shore in the jurisdiction you're claiming. But regulation offshore is obviously limited. When they deal with the Asian environment, it is half a world away. Which is why they are popular [for Asian companies]. It's thirty hours by plane. It's impossible for them to regulate a case on-shore."

> -- Hong Kong-based attorney and offshore advisor for major international legal firm with an office in the British Virgin Islands, training session for hedge fund managers on how to set up an offshore domicile, 2007.

"Working in Jersey for 14 years helped me understand how secrecy jurisdictions facilitate capital flight and tax evasion. Most of my work involved creating elaborate structures for shifting profits out of producer countries and consumer countries into offshore structures. Tax evasion, typically dressed up as tax avoidance, was the principal motive. .. But tax avoidance is only a part of what I uncovered in Jersey. … reading through the files of clients from all over the world revealed indisputable cases of insider trading, market rigging, non-disclosure of conflicts of interest, fraud, bribe paying, international sanctions busting, and, of course, tax evasion on an epic scale. These crimes are seldom exposed because they occur in a milieu of legal secrecy and judicial non-cooperation. When investigators persist, their efforts are likely to be thwarted by flee clauses[21] and redomicilation instructions built into trust and company arrangements."

-- John Christensen, FRSA, former economic advisor for the States of Jersey, August 2008[22]

Hedge funds, private equity funds and other alternative finance vehicles often establish their domiciles "offshore" in secrecy jurisdictions such as the Cayman Islands, British Virgin Islands,

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[20] ibid

[21] A "flee clause" contains language to ensure that a predetermined event, for example, any inquiry by a law enforcement agency regarding a trust held in a secrecy jurisdiction, results in the automatic transfer of the trust to another offshore jurisdiction, thereby making enforcement efforts difficult if not impossible. International Narcotics Control Strategy Report – 2007, Released by the Bureau for International Narcotics and Law Enforcement Affairs, Southeast Asia and the Pacific -- 2007

[22] John Christensen, "The Hitchhiker's Guide to Nowhere: A journey into economic anarchy," presented at European forum Alpbach – Reform Symposium, 18 – 20 August, 2008.

Jersey, Guernsey, Ireland and Mauritius.[23] Usual goals include ability to hide the origin of assets and the identities of asset, lax regulations and the avoidance of taxation (although this is technically illegal for U.S. corporations).[24]

Accountant Richard Murphy[25] identifies the two core characteristics of secrecy jurisdictions:

> *The first such characterization is that a secrecy jurisdiction creates regulation that they know is of primary benefit and use to those not resident in their geographical domain.*
>
> *The second characteristic is the creation of a deliberate and legally-backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so*.[26]

In 2004, more than 70,000 companies were registered in the Cayman Islands, including 446 banks and trust companies. Forty of the world's largest banks were present in the Cayman Islands.[27] In 1998, approximately 1,300 hedge funds were registered in the Cayman Islands.[28] Now over 10,000 hedge funds are registered there.[29]

The vast number of secrecy jurisdiction transactions with the "onshore" world requires a substantial army of lawyers, accountants and trust advisors who often work closely with the governments of such jurisdictions to ensure that beneficial legal systems are in place for their clients. For example, Ogier is a large legal and fiduciary services company with offices in the Cayman Islands, British Virgin Islands, Guernsey, Jersey, Hong Kong, Ireland, Montevideo and New Zealand. As a secrecy provider working closely with hedge funds and private equity funds, Ogier's website informs potential clients that in the Cayman Islands:

> "[T]he close relationship between the government and the private sector enables the continuing development of cutting-edge legislation relating to the industry."[30]

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[23] "Offshore" is a common but misleading term. "Secrecy jurisdiction" provides a more accurate description as it also encompasses "offshore" aspects of finance carried out "onshore" in places like London, New York, and London. According to John Christensen, "Secrecy jurisdictions are a central feature of the global financial markets. Far from being small and insignificant, secrecy jurisdictions include major financial centers like London, New York and Zurich, and many microstate jurisdictions such as the Bahamas, the Cayman Islands, the British Virgin Islands, the Channel Islands, Bermuda, Lichtenstein and others act as satellites to these major financial centers." In "The hitchhiker's guide to nowhere: a journey into economic anarchy." European Forum Alpbach – Reform Symposium, August 2008. pg.2.

