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AGENCY FOR INTERNATIONAL DEVELOPMENT

WASHINGTON, D.C.

PROJECT MEMORANDUM

NEW INDEPENDENT STATES
ENTERPRISE FUND
(110-0011)

APPROVED: August 11, 1993

USAID

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

AUG - 9 1993

ACTION MEMORANDUM FOR THE DIRECTOR, NIS TASK FORCE

THROUGH: Larry Crandall, NIS/TF

FROM: Laurie Mailloux, NIS/TF/PSI

SUBJECT: New Independent States: Authorization of the Enterprise Fund Project (110-0011)

I. PROPOSED ACTION:

You are requested to take the following actions:

A. Determine in accordance with FAA Section 498B(c) of the Foreign Assistance Act of 1961, as amended, that an Enterprise Fund for Russia (Russian-American Enterprise Fund) and an Enterprise Fund for Ukraine (Ukrainian-American Enterprise Fund) should be established and supported. However, no action shall be taken or funding obligated for the Ukrainian-American Enterprise Fund until a Congressional hold on this fund is lifted.

B. Authorize the Enterprise Fund Project (No. 110-0011), a four year activity which involves planned life-of-project funding of $400 million, subject to the availability of funds, including a Russian-American Enterprise Fund ($300 million LOP) and a Ukrainian-American Enterprise Fund ($100 million LOP).

C. Approve obligation of up to $50,000,000 in FY 1993 funds for the Russian-American Enterprise Fund.

D. Approve, subject to removal by Congress of the hold on obligation, a $2,000,000 contribution from FY 1993 funds for the Enterprise Fund for Russia to a multilateral enterprise fund for the NIS to be (i) funded by the G-7 members and the European Bank for Reconstruction and Development and (ii) overseen by the European Bank for Reconstruction and Development.

E. Invoke the "notwithstanding any other provision of law" authority provided in Section 201(c) of the Support for East European Democracy (SEED) Act of 1989 (PL 101-179) to waive the status, regulations, and A.I.D. rules specified in annex A.

II. DISCUSSION

A. Background: Section 498B(c) of the Freedom Support Act (FSA) provides for establishing one or more Enterprise Funds in the NIS. It states that if the President determines that one or more Enterprise Funds should be established and supported under the FSA, the provisions contained in section 201 of the Support for East European Democracy Act of 1989 (SEED Act) shall apply. (See Attachment B for Section 201 of the SEED Act.)

At the recent Vancouver Summit in April 1993, President Clinton announced that the U.S. would provide $50 million in FY 93 to support an Enterprise Fund for Russia. This follows and tracks earlier announcements by the Bush Administration on the establishment of Enterprise Funds in Russia and Ukraine.

A formal Congressional Notification of the President's intent to establish Enterprise Funds in Russia and Ukraine was submitted to the Congress on April 23, 1993. This notification was placed on hold by Congressman Obey due to his interest in management provisions governing the funds and a sunset clause that would provide for their eventual closeout. Congressman Obey's concerns have been addressed and the hold was formally lifted for the Russia Enterprise Fund on July 1. There is still a hold on the Ukraine Enterprise Fund. In addition, on August 3, 1992, a formal Congressional Notification was submitted regarding A.I.D's intent to obligate a $2,000,000 contribution from FY 1993 funds for the Enterprise Fund for Russia to a multilateral enterprise fund for the NIS to be (i) funded by the G-7 members and the European Bank for Reconstruction and Development and (ii) overseen by the European Bank for Reconstruction and Development. Congress has placed a hold on that $2,000,000 contribution to the multilateral enterprise fund, and A.I.D. will not obligate any such funds until Congress lifts that hold. Specific measures that will be taken to address Congressional concerns are discussed below in Section III.

The grant agreements (Agreements) between A.I.D. and the Funds will contain essential terms and conditions to implement the FSA authorities. These terms will provide that the Funds' policies and procedures, on certain matters (such as employee compensation, cash management, and environmental rules) will be reviewed and approved in writing by A.I.D. The Agreements will also require A.I.D. written approval of amendments to such policies and procedures. As will be discussed below, these policies and procedures cover many of the standards which A.I.D. normally applies.

B. Project Description: The Enterprise Fund Project is designed to accommodate Funds in select New Independent States of the former Soviet Union. However, at this time, Funds are planned only in two states: Russia and Ukraine. The Russian-American Enterprise Fund will begin in FY 1993. The Ukrainian-American Enterprise Fund will be delayed until FY 1994. Based on Ukraine's recent movements to focus more attention on privatization, A.I.D. will, at the present time, concentrate resources in Ukraine to reinforce privatization, and will phase in the Enterprise Fund in FY 1994, assuming the present Congressional hold is lifted. The NIS/TF reviewed this matter with State and the NSC, and has incorporated the input of several field visits by senior Administration officials into the recommendations on this matter.

The purpose of the Enterprise Fund Project is to encourage the creation and expansion of small- and medium-sized enterprises. This will be accomplished through transactions that assist in the initiation and expansion of a wide array of private enterprises, promote and disseminate western business know-how and practices, and demonstrate to potential investors that investments can be undertaken profitably in Russia and Ukraine. In addition, the Funds will flag for the host governments and the private sectors specific policy reforms needed to make private investment possible.

The Funds will have three important characteristics that set them apart from traditional A.I.D. programs.

1. The Board of Directors of the Funds, selected by the White House with input from A.I.D. and the State Department (including field Missions), and the management executives hired by the Board to run the Funds on a day-to-day basis will be recruited from among top U.S. businesspersons and NIS experts. Host country persons of internationally recognized stature will also sit on the Board.

2. The Boards and management will have maximum flexibility in the manner in which the Funds are structured and in strategic and operating decisions. Following the principle that these types of decisions should be left to investment professionals, neither the USG nor the host government will have a role in strategic or operational decisions. Nonetheless, Fund management will abide by certain guidelines and mandates that A.I.D. reserves the right to approve pursuant to the Grant Agreement with each Fund.

3. In line with the SEED Act and the Freedom Support Act, the Enterprise Funds will generally not be bound by the traditional rules that govern U.S. assistance, with the exception of USG policies relating to the environment, defense conversion/military assistance, the exportation of U.S.jobs/enterprise zones/labor practices (section 599), abortion, subsidiaries, conflict of interest and compensation. In hiring and awarding contracts, and making investment decisions, Fund managers will follow accepted business norms and due diligence, but they will not be subject to most government regulations other than

those noted above, which might slow down and/or impair their investment decisions.

The Enterprise Funds will be incorporated in the U.S. as non-profit corporations (they will not distribute dividends to members). Profits generated by the Enterprise Funds will be retained and reinvested in new projects, subject to the sunset and wind-down provisions which will be detailed in the Grant Agreement. As a matter of operating philosophy, however, the Funds will be run as investment corporations and will generally be expected to make a reasonable return on investments.

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The Enterprise Funds will have offices in the U.S. and in the host country. Each Enterprise Fund will have a Board comprised of approximately seven U.S. citizens and up to six citizens from the host country. The exact structure and staffing requirements of each Fund will be determined by Fund management. Overhead and all administrative expenses will be financed from a line item in the grant budget until the Funds become profitable. Once that happens, salaries and incentive payments will be drawn from the profits and not from investment or working capital. The specifics of this will be set forth in the Grant Agreement.

The Enterprise Funds will support a number of private sector transactions in their respective countries. The exact nature of these transactions will be determined by the Boards and management once selected. Transactions are likely to fall into two general categories: loan programs and equity/venture capital programs. Many transactions will cover the gamut of possibilities between the two, e.g. convertible debentures and a combination of equity and loan capital.

The Enterprise Funds will also provide technical assistance to support Fund investments directly, but not as a general program of technical assistance. Technical assistance costs will be managed from a separate source of funds other than the Funds' investment capital to ensure transparency of technical assistance cost to enterprises.

Fund management will abide by the following investment criteria:

a) **Target Group:** While the Funds will not have rigid criteria for its target group, Fund clients will generally be firms in the 100 to 1,000 employee size, which covers most definitions for the NIS of "small" and "medium" scale businesses.

b) **Demonstration Effect:** Fund management will take into account a demonstration/multiplier effect in making all investments and in providing technical assistance.

c) **Diversification:** Fund investments will be diversified across sectors, size of investment and level of risk.

d) **Leveraging:** Enterprise Fund management will leverage USG resources to the maximum extent possible. As a general rule, the Funds will only take a minority position in enterprises in which they invest, thereby requiring a majority contribution from the host country entrepreneurs that are being supported or other joint venture partners. The Funds will also raise additional private capital at the earliest opportunity.

C. Implementation: The President will select the Chairman and members of the Boards of Directors, the Funds will be incorporated, and corporate by-laws will be adopted. Since A.I.D. will be providing the Funds with a grant based on Handbook 13, once the Funds have been incorporated, they will come to A.I.D. with a proposal that will include goals, objectives and benchmarks for the Funds and management plans which will set criteria for the use of the monies, and specifics on the manner in which the Funds will be managed. Pending the outcome of successful negotiations, A.I.D. will award the Funds a small grant for administrative costs related to establishing the fund and preparing for initial operations. The day-to-day management of the Funds will be provided by a Chief Executive Officer and the management team.

D. Monitoring and Evaluation: The Funds will submit an annual report, which will provide a description of progress in meeting objectives, operations, activities, financial conditions, and accomplishments of the preceding year. The report will also contain information on the Fund's compliance with SEED and FSA. The need for further reporting on areas of particular interest to Congress will be negotiated with the Funds. A final report will be submitted and will include a full accounting of expenditures under the grant and, if applicable, reasons why established goals were not met. The Grant Agreement will provide details on further reporting requirements.

Semi-annual and annual progress reviews, focusing on performance against objectives and overall financial performance of the Funds, will be held with the A.I.D. Mission/Embassy in the respective country of operation and/or A.I.D. Washington.

The Funds will also prepare and present to A.I.D. an annual audit describing compliance with the terms and conditions of the Agreement as well as disposition of grant funds to third parties.

Office visits by an A.I.D. representative to the Funds and subsidiaries will occur on a regular basis throughout the course of the year.

E. Funding: The preliminary FY 1993 budget for the Enterprise Fund Project was $65 million, with an estimated LOP level of $400 million over four years. Initially it was anticipated that $50 million would be provided to the Russian-American Enterprise Fund and $15 million to the Ukrainian-American

Enterprise Fund in FY 1993. Recent developments in Russia and Ukraine, however, have required an immediate higher level of resources to support the privatization process and have caused us to shift $45 million FY 1993 resources ($15 million from Ukraine, $30 million from Russia) to fund privatization contracts. It is intended to make up these FY 1993 reductions in the Enterprise Fund Project in FY 1994. We will, in particular, still uphold the President's commitment of $50 million for a Russia Enterprise fund which was made at the Vancouver Summit in April 1993.

In addition to the Russian-American Enterprise Fund and the Ukrainian-American Enterprise Fund, other Enterprise funds have been discussed for areas such as the Russian Far East and the Central Asian Republics. A Far East-American Enterprise Fund was specifically raised in context of an expanded $1.8 billion assistance package for Russia which was announced at the G-7 meeting in Tokyo in April 1993, subsequent to the Vancouver Summit. Should funds become available for additional Enterprise Funds, this project will be amended accordingly.

III. PROPOSED GRANT TERMS

A. Modified Grant Terms: We recognize that the Funds' private sector and market orientation suggest that, beyond minimal requirements and other provisions in the auditing and financial management category, A.I.D. will strive to transfer its grants to the Funds in the simplest and briefest form practicable. Several special concerns in developing the Agreements are discussed below:

Program Description: Each Fund will develop objectives/goals and benchmarks and a management plan as soon as possible and before the utilization of A.I.D. funds (other than for administrative costs). The implementation of such plans will be monitored by the Boards, each Board's independent auditors, and A.I.D. Each Fund will submit a proposal for A.I.D. review and approval.

