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### The Prototype Carbon Fund: A New Departure in International Trusts and Securities Law

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# THE PROTOTYPE CARBON FUND:

## A NEW DEPARTURE IN INTERNATIONAL TRUSTS AND SECURITIES LAW

By *Sophie Smyth*\*<sup>1</sup>

### INTRODUCTION

The Kyoto Protocol to the United Nations Framework Convention on Climate Change<sup>2</sup> (respectively, the “Kyoto Protocol” and the “UNFCCC”) entered into effect on February 16, 2005. This was a major step forward in the world’s efforts to combat the deleterious effects caused by the emission of greenhouse gases into the stratosphere (effects commonly referred to as “global warming”).<sup>3</sup> However, long before the Kyoto Protocol<sup>4</sup> became effective, several small but significant steps had already been taken towards achieving its goals. The World Bank’s establishment of the Prototype Carbon Fund (the “PCF” or “Fund”) illustrates one such step. The PCF was a completely new concept in international environmental law and much has been written about the role it has played in the development of carbon finance.<sup>5</sup> A lesser known fact, however, reveals that the PCF also broke considerable new ground in the realm of international trusts and securities law. The latter aspects of the PCF are the focus of this article. This article begins by describing the backdrop against which the PCF was established and the reasons for its development. The article then describes the novel issues of international trust funds and securities law that were encountered during the Fund’s formation and the manner in which they were resolved.

### THE PCF AND THE KYOTO PROTOCOL

The PCF is an outgrowth of the new universe of obligations and opportunities spawned by the Kyoto Protocol, which emerged in 1992 when the UNFCCC was signed and ratified by 180 countries (the “Parties”). The UNFCCC remains the first instance of international recognition of the phenomenon of global warming.<sup>6</sup> Beyond providing that recognition, the UNFCCC constituted a framework within which signatories could work towards defining a regime for stabilizing worldwide concentrations of greenhouse gases. As part of that framework, the UNFCCC divides the Parties into three categories: (1) all Parties; (2) all industrialized country Parties (Annex 1 countries); and (3) all industrialized country Parties except those from the former Soviet bloc in a process of economic transition (“EIT countries”) (Annex 2 countries). The UNFCCC requires differing commitments from each category of Parties.<sup>7</sup>

The Kyoto Protocol, ratified by 141 countries, sets out the regime presaged by the UNFCCC and contains two essential elements. First, it puts all Annex 1 countries (which are listed in Annex B to the Protocol and referred to as “Annex B countries” under the Protocol) on a timetable to reduce their greenhouse

gas emissions by an average of 5.2 percent below their 1990 levels over a finite period of time, beginning in 2008 and ending in 2012.<sup>8</sup> Second, it introduces several mechanisms by which such countries can achieve these targets (the “Kyoto Mechanisms”). Two of those mechanisms, the Joint Implementation Mechanism, established under Article 6 of the Protocol, and the Clean Development Mechanism, established under Article 12,<sup>9</sup> introduced the concept that a country with obligations to reduce its greenhouse gas emission reductions under the Protocol, i.e. an Annex B country, could earn credit towards those obligations by funding a project in another country which will contribute to the reduction of greenhouse gas emissions in that country. The timetable for reductions, the Protocol’s quantifiable targets, and the relative imminence of the dates by which they were to be achieved, prompted immediate action. The ultimate effectiveness of the Protocol was generally regarded as a foregone conclusion and Annex B countries did not want to be caught short.

The Kyoto Protocol’s targets and mechanisms, and the manner in which their implementation translates into practice, lie at the heart of the PCF and the niche created for it to fill. With respect to the targets, Annex B countries pass obligations to reduce greenhouse gas emissions onto greenhouse gas-emitting industries through the passage of national legislation that imposes reduction targets on those industries. Consequently, the Protocol and the legislation flowing from it create a pool of government and private sector entities on the lookout for ways to obtain greenhouse gas emission reduction credits.

The Kyoto Mechanisms created the possibility that an Annex B country could satisfy its obligation to reduce greenhouse gas emissions by contributing to greenhouse gas reduction activities elsewhere. This presented a new and unprecedented opportunity for collaborations between countries or entities seeking to obtain such credits and developing countries that could offer a cost-effective way of doing so. The drastic difference in the cost of undertaking greenhouse gas emission reduction measures in a developed country or an EIT country, on the one hand, and a developing country, on the other, gave rise to this emerging opportunity for collaboration.<sup>10</sup> It is by one or two orders of magnitude cheaper to achieve a ton of

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greenhouse gas emission reductions in an EIT country or developing country than to achieve such reductions in a developed country; Japan being the most costly country of all for these purposes.<sup>11</sup>

The World Bank created the PCF to pioneer implementation of the opportunities offered by the Kyoto Mechanisms to create win/win collaborations between the developed and the developing world.<sup>12</sup> The Fund was designed to create a central pool of resources, or a trust fund, managed by the Bank as trustee and funded by governments and private sector entities interested in securing greenhouse gas emission reduction credits. The idea was that the Fund would sponsor projects in developing countries and EIT countries that would generate such credits. These credits would be paid to the Fund, and the Bank, acting as trustee of the Fund, would distribute the credits to the Fund's contributors on a pro rata basis in accordance with the amounts of their respective contributions. The Fund was the brainchild of Ken Newcombe, a dynamic division chief in the Bank's Environment Department. He envisioned the PCF as a central fund that would serve as a pilot of the Kyoto Mechanisms, reap benefits for donors and recipients alike, and offer, in the process, an opportunity for all parties to devise a *modus operandi* for the Kyoto mechanisms, or as he was wont to call it, an opportunity to "learn by doing." This vision was fine-tuned through extensive rounds of consultation with governments and private sector entities across the world that voiced strong need for and interest in such a fund. It was recognized from the outset that the Fund was a highly innovative concept, riding the cusp of the sweeping changes introduced by the Kyoto Protocol. Less keenly appreciated, however, was the fact that in creating the Fund, a significant amount of "learning by doing" would involve trusts and securities law.