[24] According to a former senior official from a well-known "offshore" jurisdiction, hiding the origin of assets and the names of those holding them is often the *primary* reason for setting up an offshore domicile, more so than the avoidance of taxes and regulation. Personal communication, 2008.

[25] Richard Murphy is a chartered accountant who trained with KPMG in London before setting up his own firm of chartered accountants in 1985 in London. He and his partners sold the firm in 2000 when it had 800 clients. He is a member of the Association of Chartered Certified Accountants' Research Committee.

[26] Richard Murphy, Tax Research, "Finding the Secrecy World, Rethinking the Language of 'Offshore,'" www.taxresearch.org

[27] U.S. Department of State, Background Note: Cayman Islands, February 2008 http://www.state.gov/r/pa/ei/bgn/5286.htm#econ

[28] "The view from the top," Hedge Funds Review: The Voice of the Alternative Investment Industry in association with KPMG. April 2006. pg.6.

[29] "Hedge funds perform well," Caymannetnews.com, September 15, 2008

[30] www.ogier.com

The Cayman Islands are a popular domicile for Asian funds. Many private equity funds use a Cayman Islands domicile with a British Virgin Islands manager.[31] According to Gary Linford, the head of the Cayman Islands Monetary Authority, the philosophy of the Cayman Islands' legislation for non-public funds (i.e. for professional and institutional investors) is *caveat emptor*, "with the emphasis on full disclosure."[32] He notes that a "typical Cayman Islands hedge fund's offering document will run to more than 60 pages in length, with a significant section devoted to risks and potential conflicts of interest" and that with a "principles-based approach rather than the prescriptive rules-based approach common in the regulatory framework of retail funds"… "it is the regulators of the lenders to hedge funds that will need to resource themselves appropriately if they are to monitor…exposure."[33] Despite – or perhaps because of – the length of a typical offering document, the authorization of a non-public fund "can take as little as two to five business days" and "the due diligence burden rests mostly with the investors in our non-public funds."[34]

According to a secrecy provider attorney for a major international firm with Cayman Islands and British Virgin Islands offices:

> "The Cayman Islands Monetary Authority offers a speedy turn-around. They have hired people with industry expertise to help grow business. … Offshore, it is much easier and quicker to set up an offering. There is very little regulation and the information which must be provided to regulators is light compared to on-shore. Delays are small. Cayman companies can even list on the Hong Kong stock exchange. This is strange, but good. …
>
> There is a hands-off approach. They don't review your documents or the functionaries you appoint. You just make filings. They rely on fact that there is an auditor, so they exempt you from regulation. … You can set up a fund in no time at all. You file once a year, pay a fee. It's very easy."
>
> The British Virgin Islands has about 3,000 hedge funds and 730,000 companies. BVI is more hands-on and more concerned about reputational blowups. All funds are regulated and you must submit documents to the Financial Services Commission for approval. There is a debatable level of scrutiny – it is not in-depth. You may need to wait a bit to a register a private fund. A professional fund can trade for 14 days without a license and you should get a license within 14 days. There is somewhat higher scrutiny. In Asia, many Cayman funds have BVI managers. BVI supposedly runs a check with on-shore regulators to show you're regulated on-shore in jurisdiction you're claiming.
>
> Key jurisdictions have cleaned up because of regulatory scrutiny. There are still some concerns because of economic activity – maybe $81 billion of tax revenue is lost

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[31] Partner in international offshore law firm, training session, Hedge Funds World Asia, Hong Kong, September 2007

[32] Statement by Linford in "The view from the top," Hedge Funds Review: The Voice of the Alternative Investment Industry in association with KPMG. April 2006. pg.6

[33] Ibid, pg.6

[34] Ibid, pg.7

> offshore. If offshore operations are banned, perhaps the U.S. government could capture this. "[35]

It has been estimated elsewhere that illicit financial flows total between US$1 trillion to US$1.6 trillion per year and that 60% to 65% of these funds relate to commercial tax abuse.[36] The disappearance of such taxable resources has immense implications for national economies, including for poverty alleviation efforts.