Conflict of Interest: To meet concerns about conflict of interest with respect to its activities in the investment field, the Funds will have to develop special provisions in its by-laws and corporate policies which A.I.D. will review and approve in writing. Such policies must provide for full disclosure by corporate directors and officers of their individual financial interests, recusal where those interest are involved, and a responsibility on behalf of all employees not to use inside information for their personal benefit. Under the Agreements, the Funds will agree to these standards.

Subsidiaries: A.I.D. will review and approve all spin-off venture funds, banks, or other subsidiaries of the Funds. Such spin-off funds will operate within the same guidelines and principles to which the parent Fund must adhere, including those applicable to compensation and incentive payments as well as to transparency of personnel selection processes.

Environment: As noted above the Funds have been granted a categorical exclusion under Section 216.2 (c) (1) (ii) of the A.I.D. Environmental Procedures (22 CFR 216) on the basis that "A.I.D. does not have knowledge of or control over, and the objective of A.I.D. in furnishing assistance does not require, either prior to approval of financing or prior to implementation of specific activities, knowledge of or control over the details of the specific activities that have an effect on the physical and natural environment for which financing is provided by A.I.D." However, in establishing the Funds, A.I.D. is requesting the following actions to be implemented by the Funds:

1) The Funds are required to develop their own environmental guidelines, working with our regulations, host country regulations, and appropriate international regulations;

2) These guidelines will be reviewed and approved by the Board and A.I.D.;

3) That resources are available within the project to support staff and other resources that will provide for the implementation of these guidelines;

4) A.I.D. will monitor compliance through normal mid-term and final project audit and evaluation procedures. Review of environmental compliance shall be written into the scopes-of-work for the evaluation teams.

Section 599: The Funds will comply with Section 599 of the Foreign Assistance Appropriations Act.

Compensation: Salaries (but not incentive payments) will be funded through a line item in the grant budget until the Funds begin to turn a profit. Once the Funds are profitable, salaries and incentive payments will be drawn from the profits and not from investment or working capital. In all cases incentive payments will be based exclusively on performance, and cannot be paid from initial capitalization. In addition, salaries of employees of the Funds or subsidiaries will be based on a five-year salary history. The Funds will submit to A.I.D. for our review and prior approval their proposed policies and procedures with respect to all forms of employee compensation. This will be included as part of their proposal to A.I.D. upon which the grant will be awarded.

Term Limitation of Board Members: Board members should serve a maximum of two terms. Each term will be for a maximum of three years. The Board will be requested to stagger their terms. Board members who have not completed their term will select new members. Final selection of the new Board members will be subject to USG approval.

Lobbying: The Funds, including their staff and legal counsels, will not lobby the Congress or other bodies to improve their position.

Sunset Provision: A termination date for the Funds will occur no earlier than ten years and not later than 15 years from the date of incorporation. Timing of Fund termination will be determined by the USG and will be based on progress made in the host country in creating a local private sector and financial institutions capable of supporting private enterprise, along with the success (or lack of success) of the Fund in reaching its specific objectives. A liquidation plan will be drawn up one year prior to termination to allow for an orderly liquidation of all Fund assets.

Defense Conversion: Assistance provided to Enterprise Funds may be used to support defense conversion but shall not be used to support production of weapons or final components of weapons. The A.I.D. grant to the Enterprise Funds will specify the criteria to be followed for investments, loans, technical assistance or other forms of assistance, for defense conversion activities. The Funds will be responsible for demonstrating compliance with these requirements.

B. Use of the Notwithstanding Authority: Under the SEED Act, Section 201, the Enterprise Funds may be funded by A.I.D. "notwithstanding any other provision of law". In essence, decisions in this area are fully within executive discretion provided the Agency's actions are reasonable and consistent with the purposes of relevant legislation. The General Counsel's Office advises, however, of the importance of a clear record of reasons for the proposed use of the "notwithstanding" authority and the terms adopted in place of standard provisions. Specifically, the "notwithstanding any other provision of law" authority will be used regarding many of the matters described in Attachment A.

The issues described above will be reviewed within the NIS Task Force, with the Administrator, the General Counsel, the Inspector General, and the Office for the New Independent States within the State Department. We will also exchange drafts of the Agreements with attorneys representing the Funds. Although minor details in the documentation may change based on discussions with the Funds and their counsel, we believe that this memorandum fully addresses the items to be included in the Agreements. In this context, the Agreements will:

1) include appropriate basic provisions in such areas as audit, termination, suspension, conflict of interest, and refunds;

2) obligate currently available funds; and

3) provide for disbursement of funds by A.I.D. as needed.

Prior to adding future funds to the grants, A.I.D. intends to review how the Funds are progressing in achieving their benchmarks and goals. If necessary, appropriate changes to terms of the respective grants will be considered at such time.

IV. REMAINING PROCEDURAL REQUIREMENTS:

A. Congressional Notification: The Congressional Notification for the Fund was sent to the Hill on April 23, 1993. A hold was initially placed on the project due to concern over the present European Enterprise Funds. The hold on the Russian-American Fund was lifted on July 1, 1993. The hold on the Ukrainian-American Fund is still in place. Funds will not be obligated for the Ukrainian-American Fund until the hold is lifted. In addition, on August 3, 1992, a formal Congressional Notification was submitted regarding A.I.D's intent to obligate a $2,000,000 contribution from FY 1993 funds for the Enterprise Fund for Russia to a multilateral enterprise fund for the NIS to be (i) funded by the G-7 members and the European Bank for Reconstruction and Development and (ii) overseen by the European Bank for Reconstruction and Development. Congress has placed a hold on that $2,000,000 contribution, and that hold is still in place. Funds will not be obligated for the multilateral enterprise fund for the NIS until the hold is lifted.

B. Staffing: The White House has agreed on most of the Americans who should constitute the board of the Russian-American Enterprise fund. Likewise, the individuals have accepted their positions as board members. The President announced the Russian-American board publicly at the G-7 meeting in Tokyo (July 1993).

C. Designation of Funds: In addition to the CN, the SEED Act imposes requirements that, before obligation of funds, the Fund be formally "designated" as an eligible recipient of A.I.D. funds and that the Executive Branch consult with the leadership of the House and the Senate before making such "designation." Thus, once the Boards of the Funds and other required parties have agreed to acceptable articles of incorporation, we will be in a position to consult with the Congressional leadership, after which we would then process a formal "designation" for your signature.

V. AUTHORITY:

You have authority to execute the attached Project Authorization pursuant to Interim Reorganization Delegation of Authority No. 10, dated March 30, 1992

VI. RECOMMENDATIONS

That by your signature below you:

A. Determine in accordance with FAA Section 498B(c) of the Foreign Assistance Act of 1961, as amended, that an Enterprise Fund for Russia (Russian-American Enterprise Fund) and an Enterprise Fund for Ukraine (Ukrainian-American Enterprise Fund) should be established and supported. However, no action shall be taken or funding obligated for the Ukrainian-American Enterprise Fund until a Congressional hold on this fund is lifted.

B. Authorize the Enterprise Fund Project (No. 110-0011), a four year activity which involves planned life-of-project funding of $400 million, subject to the availability of funds, including a Russian-American Enterprise Fund ($300 million LOP). and a Ukrainian-American Enterprise Fund ($100 million LOP).

C. Approve obligation of up to $50,000,000 in FY 1993 funds for the Russian-American Enterprise Fund.

D. Approve, subject to removal by Congress of the hold on obligation, a $2,000,000 contribution from FY 1993 funds for the Enterprise Fund for Russia to a multilateral enterprise fund for the NIS to be (i) funded by the G-7 members and the European Bank for Reconstruction and Development and (ii) overseen by the European Bank for Reconstruction and Development.

E. Invoke the "notwithstanding any other provision of law" authority provided in Section 201(c) of the Support for East European Democracy (SEED) Act of 1989 (PL 101-179) to waive the status, regulations, and A.I.D. rules specified in annex A.

Approve: WB

Disapprove: ______________

Date: AUG 11 1993

Annexes to Action Memorandum:

A. Notwithstanding Authority
B. Support for East Europe Democracy Act

Attachments to Authorization Package:

A Project Authorization
B. Project Memorandum
C. Initial Environmental Examination

JMoran
drafted: LMailloux/U:\PSIPUB\DOCS\EFUND\ACTION.MEM

A.I.D.:			
NIS/TF:LCrandell		Date	7/9/93
NIS/TF/PAC:CPascual	DRAFT	Date	5/28/93
NIS/TF/PAC:SHudec		Date	6-4-93
NIS/TF/FM:JWinn		Date	6/15/93
NIS/TF/EET:DLong		Date	6/3/93
GC/NIS/TF:TGeiger	KH	Date	6/17/93 7/15
USAID/Ukraine:TMcMahon	DRAFT	Date	5/20/93
USAID/Russia:BBurke	DRAFT	Date	5/25/93
State:			
State/EUR/ISCA:NCook	DRAFT	Date	5/21/93
State/S/NIS:BTaylor	DRAFT	Date	5/20/93

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Waiver No. 93-0011-01

ANNEX A

USE OF "NOTWITHSTANDING" AUTHORITY

Proposed use of "notwithstanding" authority to delete or modify standard A.I.D. rules with regard to the following four general categories:

Various Requirements for Grantees,
Nature of Project Activities,
Pre-Award Actions, and
Eligible Goods and Services and Source/Origin Requirements.

Various Requirements for Grantees

1. Non-applicability of the requirement that interest earned on grant advances be remitted to A.I.D. (HB 13, MP § 3(q); OMB Circular A-110, App. D).*

2. Non-applicability of any requirement relating to cost sharing and matching imposed on grantees (HB 13, OP § 24; OMB Circular A-110, App. E).

3. Non-applicability of any requirement that grant advances only be made to the grantee on an as-needed basis (HB 13, OP §§ 2 and 3; OMB Circular A-110, Apps. I).

4. Modification of the requirement that advanced grant funds be deposited in banks with FDIC coverage and the balance of the advances that exceeds the FDIC coverage be collaterally secured to allow a more commercially sound alternative. (31 CFR Part 205).

5. Non-applicability of all requirements prescribing how the grantee shall manage property acquired with A.I.D. funds (HB 13 OP § 21; OMB Circular A-110, Apps. N and D.

6. Non-applicability of the requirement that the grantee certify that it has not been debarred or suspended, and that its principals have not been convicted of certain crimes, etc. (HB 13, MP § 8).

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* Parenthetical references following each item are (i) to the relevant section of the mandatory standard provisions (MP) or the optional standard provisions (OP) to Handbook 13 (HB) 13), (ii) to the relevant statutory provision of the Foreign Assistance Act of 1961, as amended (the "FAA"), or another relevant act, or (iii) to any other relevant source of rules or regulations, such as a circular from the Office of Management and Budget (OMB).

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7. Non-applicability of the required undertaking by the grantee regarding the actions of its employees in Russia and Ukraine (HB 13, OP § 15).

8. Non-applicability of restrictions on the conversion of dollars into any other currency (HB 13, OP § 26).

9. Omission of any undertaking by the United States Government to permit the use of its pouch facilities (HB 13, OP § 25).

Rationale:

Most of these requirements relate to the way in which a normal grantee can manage its grant funds. Since the Freedom Support Act and the SEED Act establish a different pattern for the Enterprise Funds (i.e. to receive monies in advance of actual need and to earn interest thereon) most of these procedural requirements are per force inapplicable. The others are just not relevant to the investment orientation of the Enterprise Funds.

A further rationale for not applying these limitations is that conditions in the NIS are unique in that the purpose of our assistance is to help build a market economies in countries that have been dominated by 40 years of central planning.

