



Investment Due Diligence

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Investment due diligence is a long and complex subject area in which advisers will want considerable support from providers.

The difference between standard and non-standard assets can sometimes be blurred, and it is only with careful questioning and responsive answers, that you can judge on whether or not to deal with a fund, a DFM or other private client service.

Flexibility vs. Responsibility

The advantage of bespoke portfolios is their flexibility in all things, most obviously in investment choice. However, with great flexibility should come great responsibility. In the area of non-standard investments, particularly UCIS and close substitutes, advisers, paraplanners and providers all have a responsibility (and an interest) to balance that flexibility with an effective means for conducting due diligence.

Good providers should support you in this.

Does It Affect Me?

A provider's approach is always relevant to advisers, even if you never recommend esoteric investments. Just because you don't, it doesn't mean that other advisers don't – or didn't. All advisers need to know how their chosen provider(s) conducts due diligence on investments, their adequacy and the provider's exposure to risky esoteric investments.

Investment risk is one thing...

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Non-standard assets bring a lot more risks than just the usual “may go down as well as up” investment risks. Despite the regulator’s moves to tackle abuses, concerns over poorly structured and down-right dishonest investment schemes persist. Promoters may be pushy, marketing materials very polished and the first you hear about it may be from a client who’s already very keen.

Best practice

This is too big a subject to give you chapter and verse. However, by sharing some best practices, our aim is to help you look at your own with a fresh pair of eyes. Whether your interest is in conducting due diligence on providers, filtering out certain types of investment or meeting the independence test, hopefully everyone has an interest.

Key concerns – general tests

Not unusual in our market, many advisers conduct a two-stage process, first using in-house experts then using external experts, for many non-standard investments. Below, we have not provided a distinction between in-house and external views. However, when you conduct any due diligence on providers, you may also need to take their external partners into account, particularly with SIPPs.

Investment type and details of the investment

To assess investments properly, it is necessary to obtain all the official information such as prospectuses, terms, application forms and online or offline marketing brochures. These will be the primary source for identifying many potential issues, some of which are covered below, so there should be no short-cuts in studying these.

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Background checks

These take many forms, some direct, some amounting to detective work. For example, we check alerts from UK and overseas regulatory authorities of investment scams. Checks also include the promoter's and investment provider's websites, internet searches and peer group experiences in online communities like LinkedIn, LifeTalk and Panacea Advisers.

General web searches can be revealing, whether about the investment itself or the history of companies and people involved in their promotion. Evidence of a company's history, of previous investments that have matured and payments made, may provide reassurance that the company will still be around when the investment in question is due to mature. Past involvement with failed investments, by contrast, is a clear warning sign.

Background checks are also important for unlisted shares, for example searches of Companies House, company accounts and directors' history. The FCA Register can also be enlightening on firms and individuals.

Is it UK-based or overseas?

Overseas investments may mean a different language and will introduce differences in the legal and tax systems. The cost involved in identifying and overcoming these obstacles may make overseas investments uneconomic – this is one of the reasons why direct investment in overseas property, while not against HMRC rules, is so infrequently seen in practice.

Certain jurisdictions are in themselves potential warning signals. For instance, Cyprus, or Malta, British Virgin Islands and, specifically places like the Cayman Islands, a well-known tax-haven and a concern would be that once money is transferred there it could disappear and then become untraceable. However the Panama Papers may help at <https://www.icij.org/investigations/panama-papers>

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Is the investor advised?

As you are aware, certain investments are only deemed suitable for high net worth individuals and sophisticated investors. So it may feel at times as if providers are peering over your shoulders or treading on your toes. However, a good standard to apply is the FSA's second Thematic Review of SIPPs which made it clear just how far they expect providers to go. The FCA expects checking individual permissions and, for non-standard investments, checking whether the adviser has actually advised on their suitability.

Many potential issues lurk below the surface of non-standard investments. Looking out for them in advance can prevent tax charges, claims of unsuitable advice or time-consuming problems.

Specific issues

Can it be held in the name of the trustees?

Not all countries recognise UK trust law. For example, the USA does but France doesn't. The FCA wish to see investments registered in the name, or jointly in the name, of the trustee. This may present a basic obstacle.

Will it result in holding taxable property?