Environmental Governance in the Alternate (Investment) Universe: Knowing Your (Politically Exposed) Customer

To offset [our] carbon footprint, we are continually planning and implementing environmentally friendly practices… as well as supporting external causes.[37]

> -- Website of prominent international law firm and secrecy provider with offices throughout secrecy jurisdictions.

"When you get the property in South Cambodia which will be the next tourist destination, you plow your money in there. Your investor wants to get money out, but he is locked in until the project is completed. If they want to pull out, you can offer them land - which is worthless."

"Let's take a rainforest in Cambodia. You need to chop down trees, and you need $2 million to do that. If you have fund of $100 million, you don't want that sitting in the bank so you set up a commitment and call structure. The investor commits to provide $20 million. When you're taking the stumps out of the ground, you ask for the money. The money gets sent, the investor is comfortable. You have to give the investor an idea of when you will call them."

> -- Partner in the above prominent international law firm, teaching a training session for hedge fund managers, 2007.

It is well known that illegal logging has played a devastating role in the forests of Cambodia, Indonesia and elsewhere in tropical Southeast Asia and that political elites and armed forces are often involved in such logging. Recent reports by the Center for International Forestry Research (CIFOR) have underscored the intersection between money laundering and various environmental crimes in the forestry sector.[38]

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[35] Partner in international law firm and secrecy provider with offices in many secrecy jurisdictions in a training session for hedge fund managers.
[36] Richard Murphy, Tax Research, "Finding the Secrecy World, Rethinking the Language of 'Offshore,'" www.taxresearch.org, pg 20
[37] The "environmentally friendly practices" advertised on the website of this company apparently include sponsorship of an essay competition for young environmentalists in the Cayman Islands and an "actively green day" where staff in one offshore domicile were asked to come to work in an environmentally friendly manner. Staff responded by pushing each other in a wheelbarrow and bouncing to work on large rubber balls. Other breakthroughs included the provision of recycling bins, a reduction in the number of phone books, and the use of one "green Christmas card" that all staff signed instead of sending individual cards.
[38] M. Spek, Financing Pulp Mills: An Appraisal of Risk Assessment and Safeguard Procedures, CIFOR, 2005

The CIFOR analyses underscore the fact that without bank financing, large-scale forest exploitation projects are simply not commercial feasible, given the cost of machinery, costs of harvest, processing, and transport. Increasingly, however, high-risk forest-based projects which, in countries with significant corruption and governance issues, often involve crimes such as illegal logging and air and water pollution, are now – as a result of relatively recent anti-money laundering statutes - leading to significant legal risks to investors.

In 2003, Indonesia passed landmark legislation making banks and other financial institutions responsible for transactions involving forestry and environmental crimes. The new legislation identifies illegal logging as a "predicate offence" for money laundering, meaning that money laundering charges and strict penalty schedules can now be applied to financial institutions engaged in projects that involve illegal timber harvesting. This approach seeks to prosecute the financial backers of illegal logging.

This section provides a brief overview of anti-money laundering statutes which may be triggered during the financing and implementation of mega-projects which involve the participation of prominent and politically connected individuals. It is important to note that, while the implementation by financial institutions of anti-money laundering (AML) due diligence requirements is often very weak, a focus by environmental and human rights activists on triggers for AML due diligence can result in queries by public authorities and relatively rapid action by financial institutions.[39]

In 1989, the Financial Action Task Force on Money Laundering (FATF) was founded at the G-7 Summit in Paris with a goal of promoting national and international policies to combat money laundering and terrorist financing. The FATF meets several times per year and consists of legal, financial, law enforcement experts who monitor the status and progress of member countries, investigate money laundering, and promote the creation of appropriate global measures to combat money laundering.

FATF has identified a category of persons of concern, that is, Politically Exposed Persons (PEP). The PEP category is recognized by most governments and jurisdictions which identify Politically Exposed Persons as:

> individuals who are or have been entrusted with prominent public functions, for example current and former heads of state, senior politicians, senior government, judicial, military officials, senior executives of state-owned companies, major political party officials and their close associates and family members.