Nature of Project Activities

10. Non-applicability of the restrictions on financing commercial or agricultural activities that compete with United States businesses, as specified in part in the Bumpers and Lautenberg amendments to the Appropriations Act for fiscal year 1993 (§ 520 of the Appropriations Act; and § 620(d) of the FAA).

11. Non-applicability of any requirements applicable to participant training programs and research activities (HB 13, OP § 15 and §§ 17 and 18).

Rationale:

The Freedom Support Act and SEED Act provide specific objectives for the activities of the Enterprise Funds. The Funds are private entities, which require the flexibility to respond to market signals on a timely basis. Transactions are not expected to result in competition with U.S. businesses in major U.S. or world markets. To the contrary, the result should be to open and sustain new markets for the United States. With respect to environmental procedures, the Funds have been granted a categorical exclusion and will develop their own rules and procedures for ensuring the environmental soundness of loans and investments. A.I.D. will approve in writing these rules and procedures before the Funds begin operations.

Pre-Award Actions

12. Non-applicability of the requirement for a pre-award audit. (HB 13, Chapter 4).

13. Non-applicability of the determination that the funds have a performance record, an acceptable financial accounting system, and adequate funds to carry out the program (HB 13, Chapter 4).

14. Non-applicability of the review of the adequacy of grantee policy and procedures for travel, procurement, and property management (HB 13, Chapter 4).

Rationale:

The Enterprise Funds are new organizations with no operational history to examine. The legislation directs A.I.D. to make grants to these organizations. A.I.D. will review approve personnel rules and policies, including, those determining levels of compensation and benefits for employees of the Funds and any subsidiaries of the Funds.

Eligible Goods and Services and Source and Origin Requirements

15. Non-applicability of standard restrictions on the acquisition of the following goods:

    (a) luxury goods (HB 13, OP § 8(a)(1));
    (b) weather modification equipment (HB 13, OP § 8(a)(1));
    (c) agricultural commodities (HB 13, OP § 8(a)(3));
    (d) vehicles (HB 13, OP § 8(a)(3));
    (e) rubber compounding chemicals and plasticizers (HB 13, OP § 8(a)(3));
    (f) used equipment (HB 13, OP § 8(a)(3));
    (g) U.S. government-owned excess property (HB 13, OP § 8(a)(3));
    (h) fertilizers (HB 13, OP § 8(a)(3)); and
    (i) any commodities appearing from time to time on the Commodity Eligibility list regarding ineligible goods (HB 1B, chapter 4, and HB 15, App. B).

16. Non-applicability of any requirement that United States maritime insurers be used by the Grantee (FAA § 604(d); HB 13, OP § 8(c)).

17. Non-applicability of cost principles for nonprofit organizations.

18. Non-applicability of any restrictions regarding local cost financing (HB 13, OP § 10).

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19. Non-applicability of all statutes and restrictions on the source or origin of goods and services or nationality of suppliers, except for the exclusion of Libya, Vietnam, North Korea, Iran, Cuba, Iraq, Syria, Serbia, Cambodia, Laos, China and Afghanistan as a permitted source or origin for goods and services or nationality of suppliers including:

    (a) the requirement for the procurement of goods from the United States, NIS countries, or from developing countries (FAA § 604(a) and § 498B(h) of the Freedom Support Act; HB 1B, Chapter 5); and

    (b) restrictions on acquiring construction and other technical services from advanced developing countries (FAA § 604(g)).

20. Non-applicability of the requirement that at least 50% of A.I.D.-financed goods be shipped on United States flag vessels (§ 901(b) of the Merchant Marine Act of 1936, as amended; HB 13, OP § 8).

21. Non-applicability of the preference for using United States flag air carriers (International Air Transportation Fair Competitive Practices Act, 1974; HB 13 OP § 5).

22. Non-applicability of the requirement that motor vehicles be of U.S. source and origin (FAA § 636(i)).

Rationale:

In most cases, we don't expect the Enterprise Funds will finance transactions of the type normally prohibited, but we do not want to impose the administrative burden of having to ensure that a proscribed procurement won't happen. One of the beneficial by-products of the Enterprise Funds will be the development of indigenous credit and venture analysts who will be scrutinizing proposals for Fund financing. The tasks of teaching them good business and accounting principles will be difficult enough without the overlay of A.I.D. peculiarities. The reasons for worrying about whether a business plan might include, e.g., rubber compounding chemicals of the type normally proscribed by A.I.D. are not sufficient to overcome this basic principle. Nor do we want the commodity procurement office to have to preview proposed transactions.

In other cases, e.g., passenger cars and luxury goods, we accept that procurements may occur with at least some portion financed by the Enterprise Fund but believe that the market (i.e. price) mechanism will be the best arbiter of whether a Russian or Ukrainian company should buy such items or not. It is important to keep in mind that to the end-user these funds are not "assistance" but are investment capital with the concomitant risks of using them for non-essential requirements.

The rationale for eliminating or modifying source/origin requirements is very much tied to the market orientation of the Enterprise Funds. Moreover, competitively-priced American products are already being introduced in Russia and Ukraine; those that are able to establish a presence, particularly with maintenance and spare parts capabilities, should expect to do will in both countries.

The program of assistance for the Enterprise Funds is not commodity-oriented. Monies may be use to purchase equipment or raw materials, but may also be used for in-country costs such as buildings and salaries. At this stage, the delays and paperwork associated with source/origin requirements do not seem justified in light of the overall purpose of the Enterprise Funds and the likely orientation of the Funds in supporting U.S. joint ventures and investments in NIS countries. As required by the SEED Act, the Funds will have to take into account United States economic and employment effects in managing and investing their portfolios.

(B) to facilitate the transition from state-directed controls to a free market economy, while avoiding disincentives to domestic agricultural production and reform; and

(2) in order to ensure the necessary quantity and diversity of such agricultural assistance, shall take all appropriate steps to encourage parallel efforts by the European Community and other agricultural surplus countries.

(c) FY 1990 MINIMUM LEVEL OF AGRICULTURAL ASSISTANCE FOR POLAND.—In carrying out subsection (b) of this section, the level of assistance for Poland for fiscal year 1990 under section 416(b) of the Agricultural Act of 1949 (7 U.S.C. 1431(b)), the Agricultural Trade Development and Assistance Act of 1954 (7 U.S.C. 1691 and following), and the Food for Progress Act of 1985 (7 U.S.C. 1736o) should not be less than $125,000,000. Such assistance—

(1) to the maximum extent practicable, shall be provided through nongovernmental organizations; and

(2) shall emphasize feed grains.

(d) CONSISTENCY WITH BUDGET REQUIREMENTS.—Subsection (c) should not be construed to authorize or require any budgetary obligations or outlays that are inconsistent with House Concurrent Resolution 106 of the 101st Congress (setting forth the congressional budget for the United States Government for fiscal year 1990).

SEC. 104.[7] DEBT-FOR-EQUITY SWAPS AND OTHER SPECIAL TECHNIQUES.

(a) REDUCTION OF DEBT BURDEN.—The President shall take all appropriate actions to explore and encourage innovative approaches to the reduction of the government-to-government and commercial debt burden of East European countries which have taken substantive steps toward political democracy and economic pluralism.

(b) AUTHORITY FOR DISCOUNTED SALES OF DEBT.—Notwithstanding any other provision of law, the President may undertake the discounted sale, to private purchasers, of United States Government debt obligations of an East European country which has taken substantive steps toward political democracy and economic pluralism, subject to subsection (c).

(c) CONDITION.—An obligation may be sold under subsection (b) only if the sale will facilitate so-called debt-for-equity or debt-for-development swaps wherein such newly privatized debt is exchanged by the new holder of the obligation for—

(1) local currencies, policy commitments, or other assets needed for development or other economic activities, or

(2) for an equity interest in an enterprise theretofore owned by the particular East European government.

TITLE II—PRIVATE SECTOR DEVELOPMENT

SEC. 201.[8] ENTERPRISE FUNDS FOR POLAND AND HUNGARY.

(a) PURPOSES.—The purposes of this section are to promote—

[7] 22 U.S.C. 5414. Sec. 4 of Executive Order 12703, February 20, 1990 (55 F.R. 6351), delegated the functions conferred upon the President in this section relating to debt reduction of certain East European countries to the Secretary of the Treasury. For text of Executive Order 12703, see page 938.

[8] 22 U.S.C. 5421. Sec. 2 of Executive Order No. 12703, February 20, 1990 (55 F.R. 6351), delegated the functions conferred upon the President in this section relating to Enterprise Funds for Poland and Hungary to the Administrator of the United States Agency for International Development. For text of Executive Order No. 12703, see page 938.

(1) development of the Polish and Hungarian private sectors, including small businesses, the agricultural sector, and joint ventures with United States and host country participants, and

(2) policies and practices conducive to private sector development in Poland and Hungary,

through loans, grants, equity investments, feasibility studies, technical assistance, training, insurance, guarantees, and other measures.

(b) AUTHORIZATION OF APPROPRIATIONS.—To carry out the purposes specified in subsection (a), there are authorized to be appropriated to the President—

(1) $240,000,000 to support the Polish-American Enterprise Fund; and

(2) $60,000,000 to support the Hungarian-American Enterprise Fund.

Such amounts are authorized to be made available until expended.

(c) NONAPPLICABILITY OF OTHER LAWS.—The funds appropriated under subsection (b) may be made available to the Polish-American Enterprise Fund and the Hungarian-American Enterprise Fund and used for the purposes of this section notwithstanding any other provision of law.

(d) DESIGNATION OF ENTERPRISE FUNDS.—

(1) DESIGNATION.—The President is authorized to designate two private, nonprofit organizations as eligible to receive funds and support pursuant to this section upon determining that such organizations have been established for the purposes specified in subsection (a). For purposes of this Act, the organizations so designated shall be referred to as the Polish-American Enterprise Fund and the Hungarian-American Enterprise Fund (hereinafter in this section referred to as the "Enterprise Funds").

(2) CONSULTATION WITH CONGRESS.—The President shall consult with the leadership of each House of Congress before designating an organization pursuant to paragraph (1).

(3) BOARD OF DIRECTORS.—(A) Each Enterprise Fund shall be governed by a Board of Directors comprised of private citizens of the United States, and citizens of the respective host country, who have demonstrated experience and expertise in those areas of private sector development in which the Enterprise Fund is involved.

(B) A majority of the members of the Board of Directors of each Enterprise Fund shall be United States citizens.

(C) A host country citizen who is not committed to respect for democracy and a free market economy may not serve as a member of the Board of Directors of an Enterprise Fund.

(4) ELIGIBILITY OF ENTERPRISE FUNDS FOR GRANTS.—Grants may be made to an Enterprise Fund under this section only if the Enterprise Fund agrees to comply with the requirements specified in this section.

(5) PRIVATE CHARACTER OF ENTERPRISE FUNDS.—Nothing in this section shall be construed to make an Enterprise Fund an agency or establishment of the United States Government, or to make the officers, employees, or members of the Board of

Directors of an Enterprise Fund officers or employees of the United States for purposes of title 5, United States Code.

(e) GRANTS TO ENTERPRISE FUNDS.—Funds appropriated to the President pursuant to subsection (b) shall be granted to the Enterprise Funds by the Agency for International Development to enable the Enterprise Funds to carry out the purposes specified in subsection (a) and for the administrative expenses of each Enterprise Fund.

(f) ELIGIBLE PROGRAMS AND PROJECTS.—

(1) IN GENERAL.—The Enterprise Funds may provide assistance pursuant to this section only for programs and projects which are consistent with the purposes set forth in subsection (a).

(2) EMPLOYEE STOCK OWNERSHIP PLANS.—Funds available to the Enterprise Funds may be used to encourage the establishment of Employee Stock Ownership Plans (ESOPs) in Poland and Hungary.