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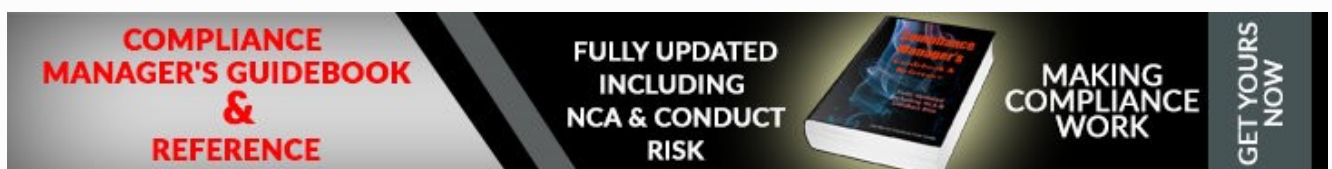
The investment literature states what your clients would be investing in and this is the main way for us to spot residential property, tangible moveable property or trading activity. Experience is invaluable as investment scenarios are innumerable and hence so are potential issues. By way of an example, investments in agricultural land or forestry are not by themselves problematic. However, if the investment means the fund holder owns and gains returns from the agricultural products from the land or from, say, cutting down the trees, the investor will be liable to tax charges.

Is it a UCIS (regardless of whether it is marketed as such)?

It is not unusual to see in the main text of sales brochures that investments are casually referred to as unit trusts when in fact they are UCIS. You may have to trawl the small print to find the statement that it is unregulated.

You may also need to read between the lines. If there are multiple investors and a manager who collects all the funds, the investment may be a UCIS even if it describes itself as, say, a property syndicate.

Remember, the FCA only deems UCIS potentially suitable for clients who are sophisticated investors or certified high net worth individuals, so ensure you record this and obtain an appropriate signed declaration etc. Advisers are not permitted to certificate a client, unless they are professionally qualified to do so.



<http://bit.ly/compmansguide>

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Valuation, liquidity and term

Some investments are difficult to value. For example, if a valuation of unlisted shares is required, you may have to obtain this from an independent accountant, which takes time and has a cost implication. If a pension client wants only a partial drawdown, say, it may be possible to segregate the unlisted shares and drawdown only on the value of easily valued assets, but only if the provider allows this.

Other investments are only valued periodically, many are quarterly. This may influence when a drawdown is conducted if, for example, the client expects the next valuation to show an increase.

In the case of multiple SIPP members jointly holding a direct investment in a commercial property, age differences may count when benefits come to be taken. While the costs of investing in and holding the property will be apportioned across the members, when one comes to take benefits the cost of a property valuation will typically fall on that member alone.

Some UCIS and close substitutes have a term, others don't. This needn't be an issue. More important is any lock-in period. For example, in the event of the member's death before taking benefits, lump sum death benefits must be paid out within 2 years of the date of death, but any lock-in period may exceed this. If the investment is transferable (not all are), the solution may be an in specie transfer, assuming the provider will facilitate it.

Other factors to consider are the existence of buy-back clauses (for example, background checks may reveal whether there is a previous history of these being honoured) and exit penalties, which may be severe.

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Issues in the area of valuation, liquidity and term may well bite at sensitive moments for your client such as when they want to take benefits, on serious ill health or on death. At the point of investing, your client may be convinced that none will apply to them but some will, unfortunately, be proven wrong. To help you put that in perspective for clients young and old, RoSPA/Department of Transport report that in 2013, 1,713 were killed in road accidents and Cancer Research UK report that in 2014, 447 people per day died of cancer in the UK alone.

What proportion of the fund is being invested in the asset?

Since administration fees and charges are usually paid from the fund, there may be a simple practical consideration to maintain an appropriate level of cash and liquid investments.

Some providers will place limits on the proportion of a fund that may be invested in certain non-standard assets.

Where, say, a provider has structured its SIPP as a contract of insurance, it will be governed by the permitted links regulations. This means it will allow a narrower range of investments and have much lower maxima for certain investments, which will be rigorously enforced.



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Is there any kick-back to the client?

These have been a feature of some non-standard investments and are, of course, unauthorised payments resulting in a likely tax charge. Consider employing a number of methods including checking the terms and conditions and application form and looking for discrepancies in valuations and simply asking.

Is that everything?