Regulations around the world now require banks and other financial institutions to "know their customer", to understand their customer's investment profile, patterns of transactions, and range of accounts owned. Most countries have adopted or are in process of adopting new Anti-Money Laundering (AML) transparency laws and a risk-based approach, as described in the Anti-Money

[39] The case of the controversial United Fibre Systems proposed pulp and wood chip mills in Kalimantan, Indonesia is a case in point. See below.

Laundering Guidance Update issued by the Jersey Financial Services Commission in 2001.[40] Under this framework, financial institutions are obliged to implement customer due diligence proportionally to the risks involved in any given project or transaction. There is a heightened focus on “Politically Exposed Persons” and “Politically Exposed Companies” with a focus on:

- Risk associated with providing financial and business services to government ministers or officials from countries with widely-known problems of bribery, corruption and financial irregularity;
- Cases where “those in power illegally amassed large fortunes by looting their country’s funds, diverting international aid payments, disproportionately benefiting from the proceeds of privatizations, or taking bribes in return for arranging favorable decisions, contracts or job appointments”;[41]
- Tracking the proceeds of such corruption which are often transferred to other jurisdictions and concealed through companies, trusts or foundations or under the names of relatives or close associates.

Under the new laws, financial services businesses that handle the proceeds of corruption face the risk of severe reputational damage, criminal charges for having assisted in laundering the proceeds of crime, and lawsuits. The new laws mandate that, where it is known or suspected that a business relationship exists with a “politically exposed person,” detailed due diligence is required at outset of the business relationship and on an ongoing basis. Financial services businesses must also assess which countries are most vulnerable to corruption (use of the Transparency International corruption list is advised) and must be most vigilant where customers are involved in businesses which appear to be vulnerable to corruption.

Under new AML statutes, due diligence should include close scrutiny of any complex structures (companies, trusts, multiple jurisdictions) “bearing in mind that most legitimate political figures would expect their personal affairs to be undertaken in a more than usually open manner rather than the reverse.”[42] Every effort must be made to establish the source of the wealth, including the economic activity that created the wealth, and to ensure that these are legitimate activities and sources, at beginning of the business relationship and on an on-going basis. It is expected that a financial services company would review, at a senior management or board level, the decision to commence such a business relationship and would regularly review the relationship, developing a profile of expected activity for the business relationship so as to provide a basis for future monitoring. The review would include close scrutiny of any unusual features such as very large transactions, the use of government or central bank accounts, particular demands for secrecy, the use of cash or bearer bonds or other instruments which break an audit trail, the use of small and unknown financial institutions in secrecy jurisdictions, and regular transactions involving sums just below a typical reporting amount.

The Case of United Fibre Systems Pulp and Chip Mills, Indonesia

Around the world increasing evidence is appearing of the use of alternative investment vehicles in infrastructure and mega-project finance. One example is the recent attempt by a new Hong

[40] The notes below are taken from Jersey Financial Services Commission, “Anti-Money Laundering Guidance Update,” 2001

[41] Jersey Financial Services Commission, “Anti-Money Laundering Guidance Update,” 2001

[42] ibid

Kong-based hedge fund to provide substantial financial support for a controversial Indonesian paper and pulp project.

In its July 2007 debut, Abax Global Capital, claimed to be a one billion (U.S.) dollar hedge fund, the largest Asian fund ever launched outside of Japan.[43] Within weeks of its launch, the fund announced plans to invest $225 million in the controversial United Fibre Systems (UFS) pulp mill project in Kalimantan, Indonesia. United Fibre Systems had been rejected, however, by most public and publicly-listed financial institutions as a result of the likelihood of tremendous environmental damage, illegal logging and climate impacts also leading to considerable financial risk.[44] In addition to environmental concerns, the UFS projects triggered international attention for the involvement of convicted felons, Suharto-era Indonesian generals and former Indonesian first family members – i.e. "politically exposed persons" -- who appeared likely to generate heightened due diligence requirements under relatively new anti-money laundering laws.