(3) INDIGENOUS CREDIT UNIONS.—Funds available to the Enterprise Funds may be used for technical and other assistance to support the development of indigenous credit unions in Poland and Hungary. As used in this paragraph, the term "credit union" means a member-owned, nonprofit, cooperative depository institution—

(A) which is formed to permit individuals in the field of membership specified in such institution's charter to pool their savings, lend the savings to one another, and own the organization where they save, borrow, and obtain related financial services; and

(B) whose members are united by a common bond and democratically operate the institution.

(4) TELECOMMUNICATIONS MODERNIZATION IN POLAND.—The Polish-American Enterprise Fund may use up to $25,000,000 for grants for projects providing for the early introduction in Poland of modern telephone systems and telecommunications technology, which are crucial in establishing the conditions for successful transition to political democracy and economic pluralism.

(5) ECONOMIC FOUNDATION OF NSZZ SOLIDARNOŚĆ.—Funds available to the Polish-American Enterprise Fund may be used to support the Economic Foundation of NSZZ Solidarność.

(g) MATTERS TO BE CONSIDERED BY ENTERPRISE FUNDS.—In carrying out this section, each Enterprise Fund shall take into account such considerations as internationally recognized worker rights and other internationally recognized human rights, environmental factors, United States economic and employment effects, and the likelihood of commercial viability of the activity receiving assistance from the Enterprise Fund.

(h) RETENTION OF INTEREST.—An Enterprise Fund may hold funds granted to it pursuant to this section in interest-bearing accounts, prior to the disbursement of such funds for purposes specified in subsection (a), and may retain for such program purposes any interest earned on such deposits without returning such interest to the Treasury of the United States and without further appropriation by the Congress.

(i) USE OF UNITED STATES PRIVATE VENTURE CAPITAL.—In order to maximize the effectiveness of the activities of the Enterprise Funds, each Enterprise Fund may conduct public offerings or private placements for the purpose of soliciting and accepting United States venture capital which may be used, separately or together with funds made available pursuant to this section, for any lawful investment purpose that the Board of Directors of the Enterprise Fund may determine in carrying out this section. Financial returns on Enterprise Fund investments that include a component of private venture capital may be distributed, at such times and in such amounts as the Board of Directors of the Enterprise Fund may determine, to the investors of such capital.

(j) FINANCIAL INSTRUMENTS FOR INDIVIDUAL INVESTMENT IN POLAND.—In order to maximize the effectiveness of the activities of the Polish-American Enterprise Fund, that Enterprise Fund should undertake all possible efforts to establish financial instruments that will enable individuals to invest in the private sectors of Poland and that will thereby have the effect of multiplying the impact of United States grants to that Enterprise Fund.

(k) NONAPPLICABILITY OF OTHER LAWS.—Executive branch agencies may conduct programs and activities and provide services in support of the activities of the Enterprise Funds notwithstanding any other provision of law.

(l) LIMITATION ON PAYMENTS TO ENTERPRISE FUND PERSONNEL.—No part of the funds of either Enterprise Fund shall inure to the benefit of any board member, officer, or employee of such Enterprise Fund, except as salary or reasonable compensation for services.

(m) INDEPENDENT PRIVATE AUDITS.—The accounts of each Enterprise Fund shall be audited annually in accordance with generally accepted auditing standards by independent certified public accountants or independent licensed public accountants certified or licensed by a regulatory authority of a State or other political subdivision of the United States. The report of each such independent audit shall be included in the annual report required by this section.

(n) GAO AUDITS.—The financial transactions undertaken pursuant to this section by each Enterprise Fund may be audited by the General Accounting Office in accordance with such principles and procedures and under such rules and regulations as may be prescribed by the Comptroller General of the United States, so long as the Enterprise Fund is in receipt of United States Government grants.

(o) RECORDKEEPING REQUIREMENTS.—The Enterprise Funds shall ensure—

(1) that each recipient of assistance provided through the Enterprise Funds under this section keeps—

(A) separate accounts with respect to such assistance;

(B) such records as may be reasonably necessary to disclose fully the amount and the disposition by such recipient of the proceeds of such assistance, the total cost of the project or undertaking in connection with which such assistance is given or used, and the amount and nature of that portion of the cost of the project or undertaking supplied by other sources; and

(C) such other records as will facilitate an effective audit; and

(2) that the Enterprise Funds, or any of their duly authorized representatives, have access for the purpose of audit and examination to any books, documents, papers, and records of the recipient that are pertinent to assistance provided through the Enterprise Funds under this section.

(p) ANNUAL REPORTS.—Each Enterprise Fund shall publish an annual report, which shall include a comprehensive and detailed description of the Enterprise Fund's operations, activities, financial condition, and accomplishments under this section for the preceding fiscal year. This report shall be published not later than January 31 each year, beginning in 1991.

SEC. 202.[9] LABOR MARKET TRANSITION IN POLAND AND HUNGARY.

(a) TECHNICAL ASSISTANCE.—The Secretary of Labor (hereinafter in this section referred to as the "Secretary"), in consultation with representatives of labor and business in the United States, shall—

(1) provide technical assistance to Poland and Hungary for the implementation of labor market reforms; and

(2) provide technical assistance to Poland and Hungary to facilitate adjustment during the period of economic transition and reform.

(b) TYPES OF TECHNICAL ASSISTANCE AUTHORIZED.—In carrying out subsection (a), the Secretary is authorized to provide technical assistance regarding policies and programs for training and retraining, job search and employment services, unemployment insurance, occupational safety and health protection, labor-management relations, labor statistics, analysis of productivity constraints, entrepreneurial support for small businesses, market-driven systems of wage and income determinations, job creation, employment security, the observance of internationally recognized worker rights (including freedom of association and the right to organize and bargain collectively), and other matters that the Secretary may deem appropriate regarding free labor markets and labor organizations.

(c) ADMINISTRATIVE AUTHORITIES.—In carrying out subsection (a), the Secretary is authorized to do the following:

(1) Solicit and accept in the name of the Department of Labor, and employ or dispose of in furtherance of the purposes of this section, any money or property, real, personal, or mixed, tangible or intangible, received by gift, devise, bequest, or otherwise. Gifts and donations of property which are no longer required for the discharge of the purposes of this section shall be reported to the Administrator of General Services for transfer, donation, or other disposal in accordance with the Federal Property and Administrative Services Act of 1949 (40 U.S.C. 471 and following).

(2) Solicit and accept voluntary and uncompensated services notwithstanding section 1342 of title 31, United States Code. A

[9] 22 U.S.C. 5422.

volunteer under this paragraph shall not be deemed to be an employee of the United States except for the purposes of—

(A) the tort claims provisions of title 28, United States Code, and

(B) subchapter I of chapter 81 of title 5, United States Code, relating to compensation for work injuries.

(3) Enter into arrangements or agreements with appropriate departments, agencies, and establishments of Poland and Hungary.

(4) Enter into arrangements or agreements with appropriate private and public sector United States parties, and international organizations.

(d) CONSULTATION WITH APPROPRIATE OFFICERS.—In carrying out the responsibilities established by this section, the Secretary shall seek information and advice from, and consult with, appropriate officers of the United States.

(e) CONSULTATION WITH LABOR AND BUSINESS REPRESENTATIVES.—For purposes of this section, consultation between the Secretary and United States labor and business representatives shall not be subject to the Federal Advisory Committee Act (5 U.S.C. App.).

(f) DELEGATION OF RESPONSIBILITIES.—The Secretary shall delegate the authority to carry out the programs authorized by this section to the head of the Bureau of International Labor Affairs of the Department of Labor.

(g) AUTHORIZATION OF APPROPRIATIONS.—There are authorized to be appropriated to the Department of Labor for the 3-year period beginning October 1, 1989, to carry out this section—

(1) $4,000,000 for technical assistance to Poland; and

(2) $1,000,000 for technical assistance to Hungary.

SEC. 203.[10] TECHNICAL TRAINING FOR PRIVATE SECTOR DEVELOPMENT IN POLAND AND HUNGARY.

(a) TECHNICAL TRAINING PROGRAM.—The Agency for International Development shall develop and implement a program for extending basic agribusiness, commercial, entrepreneurial, financial, scientific, and technical skills to the people of Poland and Hungary to enable them to better meet their needs and develop a market economy. This program shall include management training and agricultural extension activities.

(b) PARTICIPATION BY ENTERPRISE FUNDS AND OTHER AGENCIES AND ORGANIZATIONS.—In carrying out subsection (a), the Agency for International Development may utilize the Polish-American Enterprise Fund and the Hungarian-American Enterprise Fund and other appropriate Government and private agencies, programs, and organizations such as—

(1) the Department of Agriculture;

(2) the Farmer-to-Farmer Program under section 406(a) (1) and (2) of the Agricultural Trade Development and Assistance Act of 1954 (7 U.S.C. 1736(a) (1) and (2));

(3) the International Executive Service Corps;

(4) the Foundation for the Development of Polish Agriculture;

[10] 22 U.S.C 5423.

USAID

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

ATTACHMENT A

PROJECT AUTHORIZATION

Name of Country:	New Independent States (NIS)
Name of Project:	NIS Enterprise Fund
Number of Project:	110-0011

1. Pursuant to Section 498C of the Foreign Assistance Act of 1961, as amended (FAA), I hereby authorize the NIS Enterprise Fund Project involving planned obligations not to exceed $400,000,000 over a four year period from the date of the first obligation, subject to the availability of funds in accordance with the A.I.D. OYB/Allotment process, to help in financing foreign exchange and local currency costs of the project. The planned life of project is through June 1, 1997.

2. The Project will provide support to nonprofit venture capital funds to meet the demands for equity and loan capital of emerging small- and medium-scale businesses in the New Independent States, assist in the development of joint ventures, attract foreign investment, encourage U.S. private sector partnerships, and provide technical assistance to such businesses.

3. The Project Agreements which may be negotiated and executed by the Officer(s) to whom such authority is delegated in accordance with A.I.D. regulations and Delegations of Authority shall be subject to the following essential terms and covenants and major conditions, together with such other terms and conditions as A.I.D. may deem appropriate.

4. <u>Source and Origin of Commodities, Nationality of Services</u>

The source and origin of commodities, nationality of suppliers of commodities, services and ocean shipping may have their source or origin in any country excluding only: Libya, Vietnam, North Korea, Iran, Cuba, Iraq, Syria, Serbia, Cambodia, Laos, Montenegro, China, and Afghanistan.

Malcolm Butler

Malcolm Butler
Director
New Independent States Task Force

AUG 11 1993

Date

<u>Clearances (Project No. 110-0010):</u>

A.I.D.:		
NIS/TF:LCrandell		Date 7/9/93
NIS/TF/PAC:CPascual	DRAFT	Date 6/2/93
NIS/TF/PAC:SHudec		Date 6/17/93
NIS/TF/OD:RLawrence	RAL	Date 6/17/93
USAID/Ukraine:TMcMahon	DRAFT	Date 5/20/93
USAID/Russia:BBurke	DRAFT	Date 5/25/93
GC/NIS:TGeiger		Date 6/17/93
NIS/OD:BTurner		Date / /93
State:		
State/EUR/ISCA:NCook	DRAFT	Date 5/21/93
State/S/NIS:BTaylor	DRAFT	Date 5/20/93

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Illustrative Enterprise Fund Project Budget
($000)

	FY93 Planned	FY94 Planned	FY95 Planned	FY96 Planned	Total
Russian Enterprise Fund					
Capital Investment	45,250	73,800	75,600	75,600	270,250
Technical Assistance	4,750	8,200	8,400	8,400	29,750
Total Russia	50,000	82,000	84,000	84,000	300,000
Ukrainian Enterprise Fund					
Capital Investment	12,500	23,200	25,000	25,000	85,700
Technical Assistance	2,000	3,800	4,000	4,000	13,800
Total Ukraine	14,500	27,000	29,000	29,000	99,500
Evaluation/Audit	500				500
Total for Project	65,000 *	109,000	113,000	113,000	400,000

* This table reflects initial FY '93 planning levels. These levels have been adjusted as described in the action memorandum accompanying this project authorization. In brief, the FY '93 budget is now anticipated to be $20 million, which will be focused on Russia. Of this amount, $2 million may be used for a multilateral pilot program, subject to Congressional concurrence. Funding for Ukraine and the balance of funding for Russia will be deferred to future years.