### A NOVEL TRUST FUND

The Fund represented a new type of business for the Bank, which was not accustomed to administering a fund that combined both private and public sector contributors, or a fund under which it had an obligation to generate returns for the trust fund's contributors. Five broad objectives had to be reconciled within the Fund's design. First, the Fund's status as an international trust fund had to be reconciled with the participants' strong desire to exercise extensive control over the Fund's management and operations. Moreover, the Fund had to accommodate this desire for control with the participants' equally strong insistence that they should have no personal liability for the Fund's activities. Second, the participants and the Bank wanted a clear distinction and disentanglement between the Fund's operations and the operations of the Bank. Third, the potential conflicts of interest between the private sector participants in the Fund and the Fund itself had to be managed. Fourth, both the Bank and the participants wanted the Fund to include a role for the countries hosting projects (the "Host Countries"), so that these countries could gain experience through their involvement in the Fund's operations. Fifth, the Bank had to devise a mechanism to receive, hold, and distribute the greenhouse gas emission reduction credits that the Fund would accrue.

### TRUST, AGENCY, OR PARTNERSHIP

The participants' strong desire to be actively involved in the Fund's management meant that the PCF would need a governance structure within which those interests could be expressed, reconciled, and given effect, while at the same time accommodating a role for the potential Host Countries. All of this had to be balanced against the Bank's role as trustee of the Fund, as well as its ability to have a sufficient say in the Fund's operations. As a trustee, the Bank requires sufficient say in order to properly discharge its fiduciary responsibilities; the responsibility to manage and administer others' money is serious business with serious legal consequences.

This kind of intricate governance structure was new territory for the Bank. Although the Bank was used to acting as a trustee (and, indeed was then serving as trustee to well over a thousand trust funds), it generally had much more unfettered control. The Bank typically had broad discretion to administer the funds placed with it in trust under standard trust agreements, which constituted the vast majority of Bank-administered trusts prior to the PCF. Standard trust agreements usually contained broadly worded objectives. The Bank, as trustee, would select the recipients of trust fund monies within the scope of those objectives and report annually to the contributors on how the funds had been used. There was no active, ongoing involvement on the contributors' part in those situations.<sup>13</sup>

In contrast, the governance structure devised for the PCF, as set out in the Instrument to Establish the Prototype Carbon Fund (the "Instrument"),<sup>14</sup> creates a framework within which the participants can voice their opinions in the Fund's management and operations. The structure has five component parts: a Fund Management Committee, a Fund Management Unit, a Participants' Meeting, a Participants' Committee, and a Host Country Committee.<sup>15</sup> As Trustee, the Bank was charged with forming the Fund Management Committee<sup>16</sup> (which consists of the Fund Manager, Ken Newcombe, and four other members of Bank Management) to exercise general oversight over the Fund.<sup>17</sup> Day-to-day responsibility for the Fund's operations is vested in the Fund Management Unit, which is headed by the Fund Manager and consists of a staff of technical and operational specialists selected by him.<sup>18</sup>

The participants' active and ongoing involvement is achieved through the Participants' Meeting and the Participants Committee. The Participants' Meeting is an annual meeting of all contributors to the Fund<sup>19</sup> and is the vehicle through which participants exercise an overview role over the Fund's operations. At those meetings, participants review and approve the Fund's annual budget and business plan, provide the Bank with general policy advice and strategic guidance, and approve any suggestions for amendments to the project selection and project portfolio criteria.<sup>20</sup> The participants also have the power to terminate the Fund by resolution of a two-thirds majority<sup>21</sup> and the power to authorize the Trustee to remove a participant in certain circumstances.<sup>22</sup>

Participants exercise a hands-on role through their involvement in the Participants' Committee. It consists of five

participants, two drawn from the private sector and three drawn from the public sector, who are elected at the Participants' Meeting and whose membership rotates annually.<sup>23</sup> The Participants' Committee does not have to give positive approval to every project funded by the Fund; however, it vets every project proposal to determine whether to object to the inclusion of the project in the Fund's portfolio.<sup>24</sup> It also provides general advice to the Bank on the Fund's operations.<sup>25</sup>

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*The Fund involved both a collaboration and a conflict between two very different worlds: the new, dynamic, fast-changing world of international environmental law, and the more rigid, tightly construed world of trust law principles and financial securities...*

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The participants' demand for control over the Fund, risked jeopardizing their desire to be free of liability for the Fund's activities beyond the amount of their contributions. Two sources of liability were of particular concern to participants: (1) liability for claims against the PCF arising under contracts between the Bank, as trustee of the PCF and private sector project sponsors ("Project Sponsors") (the legal entities behind the projects producing the emission reductions); and (2) liability in tort for acts or omissions occurring in the course of those contracts. The extent of the participants' control under the Instrument gave rise to the risk that a court faced with a claim in contract or tort against the PCF might re-characterize the Fund as a general partnership. Additionally, given the participants' significant say in the Fund, a court might conclude that the Bank, when acting as trustee of the Fund, was acting not simply as trustee but also as the participants' agent.