Over the past five years, the troubled company sought finance from a wide range of public and private institutions. An international coalition of over 100 organizations in close to 30 countries presented detailed environmental and social analyses of proposed UFS operations to the U.S. Treasury Department, European finance ministries, and Indonesian officials. Plans for support for the UFS project from the World Bank Group's Multilateral Investment Guarantee Agency (MIGA) were dropped. The World Bank's Indonesia Country Director announced that there would be no further plans for World Bank Group involvement in the project. OECD-member export credit agencies, including Austria's OeKB, rejected the project. Deutsche Bank and JP Morgan withdrew support. The planned entry of a newly-created and apparently highly-capitalized Hong Kong hedge fund into the project set off alarms throughout the conservation and finance communities because of the lack of a coherent methodology for influencing Hong Kong hedge funds and other such international investors in the alternative investment sector in a process of environmental due diligence and upward harmonization of environmental and social standards.

It turned out, however, that there were substantial links between the new hedge fund and major private sector financial institutions. [45] Prime brokers for Abax Global Capital were Merrill Lynch and Goldman Sachs. Morgan Stanley has a significant minority share in the management company. Abax is managed by former representatives of Citadel, DBS, Mellon HBV/Fursa Alternative, Standard Chartered Bank, Allianz Hedge Fund Partners (Allianz Global Investors Kapitalanlagegesellschaft) and Morgan Stanley. Both Morgan Stanley and Goldman Sachs have committed to widespread application of Equator Principles throughout their investment and advisory portfolios. Merrill Lynch has environmental standards. The UFS projects appear to violate the Equator Principles. In September 2007, the Financial Times published an article on Abax and its involvement in the controversial UFS project. The majority of the proposed Abax finance for the controversial Indonesian pulp mill -- $200 million of the proposed $225 million

[43] Abax launches with demand of over $1 billion, Asianinvestor.net, 9 July 2007

[44] For example, see: Environmental Defense Fund, CAPPA, Walhi KalSel et al, "Memorandum on Environmental, Social, and Financial Risks Associated with the UFS pulp and wood chip mills and the proposed UFS acquisition of the Kiani Kertas mill," endorsed by 93 organizations in 27 countries, 2006

[45] *United Fiber enters $225 million financing with Abax,* Asianinvestor.com, 7/25/07

package – was never issued. As of September 2008, financing for the mill has still not been finalized.

Publicly-Funded Alternative Investments in Secrecy Jurisdictions: Multilateral Development Bank Private Equity Portfolios[46]

[T]here seems to be no regular internal ADB assessment, reporting, or focused management of reputational, environmental, or other nonfinancial risks [for Private Equity Funds]. This issue is particularly important at the investee level where any problems such as environmental damage, child labor, or other forms of corporate misconduct, are most likely to occur. It is highly unlikely that a P[rivate] E[quity] F[und] manager will engage in activities such as employing underage workers in its Hong Kong, China fund management office. However, ADB should consider that it is conceivable an investee company in which a fund invests might do so.

If such corporate misconduct were to come to the public's notice through an event such as a widespread product safety issue arising at an investee that was uncovered by a nongovernment organization, the press, or by regulators, it could damage ADB's reputation. To help address this issue, mechanisms can be put in place to regularly review PEFs on at least an annual basis, and rate and independently monitor these risks."

> -- Operations Evaluation Department, Asian Development Bank, "Private Equity Fund Operations, Special Evaluation Study", July 2008, page 95, Appendix 5.

Among emerging economies, Asia is the dominant destination for private equity.[47] Annual fundraising in Asia has soared from $2.2 billion in 2003 to approximately $23 billion in 2007.[48] Private equity funds, though also largely unregulated, stand in contrast to hedge funds in that they generally make limited number of large illiquid investments in unquoted companies, and often take controlling stakes in these companies. Investors in private equity funds may be "locked in" to their investments for as long as ten years.

Multilateral Development Banks with poverty alleviation mandates, bilateral export credit agencies and other public financial institutions have increasingly been investing in private equity funds domiciled in secrecy jurisdictions, apparently without conducting sufficient due diligence pertaining to the financial aspects of these funds as well as the potential adverse environmental, social or human rights impacts of their investments.