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I. Background

ATTACHMENT B

A. Challenge and Constraints

Assisting the transformation of the economies of the New Independent States (NIS) from command to market-driven, competitive systems is one of the greatest challenges facing the U.S. and other Western donors. The United States has a vital interest in the success of this transition to help ensure a more peaceful and stable international order. It will also open to competitive international trade and investment the world's largest untapped market and natural resource base.

Yet transforming the Soviet-style command economies of the NIS republics faces numerous constraints. The legal and regulatory framework to create the new systems is not yet complete. State-owned enterprises, particularly defense-related industries, continue to dominate and have an important influence in the economy and in macroeconomic decisions. There are also few citizens with entrepreneurial experience, even fewer with any experience operating a small or medium-size private business in a competitive market economy. Most individuals have no exposure to western management, accounting, or marketing concepts. Conversely, American firms which could assist in the transformation process have been reluctant to make financial commitments, despite a considerable amount of general interest, to a political and economic environment that faces many uncertainties.

Most recent investment in the NIS has been undertaken by companies which already had a stake in specific NIS republics prior to the political and economic reforms of the past few years or by firms investing in safer, hard currency-generating ventures such as those related to energy and minerals. Western banks have been slow to move into the NIS with full commercial/retail banking operations--in particular lending to new private enterprises. A handful of private, public and mixed investment/venture capital funds have been established but these are reaching only a very small segment of the emerging private sector. Public and private banks in the NIS have severely curtailed and in many cases completely eliminated lending to private enterprises given the opportunity to generate a safer return in other investments such as hard currency speculation and real estate. For the typical NIS entrepreneur, the result is a dearth of equity and loan capital which severely curtails opportunities for initiating or expanding new ventures.

Another major constraint is the gap between resources available from western donors and the vast financial and managerial requirements of assisting in the transformation process. For A.I.D. and the USG, a major challenge is the allocation of relatively scarce financial and managerial resources between

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complementary, mutually-reinforcing, yet diverse and resource-competing private sector assistance initiatives: privatization, policy reform, development of small-, and medium-scale business, micro enterprise development, training, and investment activities.

B. Rationale for the Enterprise Funds in the NIS

Enterprise Funds (EF), which are investment organizations that will be established in selected NIS Republics, will specifically address many of the constraints highlighted above.[1] The Enterprise Funds will fill an important vacuum that exists in the NIS Republics with respect to the incubation of a broad range of private enterprises. As noted above, some U.S. and international investment houses have begun NIS operations. However, very few, if any, of these organizations are focusing on the middle market and smaller range of companies that do not necessarily generate foreign exchange or which do not have proven track records.

There is a significant need for an investment organization--indeed for many investment organizations as the needs are considerable--to meet the demands of equity and loan capital of emerging small- and medium-scale businesses in the NIS. Beyond capital, however, there is even a greater need to attract the U.S. private sector to work within the NIS and specifically to assist in the emergence of the small-to-medium enterprise sector. While the use of consultants is one approach to meeting this need, experience to date in Eastern Europe and elsewhere indicates that jointly investing with local entrepreneurs is a very effective approach to maximizing the contribution that western businesspersons can make in disseminating western business practices and market oriented approaches.

Inter alia, the Enterprise Funds (EFs) in the NIS will:

- provide badly needed loan and equity capital to a wide-array of NIS entrepreneurs and businesses;
- promote business transactions that will serve as a model for the private sector by providing substantial business know-how and expertise;
- help incubate new businesses;

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[1] Section 498 (c) of the FY 93 Freedom Support Act permits the establishment of one or more Enterprise Funds in the NIS, under the authority of Section 201 of the SEED (Support for Eastern European Democracy) Act.

- support the crucial privatization and defense conversion programs[2];

- enhance the viability of the financial system by supporting domestic financial institutions and encouraging commercial and investment banking activities;

- assist in the development of joint ventures and attracting foreign investment;

- offer an excellent opportunity for a USG-U.S. private sector partnership; and,

- maximize the impact of USG resources by leveraging additional funds: potentially the USG's most effective investments will reinforce private investors who are willing to put up their own capital.

The Enterprise Funds will be a key component of the A.I.D. private sector strategy in the NIS Republics. By focusing its efforts on small- and medium-scale enterprise development, the Funds will complement and in many cases support other A.I.D. efforts such as privatization and policy reform. The Enterprise Funds will permit A.I.D. to support a number of private sector initiatives while limiting considerably the significant management burden of transaction-oriented private sector programs administered by A.I.D. field missions.

With a limited field and Washington staff, A.I.D. resources will be very thinly stretched in promoting substantive private sector programs in more than a few areas. With the EFs focused on enterprise development (excluding the micro-enterprise level) A.I.D. field and Washington staff will be able to focus on policy reform, micro-enterprise development, strengthening local business groups, privatization, and other key elements of a comprehensive private sector program. Demand for private sector programs in the NIS is great. The ability to consolidate enterprise development in an EF will be an extremely important A.I.D. asset. For example, the EFs will be an important conduit of assistance in many cases to the large number of U.S. businesses that seek investment support from A.I.D. Washington and field missions. With a mandate to promote joint ventures, the EFs will in many cases be in a good position to provide required assistance, including assisting local

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[2] For purposes of this project, a defense enterprise shall be defined as any organization having a significant volume of, or capacity for, military production. Defense conversion shall mean a substantial increase in non-military production accompanied by a substantial decrease in military and dual use production, or activities clearly designed to lead to such increase and decrease.

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partners wanting to enter into joint ventures with U.S. companies.

Finally, the Enterprise Funds will provide a demonstration effect that go far beyond the mere provision of capital. Even more than most developing countries, the NIS is severely lacking in business experience and know-how. The provision of that experience and know-how, coupled with concrete examples of successful enterprises are expected to be a major contribution of the Funds. This has been demonstrated in Eastern Europe where the Funds are playing important roles as the incubators of businesses and of western business practices, both of which are viewed as critical in forging private enterprise in the respective Eastern European countries. This issue is addressed in the Risk Analysis (section VII).

II. Program Description

A. Purpose

The purpose of the Enterprise Funds is to encourage the creation and expansion of small and medium enterprises in the NIS. This will be accomplished through transactions that assist in the initiation and expansion of a wide array of private enterprises and that promote and disseminate western business know-how and practices, and demonstrate to other potential investors that investments in specific activities can be undertaken profitably in the NIS.

In addition, an important element of the Enterprise Fund concept is to flag for the host governments and the private sector specific policy reforms which are needed to make private investment profitable.

B. The Enterprise Fund Concept

Enterprise Funds are investment organizations financed with USG capital. Enterprise Funds currently exist in Eastern Europe: Hungary ($60 million), Poland ($240 million), the Czech and Slovak Federation ($65 million), and Bulgaria ($50 million). All Funds have their headquarters in the U.S. with offices in the capitals of the host country. A.I.D. also recently decided to establish a Fund for the Baltics.

Enterprise Funds, including those in the NIS, have three important characteristics that set them apart from traditional A.I.D. programs.

1. The Boards of Directors of the Funds, selected by the White House input from A.I.D. (including field Missions) and the State Department, and the management executives hired by the Board to run the Funds on a day-to-day basis, will be recruited from among top U.S. businesspersons and NIS experts. Host country persons of internationally recognized stature will also sit on the Board.

2. The Boards and management will have maximum flexibility in the manner in which the Funds are structured and in strategic and operating decisions. Following the principle that these types of decisions should be left to investment professionals, neither the USG nor the host government will have a role in strategic or operational decisions. Nonetheless, Fund management will abide by the guidelines and mandate that A.I.D. and the USG will incorporate in the Grant Agreement with each Fund (see Section C 2 below).

3. In line with the Freedom Support Act, the Enterprise Funds will not be bound by the traditional rules that govern U.S. assistance, with the exception of USG policies relating to, defense conversion/military assistance, the exportation of U.S.jobs/enterprise zones/labor practices (599), abortion, subsidiaries, conflict of interest and compensation (See Section IV B - H). In hiring staff, awarding contracts, and making investment decisions, Fund managers will follow accepted business norms and due diligence, but they will not be subject to government regulations other than those noted above, which might slow down and/or impair their investment decisions.

The EFs will be registered in the U.S. as non-profit corporations. Non-profit means that the Funds do not distribute dividends to members. Profits generated by the Enterprise Funds will be retained and reinvested in new projects, subject to the sunset and wind-down provisions which will be detailed in the Grant Agreement.[3] As a matter of operating philosophy, however, the

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[3] A termination date for the Funds will occur no earlier than ten years and no later than 15 years from incorporation. Timing of the Funds' termination will be based on progress made in the host country in creating a local private sector and financial institutions capable of supporting private enterprises, along with the success of the Funds in meeting their specific objectives. A liquidation plan will be drawn up two years prior to termination to allow for the orderly liquidation of all Fund assets.

Funds will be run as investment corporations and will generally be expected to make a reasonable return on investments.

The Enterprise Funds will have offices in Washington and in the host country. For example, the Russia office will be located in Moscow and the office for the Ukraine fund in Kiev. The management of the Russia Fund will give consideration to opening other regional offices when Fund operations so justify. Based on the Eastern European experience, it is likely that the Chief Executive Officer (CEO) of each Fund and a support staff of 8-10, including investment analysts, will initially be based in Washington (by being in the U.S., the CEOs of the EFs can stay in touch with U.S. capital markets, U.S. businesses, A.I.D., the Congress and other Fund stakeholders). A staff of about 8-10 professionals will likely be placed in the field, headed by a senior managing director. The exact structure and staffing requirements of each Fund will be determined by Fund management. Overhead and all administrative expenses will be financed from a line item in the grant budget until the Funds begin to turn a profit. Once the Funds are profitable, salaries and incentive payments will be drawn from the profits and not from investment or working capital. The specifics of this will be set forth and detailed in the Grant Agreement.

The Fund's field management director should be a U.S. citizen with extensive business experience, preferably in the specific NIS republic and who, if at all possible, is fluent in the local language. Although institution building is not a program objective, Fund management should employ and develop local staff for the Fund from the start of operations. Local staff know indigenous business and political contacts and how to surmount administrative obstacles.

Each Enterprise Fund will have a Board comprised of approximately 7 U.S. citizens and up to six citizens from the host country. Section V. A provides additional information on the Boards and guidelines for the selection process.

C. <u>Guidelines for Enterprise Fund Activities and Investment Policies</u>

1. Enterprise Fund Activities

<u>A. Transactions</u>

The EFs will support a number of private sector transactions in its respective countries. The exact nature of these transactions will be determined by the Boards and management once selected. Transactions are likely to fall into two general categories: loan programs and equity/venture capital programs. Many transactions will cover the gamut of possibilities between the two, e.g., convertible debentures, a combination of equity and loan capital, etc.

Loan programs could, perhaps, be undertaken directly by the Enterprise Fund (through perhaps a subsidiary) or through existing commercial banks. Despite the considerable weakness of the financial system in the NIS, the experience of EFs in Eastern Europe suggests that the financial sector is one area where transactional activities can support significant change in policies and procedures well beyond the specific transactions financed. The Board of Directors and management of the NIS EFs should pay special attention to opportunities to make a significant contribution to initial steps in developing the financial sector.