No! Two issues that have been reported as being involved in a property investment in the Caribbean are investments that are initially part-paid (which potentially creates a future liability for a SIPP fund may not be able to meet) and breaching the borrowing limits. But there are many others. There is always the most popular non-standard asset of all, commercial property.

Remember: *if it seems too good to be true, it probably is!*

Final thoughts

Make allowance for a “smell test” so that common sense can still prevent an investment going ahead. The best scams will pass the greatest number of prescribed tests but they may still be sniffed out. For example, a third party loan or investment in unlisted shares might be put forward where common sense asks “Why would anyone want to invest in this?”



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Where to draw the line is sometimes a purely subjective issue. Ensure you are comfortable with how your provider exercises its judgement and where they draw their limits. If they don't say no to things you reject, that is probably an excellent warning sign.

Finally, and perhaps most importantly, make sure you work with a provider that gives you excellent support in this complex area.

Avoiding danger shouldn't mean discarding all opportunity.

There are of course many conflicting feelings an adviser experiences when a client wants to do something you believe they shouldn't and your relationship is at stake. *Do the right thing: maintain the courage to turn down business when you need to.*



Investment Due Diligence

1. General Fund Information

- Full legal name and address of Fund.
- Legal and tax structure of Fund (diagram if available).
- Jurisdiction of Fund.
- Full legal name and address of General Partner/Manager.
- Primary Fund contact person and contact details (phone, fax and e-mail)
- Brief overview of history of organization including information on when and how founded, funds under management currently and an overview of all investing activities carried out by the firm.

2. Placement Agents

*A **placement agent** is an intermediary who raises capital for **investment funds**. A **placement agent** can range in size from a small one-person independent firm to a large division of a global **investment bank**.*

- Name all placement agents and advisors, including contact names, addresses, e-mail addresses, telephone and fax numbers.
- Describe the placement agreements, including compensation structure. Please indicate who will be responsible for payment of placement agent compensation, and how and when compensation will be paid.
- Nature of any affiliations between placement agent(s) and General Partner.

Remember to include Target Fund size including maximum (hard cap) and minimum target sizes, together with minimum and maximum size of individual LP commitments.

3. Fund Raising and Corporate Governance

- Total commitments received to date and, if available, the names, contact details and amount committed by each investor.
- Actual or anticipated first closing date.
- If applicable, details of investments made to date.
- Expected total number of closings and date of anticipated final closing. Details of provisions regarding the admission of additional investors after first closing.
- General Partners' commitment to the Fund.
- Executive commitment to Fund.
- Describe the Fund's policy for making distributions in cash or *in specie* and the method for calculating the carried interest for *in specie* distributions. Please state the prior history of *in specie* distributions.



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- Describe the Fund's policy regarding the reinvestment of undistributed realisations. If permitted, describe the time constraints.
- Is the Fund permitted to borrow other than for short-term working capital needs and, if so, within what limits?
- What is the expected life of the Fund? What is the process for extending its life? What is the investment period of the Fund? What about follow-on investments?
- Can the Fund invest in public securities? Indicate with what limitations and in what circumstances. Will the Fund be permitted to engage in hostile transactions?
- How will investment opportunities be allocated between concurrently active funds, if any? What will be the procedure for resolving any potential conflicts of interest between funds?
- Outline the conditions which have to be satisfied before the General Partner (GP) is permitted to devote time and resource to raising a subsequent fund.



4. Investment Strategy

- Describe the investment strategy of the Fund and what differentiates this strategy from the Fund's competitors.
- Explain the market opportunity and describe how the firm is equipped to address it.
- Describe the Fund's competitive edge in executing the investment strategy and in deal sourcing.
- Indicate how the stated strategy compares with that of prior funds.
- Provide a description of the Fund's competitive position relative to the market and other private equity funds. Also describe both the current and potential future developments that may have an impact on the Fund's competitive position.
- Explain the Fund's involvement in portfolio companies, such as operational involvement, financial engineering, board positions, required equity stake etc.
- Describe the risks involved in the Fund's particular investment approach and how does it plan to manage these risks.
- Sources of value creation including data showing where value has been created in previous investments. Please include case studies to illustrate this.
- Explain the Fund's approach to the valuation of investment opportunities and pricing discipline.
- Provide an analysis of the sources of investments in all prior funds and identify those investments where you were lead investor.