#### **The PCF as a Partnership**

Under general principles of trust law, the substantive powers and decision-making authority afforded the Participants' Committee make the Fund vulnerable to being re-characterized as a general partnership.<sup>26</sup> While no single power of the Participants' Meeting or the Participants' Committee (e.g. the

veto power) creates this risk, the active, ongoing involvement of the participants, provided for throughout the Instrument, makes the risk impossible to dismiss.<sup>27</sup>

#### **The Bank as the Participants' Agent**

Similar considerations apply to the issue of when and whether the Bank, as trustee of the PCF, could also be regarded as the participants' agent. Given the participants' expectation of receiving emission reduction credits in return for their contributions to the Fund, the participants in the PCF may also be characterized as the beneficiaries of the PCF. The general rule is that a beneficiary of a trust is not personally subject to liabilities to third parties incurred in the administration of a trust.<sup>28</sup> Hence, a beneficiary is normally neither personally liable upon contracts made by the trustee in the administration of the trust nor personally liable to third parties for torts committed by the trustee.<sup>29</sup> However, if a trustee acts on behalf of the beneficiary and is subject to its control, the trustee becomes the beneficiary's agent as well as its trustee, and in its capacity as the agent, it can render the beneficiary liable upon a contract made by the trustee and for torts committed by the trustee.<sup>30</sup> The key factor in determining whether or not a trustee is also an agent of the beneficiaries depends upon the extent of the beneficiaries' right to control the trustee.<sup>31</sup> As stated in Restatement (Second) Agency:

Where a number of persons transfer property to a person, designated as trustee, who is to do business with such property for their benefit, the relation thus created may be a partnership. Whether or not it is a partnership depends upon the amount of control reserved by the contributors. If as a group, they have the power, not merely to elect the trustee, but also to direct the conduct of the business by the trustee, there is a partnership and the person designated as "trustee" is the agent of the members of the group.<sup>32</sup>

Despite these risks, the participants did not want to cede control to the Bank as trustee. Instead, they reached an understanding with the Bank on certain risk mitigation measures. The Instrument was crafted to provide for the indemnification of the participants from the Fund's assets for any liability arising out of the activities of the trust with the exception of liabilities resulting from a participant's gross negligence or willful misconduct.<sup>33</sup> The Bank was similarly indemnified as trustee of the Fund.<sup>34</sup> Further, the Instrument provides that neither the Bank nor the participants will be subject to any personal liability to any third person in connection with the Fund's activities.<sup>35</sup>

Accordingly, the Instrument directs that all contracts entered into by the Bank as trustee of the Fund shall explicitly provide to this effect.<sup>36</sup> As this provision does not fully mitigate against the risk of tort liability, an agreement was reached where the Bank would add the participants as "named insureds" under its professional liability insurance policy, and the Instrument authorizes the Bank as trustee to pay for such insurance out of Fund assets.<sup>37</sup> It was also agreed that the Bank would require the Project Entities, with which it would contract as trustee of

the Fund, to maintain appropriate general liability insurance to protect both the Bank and the participants against general liability claims that might arise from Fund sponsored projects.<sup>38</sup>

#### DISENTANGLEMENT FROM THE BANK'S OPERATIONS

The Bank and the participants both wanted to ensure that the Fund's operations were kept separate and distinct from the Bank's core lending operations. In particular, the Bank did not want a conflict of interest to arise between its obligations as trustee of the Fund and its position as lender to Host Countries of Fund-sponsored projects. The concern arose because, ordinarily, a trustee is under a duty to the trust beneficiaries to administer the trust solely in the beneficiaries' interests and to take reasonable steps to enforce claims held in trust.<sup>39</sup> This general principle does not apply, however, if the terms of the trust instrument expressly provide otherwise.<sup>40</sup>

Accordingly, the Bank and the participants agreed that the Instrument would absolve the Bank, as trustee, from any obligation to pursue any action or claim on the participants' behalf against any Project Entity or Host Country that defaulted on its agreements.<sup>41</sup> However, the Instrument stops short of determining how such actions or claims will be pursued if the Bank as trustee does decide to refrain. It simply provides that the Bank as trustee and the participants will use their best efforts to agree on satisfactory arrangements for dealing with any such dispute, including, if necessary the assignment and transfer of all or part of the Trustee's rights and obligations under the agreement in dispute to a third party.<sup>42</sup> To date, the provisions of this clause have not yet been invoked.

To further ensure disentanglement, the Bank and the participants also agreed that there would be no cross-default clause in the Bank's loan agreements that would entitle the Bank to exercise remedies if there is a default under an agreement between the Bank as trustee of the Fund and a Host Country or Project Entity.<sup>43</sup> Nor will there be any cross-default clause in the latter agreements that would allow the exercise of remedies under those agreements if there is a default under any Bank loan agreement.<sup>44</sup>

#### MANAGING POTENTIAL CONFLICTS OF INTEREST BETWEEN THE PRIVATE SECTOR PARTICIPANTS AND THE FUND

The participants from the private sector did not want their participation in the PCF to preclude them, or their affiliates, from investing in projects associated with Fund-sponsored projects, or in other funds or ventures that might compete with the PCF. The government participants and the Bank were prepared to accept private sector participants having these conflicts of interest so long as such conflicts did not interfere with the integrity of the PCF's project approval process. Accordingly, a mechanism had to be devised whereby a participant could recuse itself from the project approval process whenever it had such a potential conflict of interest.