There are several options available to Fund management. Implementing a small loan window through banks as has been done in Poland and Hungary is an option that should be strongly considered.[4] Likewise, Fund management may wish to consider taking a minority equity position in one of the dynamic young banks that lack adequate capital.

The EFs will also take equity participation in promising emerging private sector companies, including newly privatized enterprises and those related to defense conversion. Equity participation will permit the Funds not only to provide capital to these firms, but also to form a strategic partnership that will enhance the success of these firms and demonstrate the impact of sound business practices. As a general rule, the Funds will not take controlling positions in firms. Fund management will develop

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[4] In Poland, the Fund's lending subsidiary works with nine Polish banks for small business lending. Three to five officers from each bank are seconded to work exclusively on these lines (some of these officers were actually hired by the Fund). The Fund provides all the capital but the banks share in 50% of the risk. According to several sources, this is the first time that Polish "bankers" have really had to perform as true bankers. The Fund developed a very lengthy 20-plus page application form which, although bureaucratic, essentially forces the potential borrower to develop a business plan (looking at cash flows, sales growth, etc.). Many potential borrowers discover in this process that they cannot afford a loan. Even entrepreneurs rejected for loans have expressed a positive learning experience from the application process. And many bankers discover that what looked like an attractive loan was more likely to result in default. Most of the banks are now using this application for all their loans and others are requiring business plans that include all requested applications. The application was developed by the South Shore Chicago Bank which provides technical assistance to the Fund.

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exit strategies for equity investments that enhance the business environment in their respective countries, i.e., through capital markets, bringing in a U.S. investor, etc, as well as from investments that are not earning an appropriate return.

An important issue with respect to the types of activities that the Funds will support is the mix between retail (direct lending, equity participation in individual companies, including a wholly-owned bank) and wholesale operations (credit windows through commercial banks, subsidiary organizations for different types of investments, including subsidiary joint ventures with co-financiers). As a general rule, wholesale activities may have a greater impact to the extent that they can reach more clients and may, therefore, be preferable. Many wholesale operations may not be possible in the NIS, however. While it may be possible to work with one or two banks, for example, it may not be possible to establish--at least over the short-run--a broad credit program such as in Poland. To the extent that it may be more difficult to undertake wholesale type activities, there will exist a greater burden to ensure that individual transactions have a strong demonstration effect.

B. Technical Assistance

The Funds will also provide technical assistance to support Fund investments directly, but not as a general program of technical assistance. Technical assistance costs will be managed from a separate source of funds other than the Fund's investment capital to ensure the transparency of technical assistance costs to enterprises. As a general rule, however, the costs (or at least some portion thereof) of technical assistance will be passed on to clients through loan fees and other mechanisms to ensure that the technical assistance provided is necessary and valued by the participating enterprises.

Many firms in the NIS will require considerable technical assistance. Fund management will be alert to the risk, however, that high technical assistance costs will mask intrinsically high start-up costs in certain investments and make the investments appear profitable when they may not be--at least to other firms that may not receive subsidized technical assistance.

The Funds will coordinate all technical assistance with A.I.D. as described in Section VI below.

C. Policy Reform

In policy analysis, the Fund will be in a position through its transactions to highlight for the host public sector, the private sector, and A.I.D., specific policies and regulations that are undermining or hampering successful business practices. This

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process may be formalized through periodic joint meetings (preferably on a semi-annual basis) between the Fund, A.I.D., and the host government.

2. Investment Policy and Criteria

Fund management will abide by the following investment criteria.

a. *Target Group*. While the Funds will not have rigid criteria for its target group, Fund clients will generally be firms in the 100 to 1,000[5] employee size which cover most definitions developed for the NIS of "small" and "medium" scale business. Assistance to smaller firms will be made if commercially justified and an important demonstration effect will result. Assistance to larger enterprises may also be undertaken if, again, it is in line with the demonstration effect principle and consistent with the diversification criteria noted below. The Funds will focus its investments on transactions that:

-- increase employment, directly or indirectly;
-- develop capital markets;
-- generate foreign exchange
-- encourage foreign investment, particularly investment by U.S. businesses; and,
-- assist the privatization and defense conversion programs.

b. *Demonstration Effect*. The sheer size and diversity of the NIS Republics, particularly Russia, suggests that individual transactions will only have a development impact if they have an important demonstration or other systematic effects which must justify the investment (e.g., assisting a private mortgage bank participation in the housing sector). It is this demonstration/policy-reform-highlighting effect which will be the which could demonstrate the potential of private sector key to the viability of the Enterprise Funds and the source of a powerful "multiplier effect" which is deemed far more important than the provision of capital. EF management will take into account this

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[5]The definition of "small" business in Eastern Europe, as in the case of the NIS is more comprehensive than that used in traditional A.I.D. programs given the stage of development -- at least in industrial capacity-- of the countries of the former communist block. The SBA definition of less than 500 workers and $5-7 million in gross sales per annum would cover the range of small businesses with which the Enterprise Funds are likely to work. Medium-size businesses will be defined as enterprises that have greater than 500 workers, but less than 1,000 and $10-14 million in gross sales per annum.

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demonstration/multiplier effect in making all investments and in providing technical assistance.

c. *Diversification*. Fund investments will be diversified across sectors, size of investment, and level of risk. To have the greatest impact and to minimize investment risk, the Fund will diversify its investments across different sectors. Likely sectors for Fund investment include natural resources, food processing, housing, manufacturing, privatization activities related to defense conversion, and services.

1. *Size*. The Funds' mandate of reaching a wide array of firms requires that no more than 10 percent of total capital (equity and debt) be invested in any one venture. As a general rule, investments are likely to fall in the $500,000 to $1,500,000 range for equity. Loans are likely to fall in the $50,000 to $500,000 range. This target range may change over time as the Funds gain greater experience in operating in the NIS.

2. *Risk*. The Fund's portfolio will include an investment with a range of risks--including "high risk-high reward" as well as a select few of cash generators that provide a current return and help provide financial viability for the Fund and permit the Fund to finance longer-term and riskier enterprises that are nonetheless financially attractive. The Funds will be leaders in investing in middle market companies that most other investors will find too risky to finance because of unproven track records and the fluid political and economic environment in the NIS. By demonstrating the viability of lending to these enterprises, the Fund will, over time, reduce the perceived risk of investment in the NIS Republics.

3. *Regional Diversification*. A mandate for regional diversification is not initially contemplated. Whether Funds should be concentrated in select areas or diversified across a broader range of areas will be determined by Fund management and will be discussed with A.I.D. following the first annual review (see Section VI below).

4. *Consistency with Market Principles*. There is a possibility that serious microeconomic policy distortions will provide windows for investments that are profitable only because such policy distortions exist. For example, a manufacturing investment involving an energy-intensive process may be feasible only if host country energy prices continue to be a fraction of world market levels. Such investments, which subtract from, rather than add to, real national income, are to be avoided.

D. *Leveraging*

EF management will leverage USG resources to the maximum extent possible. As a general rule, the Funds will only take a minority position in enterprises in which they invest, thereby requiring a majority contribution from the host country entrepreneurs that are being supported or other joint venture partners. The Funds will also raise additional private capital at the earliest opportunity that Fund management finds prudent.

E. *Other Criteria*

Additional criteria with respect to defense conversion, environmental, Section 599, subsidiaries, conflict of interest and compensation concerns are addressed in Section IV B - H below.

3. **Expected Accomplishments**

Since Fund management will make the ultimate decisions about the Fund's programs, it is not possible at this time to define specific quantitative measures of Project accomplishments. Based on the criteria described above, however, successful project implementation will be characterized by:

-- the successful establishment of a wide-array of firms across the different sectors of the host country economies;

-- investment by other private companies in sectors where the Enterprise Fund took an initial lead;

-- the completion of a wide array of transactions that broaden and deepen financial markets in the specific NIS republics; and,

-- development by the Fund of a number of key joint ventures between U.S. and NIS private companies.

The Funds, however, will be asked to define their objectives in a "goal statement" and will be asked to establish benchmarks.

III. PROPOSED LIFE OF PROJECT AND PROJECT FUNDING

A. **Life of Project**

The Enterprise Fund Project will have a life-of-project funding of $400 million, based on the availability of funds and the pace of policy reform in specific republics. The two initial Enterprise Funds will be established in Russia and Ukraine with a preliminary life of project period of four years. It must be emphasized, however, that the USG sees the development of the EFs as a long-term effort that will require an implementation period of approximately 10-15 years, which is estimated to be a reasonable period of time to fully develop the program in the NIS republics. At the end of the ten-year period, all original capital and returns on capital will be returned to the USG or distributed to a non-profit entity to continue to assist the beneficiary country or some combination of both.

B. Funding

Cost Estimates for Initial Obligations
($000) FY 1993

	Ukraine	Russia	Total
Capital Investment	$12,500	$45,250	$57,750
Technical Assistance	$2,000	$4,750	$ 6,750
Evaluation/Audit			500
	------	------	------
TOTAL	$14,500	$50,000	$65,000

The foregoing represents preliminary cost estimates for FY 1993 set forth for illustrative purposes. Based on recent developments, these cost estimates will be modified to reflect (i) the Congressional hold placed on the funds for the Ukraine, (ii) the increased commitment of funds to privatization initiatives from FY 1993 funds previously targeted for Enterprise Funds in Russia and the Ukraine, respectively, and (iii) a $2 million contribution from FY 1993 funds for the Russian-American Enterprise Fund to a multilateral enterprise fund to be supervised by the European Bank for Reconstruction and Development, which is presently subject to a Congressional hold. Disbursement of funds to both Ukraine and Russia will be tranched. Disbursements will depend on financing needs and a periodic review by A.I.D./State of the policy environment in each Republic.

Despite the weakness of the policy environment in the NIS (see Section IV A below), it is the opinion of the project committee that demand for Enterprise Fund transactions will far exceed the proposed funding. This assessment is based on discussions with government and private sector representatives in the NIS, a review of the costs related to privatization transactions in the NIS, and the operating requirements of small- and medium-scale businesses.

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IV. PROGRAM ISSUES

A. Policy Environment

The greatest concern regarding the establishment of Enterprise Funds in the NIS is that the policy and institutional environment may not be ready to support a transactional setting such as that associated with Enterprise Funds, i.e., can you support enough successful "deals" to warrant the costs and efforts of a Fund?

Progress in the policy reform and business institutional front has been made in the course of the last few years. In particular, groundwork has been laid to assist private small businesses and the privatization program continues to move forward. Although implementing legislation is needed and there are many gaps, groundwork has been laid by establishing numerous laws that are necessary to conduct stable business practices, e.g., anti-monopoly laws, bankruptcy, foreign investment. Institutionally, there has been an explosion of new banks in Russia, although most are undercapitalized and small. More recently, there have been several joint ventures banks with foreign partners which should help to improve the financial system.

The progress that has been made aside, there is no doubt that the policy and institutional environment in Russia and Ukraine is extremely weak. Moreover, in Russia there have been slippages in the reform process in recent months due to political changes and growing conservative pressures.

The USG recognizes that the development of the Enterprise Funds in this context represents a calculated risk. This risk is taken with the understanding that transactions and policy reform go hand in hand, and indeed, that prudently selected, investment transactions contribute directly and provide support necessary for policy and economic reform. The two are not mutually exclusive. It is also made with the assumption that the reforms that are going forward at this time, e.g., privatization, are providing a base sufficient to support investment transactions. The policy environment will continue to be monitored closely by the USG and will be an important criteria in all future funding considerations.

B. Criteria for Defense conversion: Assistance provided to Enterprise Funds may be used to support defense conversion but shall not be used to support production of weapons or final components of weapons. The A.I.D. grant to the Enterprise Funds will specify the criteria to be followed for investments, loans, technical assistance or other forms of assistance, for defense conversion activities. The Funds will be responsible for demonstrating compliance with these requirements.