The involvement of public financial institutions in the world of alternate finance and the fact that they hold – through private equity vehicles alone – interests in between 1,000 to over 2,000

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[46] This section is excerpted from a longer paper on this topic, currently being prepared.
[47] Asian Development Bank Operations Evaluation Department, "Private Equity Fund Operations, Special Evaluation Study", July 2008
[48] ADB, OED "Private Equity Fund Operations, Special Evaluation Study", July 2008

portfolio companies -- leads to potentially leveraged entry points for efforts to bring transparency and environmental, social and governance standards to the world of alternative finance.

For example, both the Asian Development Bank (ADB) and the IFC have had equity investments in the Asian Infrastructure Fund (AIF), a private equity venture domiciled in the Cayman Islands, managed by a firm in Hong Kong and capitalized at close to $1 billion. The ADB reports that the Bank's $20 million commitment allowed AIF to mobilize $780 million, a leverage ratio of nearly 40:1. AIF has made equity investments in (unnamed) telecommunications, power, port, and road projects, which amounted to $6 billion in total investment, or 300 times ADB's equity stake. Yet little information is available on social and environmental aspects of these investments.

The rapid expansion of MDB private equity portfolios is a relatively recent phenomenon. The ADB has targeted private equity funds as a key component of its private sector development strategy. Approximately 40 ADB private equity funds, domiciled for the most part in secrecy jurisdictions such as the Cayman Islands, invest in an average of 10 companies each, yielding a potential total of some 400 companies, all overseen by two relatively junior staff. Approximately 50% of ADB-held funds have been approved since 2003. The European Bank for Reconstruction and Development has investments in over 70 private equity funds, potentially involving over 700 companies. The World Bank Group's International Finance Corporation (IFC) has invested in over 100 private equity funds domiciled largely in secrecy jurisdictions. If the average of 10 companies per fund holds true, this could mean investments of public funds by the IFC, alone, in over 1,000 companies with no meaningful attention to environmental and social concerns. The Overseas Private Investment Corporation has committed close to $3 billion in funding to nearly 40 private equity funds which have invested $3.5 billion in more than 400 privately owned companies.

Safeguards and Transparency

Multilateral development banks with investments in equity funds have environmental and social safeguards which must, in theory, be applied to these funds. Despite multilateral development bank transparency and environmental and social safeguard requirements, there is little publicly available data regarding these investments and their environmental and social impacts. We have found no evidence to suggest that these safeguards are being robustly implemented, if, indeed, they are being implemented at all. The ADB has found that, even on a financial basis, their private equity investments yield exceedingly poor returns. With equity in clothing factories, switchboard production and infrastructure in Vietnam, China and India, it is not difficult to imagine substantial environmental, social and labor concerns associated with these investments.

The fast-growing alternative investment communities' apparent lack of due diligence appears to be a weak link in their risk management disciplines, potentially leading to significant environmental and social impacts. MDB commitment to private equity funds often spans a decade and involves contractual obligations which provide a leverage point for the application of environmental and social safeguards to the otherwise opaque operations of these funds.

The German government -- and the French government, to some degree - has been at the forefront of efforts to call for more transparent management of the global financial flows associated with alternative investments.

Sustainable Development and Tax Evasion
The investment of public money from institutions with sustainable development mandates in secrecy jurisdictions with potentially unknown partner investors raises significant concerns, in addition to concerns about the identities of the co-investors and the sources of their funds. MDB private equity staff have indicated that the primary reason for using secrecy jurisdictions such as the Cayman Islands are “tax benefits.” When it was pointed out that MDBs do not pay taxes, staff explained that they meant “tax benefits” for the other investors.[49] It is important to examine this assumption further. Some have argued that secrecy jurisdictions drive down tax rates for mobile capital (i.e. “tax competition”) which means that tax rates climb higher for other factors, such as labor.[50] This would not seem to be a “sustainable development” oriented process. According to a former high ranking official in the secrecy jurisdiction of Jersey:

> *Secrecy jurisdictions…are used primarily to shift profits artificially out of the countries where they are created. Tax competition is profoundly anti-democratic: it prevents governments from providing the tax systems their electorates vote for. … My trainers justified this by arguing that tax avoidance is legitimate and that company directors have a duty to minimize tax payments so as to maximise shareholder value. This argument needs careful unbundling. Firstly, tax is not a business cost but a distribution to the societies which provide the infrastructure and markets within which profits are created. Treating tax as a production cost enables economic free-riding, and undermines both corporate responsibility and good governance. Second, company directors who maintain a more ethical position on tax avoidance will suffer a competitive disadvantage compared to their less scrupulous rivals, and this creates market distortions. Third, no country requires company directors to minimize tax under company law, especially when this involves seeking to defeat parliamentary democracy and keeping tax planning structures hidden from shareholders, investors and national authorities.*
>
> *We must reconsider what constitutes corruption. It is right to be concerned by bribery and embezzlement of public assets, but tax evasion is generally overlooked even though it represents theft of public assets and, in terms of orders of magnitude, has far greater impact on public revenues than bribery and embezzlement Tax evasion involves abusive behaviour at the intersection between private activity and the public interest. It … provides one set of rules for the rich and well-connected and another set of rules for the poor and weak. More insidiously, it involves privileged elites, who use secrecy jurisdictions to undermine the will of elected parliaments.*[51]

Thus, it is clear that in addition to the potential environmental and social harms which may be associated with investee companies associated with private equity funds held by multilateral development banks, the question of the development impacts of tax losses must also be examined.

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[49] Personal communication, MDB staff.
[50] John Christensen, “The Hitchhiker’s Guide to Nowhere: A journey into economic anarchy,” presented at European forum Alpbach – Reform Symposium, 18 – 20 August, 2008., pg.4
[51] John Christensen, “The Hitchhiker’s Guide to Nowhere: A journey into economic anarchy,” presented at European forum Alpbach – Reform Symposium, 18 – 20 August, 2008., pg.6-8

Sunshine is the Best Disinfectant

As complex and secretive as the world of alternative finance appears to be, the global financial crisis has drawn unprecedented attention to its structures and operations. The current "credit crunch" and rapidly unfolding financial crisis is increasing pressure for the revamping of national and international financial systems and is leading to an increased focus on transparency requirements, and on all aspects of due diligence, including environmental, social and governance assessments. Investors are likely to increasingly seek guarantee "cover", insurance, or other association with multilateral banks and bilateral institutions to safeguard their funds and attract other investors.

News media are also increasingly eager to report on the alternative finance universe. For some time, journalists have shared their frustration that it is "hard to extract information from these companies, there are no line charts, no bench marks. …equity firms don't even give us graphs, performance figures. There is no disclosure."[52]

While some in the alternative investment community may have as a goal "keeping the conversation as short as possible", environmentalists and human rights activists are honing their analytical tools with the realization that there are ways of tracking even some of the most opaque financial structures. Investors who have been venturing into alternative investments are increasingly interested in environmental, social, and governance aspects of their portfolios.

The case of United Fibre Systems and the growing concerns about the investment of public funds in private equity firms domiciled in secrecy jurisdictions demonstrate that these structures are no longer impenetrable to global networks of environmental and human rights activists. Secrecy jurisdictions have regulatory bodies which are likely to have concerns about the enforcement of anti-money laundering statutes, especially if there is a public outcry about specific investments. Activists have learned that when a billion U.S. dollar hedge fund launches in Hong Kong and proposes to finance a potentially environmentally devastating project, there are levers of influence in Hong Kong, elsewhere in Asia, in Europe and the United States. The entry of new "retail" players and potential victims, including pension funds and university endowments, into alternative finance is changing the playing field as calls for transparency become louder. Investors, funds of funds, family funds, institutional investors increasingly have reputational risk concerns and more of them are beginning to seek and respond to analyses of environmental and social impacts of funds held in their portfolios.