Towards this end, the Instrument requires a participant who has an interest in a project associated with a project being considered for funding by the PCF or is in a venture that competes

with the PCF, to disclose that interest to the Bank as trustee, prior to the Participant Committee's review of the pertinent project proposal.<sup>45</sup> The Bank as trustee has the authority to determine whether the participant's interest is such that it should not take part in the Participant Committee's deliberations on the project.<sup>46</sup> If the participant disagrees with the Bank's determination, it can advise the Participants' Committee of the conflict or potential conflict, and the Participants' Committee (with the exception of the participant making the disclosure) will decide whether the participant should be permitted to take part in the Committee's deliberations on the project.<sup>47</sup> The Bank as trustee, in consultation with the Participants' Committee, can decide on how to sanction a participant who fails to provide timely disclosure of a competing interest.<sup>48</sup>

#### THE HOST COUNTRIES' ROLE

The goal of involving the Host Countries in the Fund's work was achieved by including the Host Country Committee as a part of the Fund's governance structure.<sup>49</sup> The Host Country Committee is composed of representatives of Host Countries and potential Host Countries (countries that have given written endorsement of project proposals under consideration by the Fund).<sup>50</sup>

The Host Country Committee provides guidance to the Bank and the participants on the Fund's development and implementation, which includes giving advice on proposed amendments to the Fund's project selection and portfolio criteria and on effecting an equitable sharing between the participants the Host Countries of any greenhouse gas emission reductions arising from Fund sponsored projects.<sup>51</sup> It meets at least annually at locations the Bank considers appropriate, so as to allow for interaction with the participants.<sup>52</sup> Further, representatives of the Host Country Committee attend Participants' Meetings and Participants' Committee Meetings as observers in order to further strengthen the interaction between the Fund and the Host Countries.<sup>53</sup> These provisions are ground-breaking in that they allow meaningful participation by non-contributing developing countries and EIT countries in the work of an international trust fund.

#### ADMINISTERING A PORTFOLIO OF EMISSION REDUCTION CREDITS

As the PCF was being established to implement the Kyoto Mechanisms, there was no established modality or consensus as to the nature of the instruments that would reflect the participants' interests in their pro rata shares of greenhouse gas emission reductions. The precise nature of the Bank's obligations as trustee with respect to such instruments was, therefore, unknown and the Bank's responsibilities had to be framed in a way that took the evolving nature of the international framework into account. Therefore, the Instrument provides that the Bank, as trustee, will facilitate the process of validating, verifying, and certifying emission reduction credits earned by Fund-sponsored projects.<sup>54</sup> Additionally, the Instrument explicitly authorizes the Trustee to carry out this function by engaging qualified third parties to perform those functions in accordance

with relevant standards and criteria “to be developed under the regulatory framework of the UNFCCC and/or national laws.”<sup>55</sup> The Bank as trustee also facilitates the transfer of greenhouse gas emission reduction credits from the Host Countries to the participants, although the scope of this obligation to facilitate is not entirely clear.<sup>56</sup> In order to enhance the Bank’s ability to perform this function, the Bank has the authority to engage third persons to serve as registrar, transfer agent, or custodians in respect of the Fund’s property, including instruments evidencing participants’ entitlement to greenhouse gas emission reductions, as necessary.<sup>57</sup>

With respect to reporting obligations to the participants, the Bank reports bi-annually to participants on the operation of the Fund and provides each participant with a statement of account regarding its share of Fund property.<sup>58</sup> Further, it agreed to produce a statement of account, at the participant’s request, which confirms the participant’s pro rata share of greenhouse gas emission reduction credits held by the Fund.<sup>59</sup> The Instrument explicitly exempts the Bank, however, from any responsibility to ensure that greenhouse gas emission reduction credits earned by the PCF will be credited under the UNFCCC or the Kyoto Protocol.<sup>60</sup> The most the Bank could undertake was to “endeavor to ensure” that the contractual arrangements entered into among it, the participants, and the Host Countries and Project Entities would be “structured flexibly so as to enable them to conform with the guidelines, modalities and procedures of the regulatory framework of the UNFCCC/Kyoto Protocol if, when, and as they are developed.”<sup>61</sup>

### A NOVEL FINANCIAL INTEREST

In addition to the issues regarding the legal nature of the PCF itself, an additional question arose about the precise legal nature of the participants’ interests in the PCF. This issue surfaced because the participants expected a return on their contributions to the Fund (the emission reduction credits to be garnered from Fund-sponsored projects), and this meant that participants’ interests in the Fund could, conceivably, be regarded as securities.<sup>62</sup> If such interests were, in fact, securities, then any efforts undertaken within the United States to solicit interest in the Fund amongst potential participants would have to be conducted within the defined rubric permitted under U.S. Securities Laws, or the equivalent of such laws in any other jurisdiction in which the Fund was being marketed.

#### THE LEGAL STATUS OF INTERESTS IN THE FUND FOR SECURITIES LAWS PURPOSES

The Bank pursued the question of whether interests in the Fund were securities in the Netherlands, Finland, Norway, Sweden, Japan, Canada, and the United States, countries where the Carbon Team were conducting conferences, talks, and consultations on the Fund in these countries as a way of soliciting interest in it. In Europe and Japan, the answer was straightforward; interests in the Fund would not be regarded as securities. In the United States and Canada, however, the situation was far less clear; arguments could be made either way. The vagaries of Canadian law were not a major obstacle as initial interest in the

Fund from the Canadian private sector was limited, and Canada was not a prime target market. The lack of clarity under U.S. law, however, was a major stumbling block. The United States was a target market and, by virtue of the location of the Bank’s headquarters in Washington, D.C., many of the Carbon Team’s solicitation activities were held in the United States. Moreover, U.S. Securities Laws have a degree of extra-territorial reach, depending on whether an issuer’s activities abroad may have an effect within the United States.<sup>63</sup>

Although the Bank, as an international organization, is immune from the application of U.S. and other national securities laws, it voluntarily complies with the requirements of such laws in all jurisdictions in which it issues securities. The proper functioning of the Bank depends on its ability to sell its bonds on the international financial market.<sup>64</sup> The Bank goes to considerable lengths to preserve investor confidence in its bonds, in part, by operating in accordance with the norms and requirements of the national securities laws in the markets where bonds are sold. Thus, the Bank did not want to risk damaging its good standing in the U.S. market (one of the largest markets for its bonds), and the excellent relations it has with the U.S. Securities and Exchange Commission (the “SEC”), by acting in a manner, vis-à-vis the PCF, that was inconsistent with its scrupulous voluntary observance of U.S. Securities Laws and SEC regulations in respect to its own bonds.