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C. Environmental Criteria: The Enterprise Funds have a categorical exclusion from Section 216 requirements. Nevertheless, the Enterprise Funds will be required to develop their own environmental guidelines based on A.I.D. regulations, host country regulations, and appropriate international regulations. Compliance shall constitute substantial conformity with agreed-upon internationally accepted environmental standards and with the expectation of responsibility embodied in Section 216 toward activities whose environmental consequences are significant. Investments and loans that involve significant natural resource utilization shall occur only where designed in order to minimize resource depletion and maximize ecological sustainability. Enterprise Funds shall be encouraged to invest in, and lend to, economically sound activities that improve environmental health and reduce industrial process and energy waste, and to incorporate these principles to the extent feasible, when they support ongoing enterprises. Enterprise Funds shall monitor environmental implications and consequences of their activities, and shall report on these on an annual basis. Environmental soundness of Enterprise Funds operations will be reviewed and approved by the Enterprise Fund Board and A.I.D.. Moreover, A.I.D. will monitor compliance through normal semi-annual and annual reviews and mid-term and final project audit and evaluation procedures. To advance these goals, Enterprise Funds board and managers shall be encouraged to include members experienced in environmentally-sound investment and business matters and may also access the technical assistance fund.

D. 599: The Enterprise Funds will also comply with Section 599 of the Appropriations Act. Specifically, the Funds may not invest, grant, loan or provide other forms of assistance to business enterprises currently located in the U.S. for purposes of inducing such an enterprise to relocate outside the U.S. Furthermore, the Funds may not invest, grant, loan or provide any other assistance for purposes of establishing or developing any export processing zone. Finally, the Funds may not provide assistance for any project or activity that contributes to the violation of internationally recognized workers rights. The A.I.D. grant to the Funds will specify the details to be followed so as to comply with Section 599 of the Appropriations Act.

E. Abortion: The Enterprise Funds will also abide by the statutes governing foreign assistance that prohibits the use funds for abortions, involuntary sterilizations, coercion of abortions or involuntary sterilizations, biomedical research on abortions and involuntary sterilizations as a method of family planning.

F. Subsidiaries: A.I.D. will review and approve all spin-off ventures Funds, banks, or other subsidiaries of the Funds, including compensation and incentive payments. Such spin-off Funds will operate within the same guidelines and principles to which the parent Fund must adhere, including transparency of personnel selection processes.

G. Conflict of Interest: Disclosure of conflicts and potential conflicts of interest will be required. If any officer, director, or spouse/children of an officer or director has an interest in an entity negotiation or transacting business with the Fund, a letter will be submitted to the Board of Directors explaining the nature of the potential conflict. The officer or director with the possible conflict will be recused from participating in any part of the negotiations or transactions between the Fund and the entity.

H. Compensation: Salaries, but not incentive payments, will be funded through a line item in the grant budget until the Funds begin to turn a profit. Once the Funds are profitable, salaries and incentive payments will be drawn from the profits and not from investment or working capital. In all cases, incentive payments will be based exclusively on performance, and will not be paid from initial capitalization. In addition, salaries of employees of the Enterprise Funds or subsidiaries will be based on a five-year salary history. Notwithstanding this criterion, A.I.D. approval is required on the Funds' policies regarding executive salaries and incentive compensations and in any subsidiary venture funds or banks that bring in Americans and establish their salaries and other compensation.

I. Cash Management: The Enterprise Fund Project will adhere to A.I.D.'s cash management policies which will be spelled out specifically in the grant agreements. A.I.D. and the Enterprise Funds will work closely together to adopt guidelines that are of mutual agreement and assure effective management of the U.S. Governments's cash. Further, A.I.D. will oversee the cash management practices of the Funds to ensure that federal cash is not maintained in excess of immediate disbursing needs. Finally, A.I.D. will require the Funds to implement a system of cash reporting which will permit A.I.D. to monitor the adequacy of the Funds' cash position throughout the life of the project.

V. PROGRAM IMPLEMENTATION

A. Selection of the Boards

The men and women selected by the USG to oversee the Funds, and the people that these Boards select to run the Funds on a day-to-day basis will be an important factor in project success. Accordingly, selection of the Boards is an important agenda item to be undertaken by the USG.

U.S. members of the Boards will be selected by the President of the United States. The Department of State and A.I.D. will provide a list of candidates to the President shortly after the project is authorized. While Presidential appointment may delay

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selection somewhat, it gives Board members the prestige necessary to attract top-notch talent. Based on the experience of several of the Eastern European Funds, it is recommended that the President of the Board be selected first and that this individual have an opportunity to identify and approve other members with which he/she can develop a productive relationship. It is anticipated that the Board will operate on a pro bono basis but will be reimbursed for expenses incurred in attending Board meetings.

Board members should have a diverse set of business experience. In particular, representatives from the investment banking, venture capital, commercial banking, and non-financial institutions should be represented. This diversity will ensure that the Funds' operations also take into consideration diverse approaches to business development. While international political and NIS-specific political experience is useful, the Boards should be comprised of diverse mix of men/women. Moreover, it should be balanced geographically, politically, and broadly representative of the U.S. interests in the NIS. An important criteria in the selection process, particularly for the Chairman of the Board, is that the individual be known to the NIS business and public sectors and that he/she can command the attention of NIS leadership when so required.

B. Incorporation and Subsequent Steps

As soon as the U.S. Boards are named, the first action item will be for them to incorporate the Funds and submit a proposal to A.I.D., thereby enabling A.I.D. to sign a grant agreement. Concurrently or shortly-thereafter, the members of the Boards, working closely with State and A.I.D., will select the representatives of the local boards. These should include one or two business leaders. The proliferation of competing business groups in the NIS republics suggests that extreme care must be taken to ensure that the local members are representative of the business community. U.S. members of the Board may wish to consider shifting or rotating membership of host country representatives to lessen the possibilities of conflicts of interests which are likely to arise in the NIS context. Public sector officials that strongly support the reform process should not be excluded.

Finally, a managing team will be hired to handle day-to-day activities. The senior directors of the managing team will be drawn from the U.S. business community and represent strong managers with extensive practical experience. The remainder of the management team will be composed of a mix between American and local employees. It will be a goal to reduce the percentage of Americans in top management positions as quickly as practicable and replace them with host country nationals.

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VI. IMPLEMENTATION DETAILS

* **Monitoring:** The Funds will develop their own mechanism for monitoring investments on a continuing basis, taking into account the means by which private U.S. venture capital companies and institutional investors monitor offshore investments. The Funds will develop appropriate means of monitoring the provision of grants, technical assistance and other forms of assistance.

The Funds will also publish annual reports which will include comprehensive and detailed descriptions of the operations, activities, financial conditions and the Funds' progress in meeting agreed upon objectives for each preceding fiscal year. The Funds will report on all items required for compliance with the SEED and FSA.

The A.I.D. grant to the Enterprise Funds will specify the nature and format for required consultations with, and reports to, A.I.D. The following are recommended to be included in the grant: The Funds will provide reports on a) the rate of commitment and utilization of grant funds; b) performance of investment portfolio; c) use of technical assistance funds; d) progress towards self-sustainability of the Funds; e) overhead analysis; f) cash flow analysis including investment income reflows and, g) salaries and related compensation for employees working for the Fund and its subsidiaries. All technical assistance provided by the Funds to the host governments must be approved by A.I.D.Thereafter, Enterprise Funds and A.I.D. will conduct semi-annual and annual reviews with the A.I.D. Mission in the respective country of operation and/or A.I.D. Washington.

* **Evaluation:** Based on the annual reports, the annual and semi-annual reviews meetings, A.I.D.'s ongoing discussions of the macroeconomic policy environment, and information derived from audits (see below), A.I.D. will review the effectiveness of the Funds before making any additional obligations to the organizations. A comprehensive A.I.D. evaluation of the Enterprise Funds will be conducted after three years of operation. This evaluation will focus on progress toward the "expected accomplishments" detailed in Sections II-C-3. It will also assess performance against the policies and criteria in Section II-C-2.

* **Audit:** Each Fund's activities will be subject to audit by representatives of the General Accounting Office and A.I.D.'s Inspector General, and will be audited annually by an independent accounting firm. A.I.D. will not impose federal allowable cost standards (OMB Circular A-122) but will encourage the Funds to use these standards as a guide in developing their operating policies and procedures. The Funds will develop cost standards in their policies and procedures and will submit these to A.I.D. in anticipation of the grant. The Grant Provisions incorporate the policies by reference and require revisions to be mutually agreed

upon by A.I.D. and the grantees. The audit will be conducted on compliance with the grant terms and policies.

VII. RISK ANALYSIS

A. Decapitalization and Hyperinflation - the uncertain and abnormally high rates of inflation (estimates are as high as 1500% for 1992) have raised concerns of any capital initially provided becoming significantly devalued, due to negative real rates of financial returns and exchange devaluation. Returns put back into the Fund, could suffer continuous real losses under these circumstances.

The probability for hyperinflation will be very high and perhaps unavoidable during the initial stages of implementation of these funds. However, as governments follow the fiscal and monetary policies which they are developing with the World Bank and IMF, the high rates of inflation could be significantly under control in 18 - 24 months. As reform moves forward the prospects for lower inflation rates and financial stability becomes greater.

> Assessment: The main objective of the EFs is to foster long-term private sector development. Investments financed under the project will be subject to vigorous tests of market viability and should therefore be contributing to rational economic restructuring.
>
> Moreover, it is likely that the EFs will seek to invest in domestic assets viewed as productive and/or in short supply. These assets should appreciate at the same or greater rate than that of existing inflation. Thus the EF's equity and capital invested in selective assets should march at the same pace as domestic inflation, thereby protecting the EF's capital investment. It will be important to avoid holding long-term substantial ruble cash accounts in the NIS. Obviously this would decapitalize the EFs.
>
> Finally, if the assumption that progress towards stability will continue proves to be wrong, and hyper-inflation takes over, this (along with most other) projects will have to be re-appraised.

B. Demand - Can the Russian and Ukrainian markets effectively absorb the capital invested by the EF? Is there a demand for the funds?

> Assessment: Mass privatization efforts are underway throughout Russia. Almost 47,000 retail enterprises have already been privatized and an estimated 20,000 medium and large enterprises are expected to be privatized over the next three years. In order for there to be incentives for enterprises to go through the privatization process, they must

be given some hope of assistance once privatization is complete. All sectors at every stage of product development will be privatized to meet the supply and demand needs of a market driven economy. This will open up supply and distribution channels and create competition among companies, leading to the most efficient use of resources. The newly privatized companies will be seeking urgently needed capital to upgrade facilities. Furthermore, the enterprises will be in need of technical assistance, technology upgrades, and management skills transfers to cultivate a profitable venture. The Enterprise Funds provide such a mechanism and can offer the management guidance to increase the potential for success.

Studies conducted by the World Bank have determined that the Russian needs $23 billion a year in savings to finance the investments needed for restructuring. The Enterprise Funds can be a catalyst in bridging the large gap between savings and investment requirements and they can help stimulate the private sector to investment in multiples of the EF's financing.