At the same time, alternative investments held by multilateral development banks in secrecy domiciles are increasingly coming under scrutiny. Public financial institutions involved in such financial vehicles are finding that they are now being pressed to show that they are implementing environmental and social safeguards and that these investments have a positive impact on poverty alleviation and are, as investments, financially viable.

Despite this, multilateral development banks are currently working to push borrowing countries to pass "enabling legislation" to facilitate the broader use of alternative financial instruments --

[52] Bernie Low, Bloomberg TV, Hong Kong, Panel discussion on news media and hedge funds, Hedge Funds World Asia, September 2007

for example, to allow greater pension fund investment in alternative funds in India and other countries.

In the midst of the global financial crisis, during the international push for the "re-regulation" of financial architecture and an increase in transparency measures, the Asian Development Bank has proposed, instead, the further deregulation of such risky investments. The ADB's October 2008 "Draft Safeguard Policy Statement" calls for the weakening of rules for "financial intermediaries", which now include private equity and other alternative investments. The new proposals include the reduction - by 50% - of the amount of time required for public notice and comment on such investments.[53]

The safeguard standards required of investments by public financial institutions do not yet appear to be implemented by the private funds in which they invest, leading to significant environmental and social concerns, in addition to concerns about fiduciary responsibility. Many of the MDB-held and bilaterally financed private equity investments are in sectors that typically involve substantial environmental and social impacts – power, roads, and factories. Basic information about the funds – including the names of their portfolio companies and assessments of the environmental and social impacts of the investee companies – is not routinely made public. The lack of public information means that those affected by the projects may not know that they have recourse to multilateral or bilateral compliance and accountability mechanisms, as well as the right to information disclosure, participation in environmental impact assessments, and livelihood protection.

Given official MDB mandates of poverty alleviation, good governance and environmental protection, in the context of the massive recent investment failures, it would make more sense, instead of attempting to increase pension fund exposure to highly risky and volatile investments, reducing transparency and further deregulating these investments, for public financial institutions to support efforts to increase transparency for alternative investments, to commit to move away from the use of secrecy jurisdictions and to work towards labeling tax evasion as a "predicate offense" under the UN Convention Against Corruption and the anti-money laundering statutes of all countries providing financial services to non-resident clients. In addition, it would make sense to support new regulations to require professionals covered by anti-money laundering regulations to submit suspicious activity reports for every client they suspect of tax evasion.[54]

As private equity funds struggle to find credit and as hedge funds are swamped by "pre-IPO" investments[55] (among other things), the World Bank Group and other MDBs – until recently increasingly eclipsed by the flood of alternative finance – are now attempting to reposition themselves at the forefront of efforts to "modernize the multilateral system" and overhaul global

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[53] ADB, Safeguard Policy Statement, 2nd Draft ,October 2008; See also, ADB OM Section F1/BP, Operations Manual, Enviornmental Considerations in ADB Operations, 2003.

[54] Useful and detailed proposals pertaining to recommended steps to curb the theft of public resources through tax evasion, including those listed above, can be found in John Christensen, "The Hitchhiker's Guide to Nowhere: A journey into economic anarchy," presented at European forum Alpbach – Reform Symposium, 18 – 20 August, 2008., pg. 10

[55] Hedge funds increasingly bought stakes in "hot companies" before they went public, known as "pre-IPO financing." See, for example, "Hedge Funds haunted by Asia pre-IPO deals", Reuters, October 10, 2008

financial architecture.[56] Unfortunately, the MDB track record with alternative investments is not inspiring. There is a pressing need for a focus by concerned citizens, policy makers, and regulators on bringing transparency and public process to the world of alternative investments, including those held by public financial institutions. The timing is right, in the context of the financial crisis, for swift action to strengthen environmental, social and governance aspects of alternative finance.

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[56] World Bank Press Release, "Multilateral System Needs Fundamental Overhaul, Zoellick Says: Global financial crisis pushing many developing countries towards a 'tipping point'", October 6, 2008; "£1 billion of private equity deals put back as debt market freezes over," The Independent (UK), October 12, 2008;, "World Bank President: Financial Crisis Will Hurt Poor Countries Most", VOA News, Oct 13, 2008.