The uncertainty under U.S. law arose from the broad definition of what constitutes a “security.” A “security,” according to the United States Supreme Court in *SEC v. W.J. Howey Co.*,<sup>65</sup> is something that creates a “financial relationship” between the parties and looks like an “investment contract.”<sup>66</sup> Further, an “investment contract,” according to the Supreme Court, has certain key characteristics: it is a contract, transaction, or scheme whereby a person invests money in a common enterprise and is led to expect profits, derived solely or essentially from the efforts of the promoter of the enterprise or a third party.<sup>67</sup>

Analyzing participants’ interests in the PCF under this definition, interests could be regarded as securities. The Fund gives rise to a financial relationship between the participants inter se and between the participants and the Bank as Trustee. Additionally, it involves the investment of money in a common enterprise, with the expectation of earning greenhouse gas emission reduction credits which could be derived from the efforts of parties other than the participants.<sup>68</sup>

On the other hand, several factors support the position that interests in the PCF are not securities. The Bank is a development institution, not a for-profit institution, and many of the participants in the PCF are governments. Moreover, PCF’s primary purpose is to provide an opportunity for all affected parties, participants, the Bank, and Host Countries to pilot the Kyoto Mechanisms and to “learn by doing.” True, the participants saw involvement in the PCF as a way of receiving emission reductions credits, and such credits would count against any future domestic or international legal obligations to reduce their emission reductions that might accrue to them in the future. However, those obligations were putative, potential future obli-

gations as they were just evolving and in a very nascent state at the time the PCF was established. Arguably, therefore, the participants' hope that their contributions to the PCF might at some point in the future help satisfy those obligations, fell short of an actual "expectation of profit."<sup>69</sup>

The Bank sought SEC advice on how interests in the PCF should be characterized. Pending receipt of this advice, however, a decision had to be made on how to proceed. Needless to say, concerns about the precise legal nature of participants' interests in the PCF were far from the Carbon Team's radar screen. Their key concern was to build public and private sector knowledge and interest in the PCF, the opportunities it offered to be involved in piloting the Kyoto Mechanisms, and the implications of the Kyoto Mechanisms for countries and industry over the long term. The very newness of the concepts necessitated an extensive and aggressive marketing campaign. Accordingly, they were engaged in an extensive worldwide effort to promote the PCF by giving speeches, holding conferences, and meeting with government and industry representatives. In addition, they launched a public PCF website. In the face of the uncertain legal status of interests in the PCF, these marketing efforts became a cause for concern. If interests in the PCF were considered securities, then these efforts clearly flew in the face of U.S. Securities laws and regulations; the Bank had not filed any information on the PCF with the SEC or followed any of the SEC's registration requirements. The Bank had no inclination to do so because registering with the SEC is a time-consuming process and is inconsistent with the accelerated pace at which the Bank was planning to launch the PCF.

Pending guidance from the SEC, the Bank decided to strike a midway point and to conduct its PCF marketing activities in accordance with the requirements of the "private placement exemption" to the U.S. Securities Exchange Act of 1933 (the "1933 Act").<sup>70</sup> Under that exemption, transactions "not involving any public offering" are exempt from the registration requirements of the 1933 Act.<sup>71</sup> The exemption is premised on the notion that not all investors are equal and that institutional investors that are sufficiently sophisticated and have sufficiently strong bargaining positions do not need the protections of federal registration.

The parameters of this exemption have evolved through case law. In *SEC v. Ralston Purina Co.*, the Supreme Court established guidelines for the application of the exemption.<sup>72</sup> It held that the exemption only applies if: (1) the offering is made to a limited number of offerees, all of whom have access to the type of information that would be contained in a registration

statement filed under the 1933 Act; (2) the offerees are sufficiently sophisticated to demand and interpret the information provided to them; and (3) the offering is of a limited size both in terms of the number of securities offered and the aggregate offering price.<sup>73</sup> The Court also indicated that the requirement that the offer be made only to a limited number of offerees is more readily established if it can be shown that the issuer has a pre-existing relationship with the offerees.<sup>74</sup>

The burden of proof for establishing that the exemption applies lies on the party claiming its protection.<sup>75</sup> That party must show that the exemption's requirements are met not only with respect to each purchaser but also with respect to each offeree.<sup>76</sup> Indeed, the exemption has been held not to apply where the issuer could adduce no evidence concerning the actual number of offerees, the offerees' particular characteristics or of a relationship between the issuer and numerous offerees.<sup>77</sup> Further, any public advertising is regarded as inconsistent with a claim of a private offering.<sup>78</sup> And the use of investment seminars and other promotional meetings will lead to the denial of the exemption.<sup>79</sup>

Thus, the decision to market interests in the PCF within the boundaries of the private placement exception had wide-sweeping ramifications. The constraint on the nature of potential participants who could be approached and the size of the Fund were not a problem; the PCF was designed for corporate, not retail, participants, and the maximum size of the Fund (consistent with its pilot nature) was \$150 million.<sup>80</sup> But the constraints on the number of offerees meant that the Carbon Team had to completely change their way of doing business. It stymied their wide-ranging road shows and investment seminars, in which they would convey information on the terms and proposed size of the fund and predictions relating to its performance and the value of the greenhouse gas emission reductions it was hoped Fund-sponsored projects would generate. Instead, the Team's communications about the PCF had to be pre-screened and edited by Bank lawyers. Even seemingly innocuous communications, such as several pages of a draft article written for *Environment Affairs* magazine, were pre-screened. The Carbon Team was also restricted in the kinds of meetings they could hold and on the numbers of attendees they could allow. Further, they had to dismantle their public website and erect a new one devoid of anything that could be construed as an exhortation to participate in the PCF. They erected a separate password-protected site for potential participants, who were given access once they signed a memorandum of understanding with the Bank indicating their intention to participate in the Fund.