C. Banking System and Financial Institutions - With the reduction of state control, the emergence of small, undercapitalized banks in the Russian Federation has resulted. Many of these small banks are owned and operated by enterprises and collectives whose objectives are to have their projects financed at uneconomic interest rates. This has resulted in preferential treatment made to select enterprises, regardless of the enterprises' ability to generate cash flow for loan payments; thus many of the outstanding loans are in default. Currently, resources are misallocated and banks are becoming insolvent. Non-performing loans are preventing the financial stabilization necessary for successful transition to a market driven economy. The financial sector lacks the technical know-how to assess the potential profitability of existing enterprises and new ventures to support the activities of the financial institution; the system must be redesigned to support the productive sector. The World Bank stresses the importance of this issue: "the emerging private sector together with the more productive state-owned enterprises will require enhanced financial services ranging from the provision of a payments system that facilitates trading to the screening of loan applications and the monitoring of firms' performance. Thus, fostering the development of some financial institutions providing high quality financial services and behaving in a prudent manner should be a major objective."[6]

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[6] Russian Economic Reform: Crossing the Threshold of Structural Change; World Bank 1992:10

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<u>Assessment:</u> To overcome the present banking practices of loaning to unsound enterprises incentives need to be provided for banks to conform to international banking standards. The World Bank has proposed to establish an International Banking Standards (IBS) program that would institute a series of standards a bank must meet and would set up benefits for the banks meeting the requirements. These benefits include: recognition of being an IBS, attracting the public to a "safe" bank; lower discount rate when borrowing from the Central Bank; interest on reserves; direct access to the payments system; and lower premiums for deposit insurance. These extra privileges are aimed at reforming many of the nearly defunct banks and demonstrating that "common" banking procedures can be applied, and result in a profitable and stable bank. The IBS program is part of a World Bank financial sector loan which is still being developed.

The Enterprise Funds could be an appropriate mechanism to demonstrate the financial skills necessary for loan analysis and portfolio management, while aiding the institutions to meet the high set of financial standards established under the IBS program. As the EFs move into lending, the Board may decide to work with newly created banks (as in the case of Poland) to demonstrate proper banking techniques: portfolio management, cash flow analysis, net present value assessment and ratio analysis - all skills necessary in loan processing. As these tools are applied and learned, they can be used in subsequent loan applications to enhance the financial positions of the banks. The Enterprise Funds can demonstrate to several banks these techniques, providing for a few stable financial institutions - while also with meeting the criteria of the IBS program when it comes into place. Stable institutions are in a better position to attract capital and continue the cycle of dispensing productive loans. Overall, the EFs are one potential vehicle in laying a foundation for building a modern private financial system.

D. **Interest Rate Policy** - The interest rate environment ties in closely with hyperinflation and the overall banking system. The uncertainty of inflation has led to great uncertainty as to the appropriate interest rates. The interest rates are such that they are too low to attract savings, thereby curtailing any chance for the banking system to make new loans. However, a few elite enterprises are given loans at low rates - so low in fact, the financing does not cover the cost of the loan. In contrast, small and independent enterprises are fortuitous to receive loans at high rates and short time periods - long term credit is virtually non-existent.

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Assessment: To overcome these obstacles, differing interest rate policies can be developed and demonstrated to the respective financial institutions. For instance, the Enterprise Funds could index interest rates to an inflation index and create floating rate. An equitable interest rate can be attained by tying the interest rates to a hard currency, but denominated in the ruble. Business development could be further encouraged by providing long-term credit that is structured in such a way that the bulk of the payments are repaid near the end of the term. Enterprises can then recycle initial cash flows back into the business and make repayments when in a better financial position. These and other innovative techniques can be used to circumvent some of the problems associated with high interest rates. By instituting some of these applications through the financial institutions, know-how can be transferred and replicated.

At this stage, none of these alternative interest rate policies have been discussed with the central banks in either Russia or Ukraine. Hence while the policies may contribute to the financial viability of the Enterprise Funds, there is no guarantee that they will be authorized by the relevant banking authorities. Once the Boards are established for the Enterprise Funds, A.I.D. will seek their recommendations on policy measures that should be negotiated with NIS host governments. To the extent that such policies cannot be pursued, the Enterprise Funds will need to either modify their financial strategies, or reduce the capital available for loans.

E. Business Risk - Common to any venture is the uncertainty of success. Russian and Ukrainian enterprises are more susceptible than most - particularly due to the lack of business management abilities. In the United States, the number one cause of bankruptcy is lack of adequate cash flow.

Assessment: In many instances the business may be profitable on paper, but lacks the cash flow to carry the business through periods of slow cash inflow - usually at the initial stages of operation. The solution is to acquire financing to cover these deficit periods and pay back during periods of surplus. The EF would be one mechanism to finance the start up phases of viable operations and reduce the chances of failure.

The management unit of the EF will represent experienced U.S. businesspersons. This management unit will be highly qualified in assessing those business plans which possess the greatest potential for success. Furthermore, a diversified portfolio of investments will be encouraged to balance strong, high cash generating activities with those that show great potential, but require long-term development to recouping

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initial investment. The management team will work actively with the selected enterprises in providing management oversight to further ensure the success of the companies. In addition, the experience of the managing unit will enable them to apply innovative and creative financing techniques in maximizing the impact of the EFs.

F. Impact of USG money on Russia and Ukraine - The question has been raised as to whether or not the amount of these funds is too little to have any impact on improving the Russian economy.

Assessment: The EFs are one of many tools to be applied in meeting the great capital demands of Russia and Ukraine. A.I.D.'s private sector portfolio includes assistance in privatization, trade and investment, small business and agribusiness. It also supports activities in economic restructuring. OPIC provides political risk insurance and financing for U.S. investments and ERBD plans on providing similar assistance. Department of Commerce and Peace Corps are also active in the promotion of private sector in the NIS. In addition, the World Bank is providing assistance in the privatization efforts to aid private sector development. Pooled together, these activities will provide not only considerable economic support, but also enhance the perception that the West is backing reform and is willing to provide the capital that is so necessary.

The EFs will take the lead in demonstrating the viability of business opportunities in Russia and Ukraine. Currently, many businesses are skeptical and unwilling to take the large risk associated with the environment of the NIS regions. As success stories become apparent and the western governments confirm their commitment to NIS reform, other private industries will be stimulated to establish a presence in the large, untapped markets of Russia and Ukraine.

G. Policy environment - The current Russian policy environment is not overly supportive of foreign investment and private sector activities. An activity of this sort may be too early to implement given the policy constraints. The success or failure of the Eastern European Enterprise Funds, which was faced with many of the same regulatory obstacles as Russia, is indicative of the ability of the Russian Fund to meet its objective of fostering private sector development.

Assessment: Based on the ongoing experience of the Eastern European Enterprise Funds, there is a general consensus among independent businessmen, A.I.D. staff, and other donors that the funds are meeting their objectives of catalyzing private sector investment and enhancing overall business development. It appears that the EFs are prudently taking advantage of

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their independence from normal A.I.D. regulations. Fund management has been able to organize and restructure functions as required by circumstances in their respective working environment (e.g., establishing separate finance and venture capital subsidiaries, establishing a mortgage bank in Poland when other options to support the housing sector were not advisable), and have an investment portfolio in diverse enterprises. Thus, the EF's management team has been effective in developing innovative approaches to providing capital assistance and circumventing the restraining policy environment.

The EFs play an important role by providing badly needed term loan and/or equity capital. In Poland, for example, the Fund is having a positive impact by being a major player in some sectors. With a portfolio of over $25 million, the credit subsidiary of the Polish Fund is reportedly the second largest lender to small business in Poland (over 1,600 loans for medium- to long-term capital have been made) and perhaps the most influential in terms of the impact it has had on how the small- and medium-scale business market is now serviced.

The benefits of the EFs, however, go beyond the provision of capital. As in any developing country, people in Poland, Hungary, and elsewhere frequently point to the dearth of capital as a critical problem. In most cases the shortage of capital is in fact a major development constraint. But the key constraint is not only a shortage of capital per se, but a paucity of business experience and know-how. The provision of that experience and know-how appears to be the greatest contribution of the EFs in Eastern Europe. As reported by a wide range of sources, including numerous independent businessmen, the Polish fund's small business credit program is having an impact that extends beyond the provision of capital by providing a valuable model of efficient credit analysis that is being replicated throughout Poland. The EFs in all four countries (Poland, Hungary, Czech/Slovakia and Bulgaria) where programs have been initiated for more than a year are playing important roles as incubators of businesses and of western business practices that is very important in forging private enterprise in their respective economies. The EFs are also very valuable politically. They are extremely visible and, despite their arms length relationship with A.I.D., they reportedly generate good will for the USG. They are very highly regarded by host countries who value their ability to make an immediate investment impact in their economies.

The apparent success of the Eastern European Enterprise Fund model is tempered by the fact that the Funds are relatively new and, in many ways, untested. Moreover, the NIS Enterprise Funds will need to contend with a much more unstable financial environment than ever existed in Eastern Europe. The Eastern European Funds have not existed long enough to test their financial performance as successful venture capital firms. Fund staff are the first to admit that they do not have a clear strategy for divestiture of their holdings. They site the local stock markets as possible future vehicles for resale of their investments. But they recognize that stock markets in Eastern Europe and the NIS are unlikely to be viable for selling minority share holding of small- and medium-scale enterprises in the near future.

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INITIAL ENVIRONMENTAL EXAMINATION

(A)	PROGRAM COUNTRY:	New Independent States Regional
(B)	ACTIVITY:	Enterprise Funds Project (No. 110-0011)
(C)	FUNDING:	$400 million
(D)	PERIOD OF FUNDING:	FY 1993 - FY 1996
(E)	STATEMENT PREPARED BY:	L. Mailloux, Project Officer NIS/TF/PSI
(F)	RECOMMENDED ENVIRONMENTAL ACTION:	Negative Determination under AID Environmental Procedures (22 CFR 216), granting a categorical exclusion under Section 216.2 (c)(1)(ii).
(G)	DECISION OF DIRECTOR NIS/TF:	Malcolm Smith Approved Disapproved AUG 11 1993 Date
(H)	DECISION OF NIS/TF ENVIRONMENTAL OFFICER:	[signature] Approved Disapproved 6/3/93 Date

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EXAMINATION OF THE NATURE, SCOPE AND MAGNITUDE OF THE ENVIRONMENTAL IMPACT OF THE ENTERPRISE FUND PROJECT (100-0011)

A. DESCRIPTION OF THE PROGRAM: The Enterprise Fund Project (100-0011) will encourage the development and expansion of small- and medium-size enterprises in the NIS by taking loan and equity positions in promising ventures. Once created, the Fund(s) will operate fully according to private sector principles, without operational oversight by the government. Investment provided by the Fund(s) will assist in the initiation and expansion of a wide array of private enterprises, promote and disseminate western business know-how and practices, and demonstrate to potential investors that investments can be undertaken profitably in Russia and Ukraine. In addition, the Fund(s) will flag for the host governments and the private sectors specific policy reforms needed to make private investment possible. The Enterprise Fund Project will have offices in the U.S. and in the appropriate host country(s).

B. RECOMMENDED ENVIRONMENTAL ACTION: A categorical exclusion is granted under Section 216.2 (c)(1)(ii) of the A.I.D. Environmental Procedures (22 CFR 216) on the basis that "A.I.D. does not have knowledge of or control over, and the objectives of A.I.D. in furnishing assistance does not require, either prior to approval of financing or prior to implementation of specific activities, knowledge of or control over the details of the specific activities that have an effect on the physical and natural environment for which financing is provided by A.I.D." However, in establishing the Funds, A.I.D. requests the following actions to be implemented by the funds:

1) The Funds are required to develop their own environmental guidelines, based on our regulations, host country regulations, and appropriate international regulations;

2) These guidelines will be reviewed and approved by the Board and A.I.D.;

3) That resources are available within the project to support staff, etc. to provide for the implementation of these guidelines;

4) A.I.D. will monitor compliance through normal mid-term and final project audit and evaluation procedures. Review of environmental compliance shall be written into the scopes-of-work for the evaluation teams.

Action Recommended: A Negative Determination under AID Environmental Procedures (22 CFR 216) is recommended, with the a categorical exclusion granted under Section 216.2 (c)(1)(ii).