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*Less keenly appreciated... was the fact that in creating the Fund, a significant amount of "learning by doing" would involve trusts and securities law.*

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These constraints gave rise to many tensions. The rigid requirements of the private placement exemption were directly at odds with the Carbon Team's strong need to market the Fund and encourage governments and industry to participate. The Team viewed the constraints as a muzzle and argued that they would kill the Fund's prospects for success. The constraints were also at odds with the Bank's broader need to highlight its leadership in international environmental matters and its institutional mandate to be open and transparent. The Bank's credibility was especially important in the post-Kyoto Protocol world as non-governmental organizations ("NGOs") had already voiced suspicion of the PCF. NGOs publicly accused the Bank of trying to corner the market in emissions reductions trading. NGOs also claimed that the Bank was helping the Western World at the expense of developing countries by plucking "the low-hanging fruit" that would earn emission reductions credits for those Western nations.<sup>81</sup>

Nonetheless, the balance tipped in favor of guarding the Bank's reputation and the market standing of its bonds. While the Bank ran the risk of being sued for failing to disclose information or for providing inadequate disclosure by a disgruntled participant, the likelihood of this occurring was relatively remote. Instead, the Bank's main risk was to its reputation for violating U.S. Securities Laws. The Bank potentially faced negative press (should the Bank be found in violation of the laws of its largest shareholder), revocation of its then fifty-year-old legislative exemption from registering its securities in the U.S., and an investigation of its securities and investment operations by U.S. Government General Accounting Office, SEC, or similar

entity. The Bank might also face collateral negative effects on replenishment legislation concerning the Bank's sister organization, the International Development Association, in the U.S. Congress and erosion of the benign treatment the SEC had accorded to the Bank over the years due to its credibility as a good citizen. The prospect of this parade of horrors meant that the conservative approach of relying on the private placement exemption prevailed.

## CONCLUSION

Despite facing many new issues and competing needs and concerns, the Fund successfully closed on April 10, 2000 at the level of \$135 million, and was considered a major triumph in ingenuity and perseverance.<sup>82</sup> From its conception, the Fund involved both a collaboration and a conflict between two very different worlds: the new, dynamic, fast-changing world of international environmental law, and the more rigid, tightly construed world of trust law principles and financial securities (which in the case of trusts date back to the 1800s and in the case of securities originates in the U.S. post-depression era of the early 1930s). Therefore, in addition to being a pilot for the Kyoto Mechanisms, the Fund also served as a pilot for a new form of public/private sector international trust fund and for a new form of security, or quasi-security. Already, its governance structure has become a precedent; in the five years since it was established, many new carbon funds have been created for which the Bank acts as trustee, including, for example, the Bio-Carbon Fund, the Community-Driven Carbon Fund and separate Italian, Danish and Dutch Funds. The nature of the participants' interests in those funds remains an open question. 

## ENDNOTES: The Prototype Carbon Fund

<sup>1</sup> The views expressed in this article are the views of the author and do not necessarily represent the views of the World Bank.

<sup>2</sup> See The United Nations Framework Convention on Climate Change ("UNFCCC"), U.N. Doc. Distr. General A/AC. 237/18 Part II/Add. 1.15 (May 1992).

<sup>3</sup> Greenhouse gases are gases that trap heat in the stratosphere. When trapped, this heat gives rise to the warming effect, commonly known as global warming. These gases are produced by human activity, for example, by activities involving the burning of fossil fuels. Their spread is also advanced by activities such as the cutting down of trees, which denude the earth of natural barriers to the build-up of such gases. The effects of global warming are felt worldwide and include, for example, rises in the sea level, with serious consequences for low-lying areas and island states; an increase in the range of tropical diseases, such as malaria and dengue fever; and marked changes in rainfall, resulting in increased desertification. The six greenhouse gases regulated by the Kyoto Protocol are car-

bon dioxide, methane, nitrous oxide, hydrofluorocarbons, perfluorocarbons and sulphur hexafluoride. For more information on climate change, see the Pew Center on Global Climate Change website, at <http://www.pewclimate.org> (last visited Apr. 15, 2005).

<sup>4</sup> See U.N. Doc FCCC/CP/1997/7/Add.1, which should be read together with the decisions 1/C.P.3, 2/CP.3 and 3/CP.3 [hereinafter Kyoto Protocol]. The text of the Kyoto Protocol was adopted at the third session of the Conference of the Parties to the UNFCCC ("COP-3") in Kyoto, Japan on December 11, 1997.

<sup>5</sup> See David Freestone, *The World Bank's Prototype Carbon Fund: Mobilizing New Resources for Sustainable Development* in LIBER AMICORUM IBRAHIM F.I. SHIHATA 265 (Kluwer Law International 2001).

<sup>6</sup> See UNFCCC, *supra* note 1, at art. 2.

<sup>7</sup> See UNFCCC, *supra* note 1, at arts. 2, 4.

<sup>8</sup> See Kyoto Protocol, *supra* note 4, at Art. 3.

ENDNOTES: The Prototype Carbon Fund *Continued on page 80*

- <sup>9</sup> See Kyoto Protocol, *supra* note 4, at Arts. 6, 12. The Joint Implementation Mechanism under Art. 6 of the Kyoto Protocol and the Clean Development Mechanism under Art. 12 are both project-based. However, they operate according to different criteria. Joint Implementation projects only may be carried out in Annex 1 countries, and the greenhouse gas emission reduction credits that may be earned as a result of them are known as “Emission Reduction Units.” Typically, such projects will involve an agreement between two Annex 1 countries, one of them being an EIT country. Clean Development Mechanism projects can be carried out in non-Annex 1 countries. Such projects, however, have to be approved by the Clean Development Mechanism Board, which was set up pursuant to the Kyoto Protocol. The greenhouse gas emission reduction credits that can be earned through such projects are known as Certified Emission Reductions.
- <sup>10</sup> See A.D. Ellerman & A. Decaux, Sloan School of Management and Mass. Inst. of Tech., *Analysis of Post-Kyoto CO2 Emissions Trading Using Marginal Abatement Curves* (1998), available at [http://web.mit.edu/afs/athena.mit.edu/org/globalchange/www/MITJP-SPGC\\_Rpt40.pdf](http://web.mit.edu/afs/athena.mit.edu/org/globalchange/www/MITJP-SPGC_Rpt40.pdf) (last visited Apr. 15, 2005).
- <sup>11</sup> *Id.*
- <sup>12</sup> See, Annex 1 to Res. No. 99-1, International Bank for Reconstruction and Development (“IBRD”) (as amended by Resolutions No. 2000-1 and No. 2001-3).
- <sup>13</sup> The one notable exception to this standard format was the Global Environment Facility Trust Fund (“GEF”), established in 1994 by Res. No. 94.2 of the Exec. Dirs. of the IBRD. It has an elaborate governance mechanism according to which the donors, sitting as a donor council, decide on the selection of projects to be funded. However, that trust fund is wholly funded by governments and therefore does not raise the same legal issues raised by the PCF. For text of the GEF, see Instrument for the Establishment of the Restructured Global Facility, Report of the GEF Participants Meeting, 33 ILM 1273 (Geneva, Mar. 14-16, 1994).
- <sup>14</sup> *Instrument Establishing the Prototype Carbon Fund*, Res. No. 99-1 of the Exec. Dirs. of the IBRD (as amended by Resolutions No. 2000-1 and No. 2001-3, Annex 1).
- <sup>15</sup> Instrument, *supra* note 14, at art. VIII, §§ 8.7 & 8.8 & arts. V, VI, and VII.
- <sup>16</sup> Instrument, *supra* note 14, at art. VIII, § 8.7.
- <sup>17</sup> Instrument, *supra* note 14, at art. VIII, § 8.7.
- <sup>18</sup> Instrument, *supra* note 14, at art. VIII, § 8.8.
- <sup>19</sup> Instrument, *supra* note 14, at art. V, § 5.1.
- <sup>20</sup> Instrument, *supra* note 14, at art. V, § 5.1 (a)-(g).
- <sup>21</sup> Instrument, *supra* note 14, at art. XV, § 15.2 (a).
- <sup>22</sup> Instrument, *supra* note 14, at art. IX, § 9.2 (a).
- <sup>23</sup> Instrument, *supra* note 14, at art. VI, § 6.1. However, the Instrument provided that the first Participants’ Committee would consist of seven members, who would serve from the date of their first (organizational) meeting until the second annual Participants’ Meeting.
- <sup>24</sup> Instrument, *supra* note 14, at art. VI, § 6.4(c).
- <sup>25</sup> Instrument, *supra* note 14, at art. VI, § 6.4(a).
- <sup>26</sup> See BOGERT & BOGERT, *THE LAW OF TRUSTS AND TRUSTEES* at Section 247(H) (2nd ed. 1992); see also *Bank of America National Trust & Savings Ass’n v. Scully*, 92 F.2d 97 (10th Cir. 1937), *Earlsboro Gas Co. v. Vern H. Brown Drilling Co.*, 52 P. 2d 730 (1935), and *Case v. Kadota Fig Ass’n of Producers*, 207 P. 2d. (Cal. App. 1949).
- <sup>27</sup> See *Crocker v. Malley*, 249 U.S. 223 (1919).
- <sup>28</sup> RESTATEMENT (THIRD) OF TRUSTS § 5(e) (2003).
- <sup>29</sup> RESTATEMENT (SECOND) OF TRUSTS §§ 274,275 & 276 (1959).
- <sup>30</sup> RESTATEMENT (SECOND) OF TRUSTS § 275 (cmt. e), §276 (com. b) (1959).
- <sup>31</sup> RESTATEMENT (SECOND) AGENCY § 14(B) (cmt. d) (1958).
- <sup>32</sup> RESTATEMENT (SECOND) AGENCY § 14(B) (cmt. j) (1958).
- <sup>33</sup> See Instrument, *supra* note 14, at art. XII, § 12.2.
- <sup>34</sup> See Instrument, *supra* note 14, at art. XII, § 12.1.
- <sup>35</sup> See Instrument, *supra* note 14, at art. XII, § 12.4.
- <sup>36</sup> See Instrument, *supra* note 14, at art. XII, § 12.4.
- <sup>37</sup> See Instrument, *supra* note 14, at art. 8, § 8.1(j).
- <sup>38</sup> See IBRD, Standard Form Prototype Carbon Fund Participation Agreement; see also Carbon Finance at the World Bank, at <http://www.carbonfinance.org> (last visited Apr. 15, 2005).
- <sup>39</sup> RESTATEMENT (SECOND) TRUSTS §177 (1959).
- <sup>40</sup> RESTATEMENT (SECOND) TRUSTS §164 (1959).
- <sup>41</sup> See Instrument, *supra* note 14, at art. XVII, § 17.1.
- <sup>42</sup> See Instrument, *supra* note 14, at art. XVII, § 17.1.
- <sup>43</sup> See IBRD, Standard Form Prototype Carbon Fund Participation Agreement.
- <sup>44</sup> *Id.*
- <sup>45</sup> See Instrument, *supra* note 14, at art. XVII, § 17.2.
- <sup>46</sup> See Instrument, *supra* note 14, at art. XVII, § 17.2.
- <sup>47</sup> See Instrument, *supra* note 14, at art. XVII, § 17.2.
- <sup>48</sup> See Instrument, *supra* note 14, at art. XVII, § 17.2.
- <sup>49</sup> See Instrument, *supra* note 14, at art. VII, § 7.1.
- <sup>50</sup> See Kyoto Protocol, *supra* note 4. All projects undertaken pursuant to the Kyoto Mechanisms must be endorsed, in advance, by the host country.
- <sup>51</sup> See Instrument, *supra* note 14, at art. VII, § 7.2.
- <sup>52</sup> See Instrument, *supra* note 14, at art. VII, § 7.4.
- <sup>53</sup> See Instrument, *supra* note 14, at art. VII, § 7.3.
- <sup>54</sup> See Instrument, *supra* note 14, at art. III, § 3.2.
- <sup>55</sup> See Instrument, *supra* note 14, at art. III, § 3.2, art. VIII § 8.4.
- <sup>56</sup> See Instrument, *supra* note 14, at art. III, § 3.2, art. VIII § 8.4.
- <sup>57</sup> See Instrument, *supra* note 14, at art. VIII, § 8.4.
- <sup>58</sup> See Instrument, *supra* note 14, at art. X, § 10.4.
- <sup>59</sup> See Instrument, *supra* note 14, at art. XIII, § 13.2.
- <sup>60</sup> See Instrument, *supra* note 14, at art. XIII, § 13.3.
- <sup>61</sup> See Instrument, *supra* note 14, at art. XIII, § 13.1.
- <sup>62</sup> The legal status of the PCF and Participants’ interests in the PCF also had tax law implications. Those implications are beyond the scope of this article.
- <sup>63</sup> T.L. HAZEN, *THE LAW OF SECURITIES REGULATION* (4th ed. 2002).
- <sup>64</sup> The Bank borrows on average about \$20 billion a year though the issuance of bonds, and those bond proceeds are the funds the Bank uses to lend about US\$20 billion annually to its developing member countries.
- <sup>65</sup> See *SEC v. Howey*, 328 U.S. 293 (1946).
- <sup>66</sup> *Id.* at 298-299.
- <sup>67</sup> *Id.*
- <sup>68</sup> See *SEC v. Banner Fund International*, 211 F.3d 602 (D.C. Cir. 2000) (holding that beneficial interests in a business trust constitute securities under the Howey test).

<sup>69</sup> See *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), for example, where the Supreme Court held that an insignificant profit motive will not satisfy the expectation of profit requirement. This was echoed in the Court's later decision in *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551 (1979). There is also some support for the view that the profit motive must be the primary factor in the marketing of the investment, *see e.g.* *Teague v. Bakker*, 139 F.3d 892, 1998 WL 168876 (4th Cir. 1998) (unpublished) (affirming lower court decision), although this decision has been described as "questionable." *See also Hazen*, *supra* note 63, at §1.6[2][C].

<sup>70</sup> 15 U.S.C. § 77d(2) .

<sup>71</sup> *Id.*

<sup>72</sup> *SEC v. Ralston Purina Co.*, 346 U.S. 119, 73 S.Ct. 981 (1953).

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> See *Mary S. Krech Trust v. Lakes Apartments*, 642 F.2d 98 (5th Cir. 1989); *see also Kane v. SEC*, 842 F.2d 194 (5th Cir. 1988).

<sup>76</sup> See *SEC v. Murphy*, 626 F.2d 633 (9th Cir. 1980).

<sup>77</sup> *Kunz v. SEC*, (10th Cir. 2003), 64 Fed. Appx. 659 (2003) WL1605865 (unreported); *see also Mark v. FSC Securities Corp.*, 870 F.2d 331 (6th Cir. 1989) (the absence of evidence as to actual number of offerees precluded reliance on the private placement exemption).

<sup>78</sup> Non-Public Offering Exemption, SEC Act Rel. No. 33-4552, 1962 W.L. 3573.

<sup>79</sup> See *Koehler v. Pulvers*, 614 F. Supp. 829 (S.D. Cal. 1985).

<sup>80</sup> Instrument, *supra* note 14, at Art. II, § 2.3. This figure was subsequently raised to \$180 million by Res. No. 2000-1 of the Exec. Dirs. of the IBRD.

<sup>81</sup> See Paul Brown, *World Bank eyes trade in carbon credits*, THE GUARDIAN, Nov. 13, 1998.

<sup>82</sup> The closing included six governments: Finland, Norway, Sweden, the Netherlands, Canada, and Japan Bank for International Cooperation; and fifteen companies, including British Petroleum-Amoco, Chubu Electric Power Co., Chugoku Electric Power Co., Deutsche Bank, Electrabel/Suez-Lyonaise des Eaux, Gaz de France, Norsk Hydro, R.W.E., Statoil, and eight Japanese companies, including Chubu Electric Power Co., Chugoku Electric Power Co., Kyushu Electric Power Co., Shikowu Power Co., Tohoku Electric Power Co., Tokyo Electric Power Co, Mitsubishi Corp., and Mitsui. The \$150 million cap on the Fund was raised in May 2000, *see* Res. 2000-1, Bank Minutes and International Finance Corporation ("IFC") Minutes, Meeting of the Exec. Dirs. of the Bank and IDA and the Directors of IFC (May 23, 2000). A second closing in took place on Oct. 31, 2000, and two additional private sector participants, Fortum and Rabobank joined. The Fund is now closed.