Provide details of the proposed investment focus for the Fund:

Target %

Seed/early Stage

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Later Stage/Development Capital

If others please explain

Small/Midcap Buy-out (please define criteria)

Large Cap Buy-out (please define criteria)Special SituationTotal

Provide the same analysis for all prior funds.



Provide details about the planned diversification of the Fund

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- Provide details of planned geographical spread of the Fund:
- Provide details of the Fund's proposed sector focus together with details of your particular expertise within these sectors and why you consider them to be attractive.
- Describe the potential risks to the market opportunity that the Fund addresses.
- Indicate the projected portfolio gross and net rates of return to investors.
- Describe the Fund's syndication policies including those that relate to limited partner co-investments.
- Provide a description of any other affiliates who may participate in transactions.
- Describe how you expect the investment environment over the investment period of this Fund to differ from the past and the implications of these differences on the Fund's strategy?
- Which previous deals were led by other private equity groups?
- State the Fund's policy regarding finder's-fees. Please include a list of transactions where finder's-fees have been paid and state the amounts paid.
- Describe the Fund's policy regarding auctions and indicate the proportion of the portfolio that is expected to be deployed through auctioned deals. Please include a list of deals that were won in auctions and a description of their subsequent performance, including the IRR and multiple.
- Provide an analysis of the historic deal flow for all prior funds in terms of their source, i.e. investment banks, accountants, brokers, lawyers and direct relationships from contacts of the investment team.

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- Describe the role of outside consultants in the evaluation of potential investments and the extent to which due diligence is outsourced. Please provide a list of consultants, the deals in which they have been involved, and their compensation arrangements including any share of the carried interest.
- Describe the extent that leverage will be used in a typical investment and if there are any lenders that the Fund favours.

Number of portfolio companies

Investment per portfolio company (in %)

Target holding period

Provide the actual diversification details for all prior funds.

<i>Country/Region</i>	<i>Minimum %</i>	<i>Maximum %</i>	<i>Expected %</i>
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Provide the actual geographical spread data for all prior funds.

<i>Sector</i>	<i>Minimum %</i>	<i>Maximum %</i>	<i>Expected %</i>
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Provide the actual sector analysis for all prior funds.

5. General Partner Information

- Full legal name, address, telephone number, fax number and regulatory body registration number of the General Partner/Manager/Fund sponsor.
- Description of other entities that will participate in management of the Fund including advisors, custodians and administrators.
- Legal structure and date and jurisdiction of formation for each entity specified above together with details of any regulatory recognition obtained by each entity.
- Describe the management organisation, including partners, principals, associates, and support staff. (Please include organisation chart). Provide a list of all offices with contact information of each and a list of all staff.
- Describe the controls in place to avoid potential conflicts of interest between current and prior funds, and between the current Fund and other business interests of the GP management team.
- Describe the co-operation/communication between your various offices.
- Explain how the interests of the GP and LP will be aligned.
- Describe the Fund's policy regarding personal investment by team members in deals reviewed by the GP (both accepted and rejected deals). If permitted, please provide a list of all previous investments of this nature.
- Describe any limitations on the ability of the principals to assign their interests in the general partner.
- Provide details of all matters referred to your advisory committees/board over the period of your track record, including currently unresolved matters. How often do they meet?
- Describe the remit of the Advisory Board/Committee to be utilised by the Fund including names, affiliations and biographies.
- Provide summary tables of all realised and unrealised investments in previous funds, showing both IRR and multiple of cost data.
- Provide summary IRR and multiple of cost data (net of all fees) for all previous funds attributable to LPs.

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1. You are always dealing with the principal when you are dealing with my firm. This means that I am the relationship manager and there is no junior partner to whom responsibility will be transferred. There is no decreased accountability, no "hand-off" to a less-informed colleague. If your interests are at stake continually, shouldn't you reasonably expect my continual involvement?

2. We can usually provide resources on a "just in time" basis. That is, our projects do not have to cover excessive overhead, such as multiple offices, large administrative backup, recruiting, partner perks, etc. We are organized to efficiently provide everything that you, as the buyer needs, but nothing more than that which means that you are paying for value and results and only minimum overhead. 3. There is more likelihood of your privacy and confidentiality being observed with fewer people working on the project. In addition, there are fewer "voices" in terms of differing consultants' and their differing perceptions (a very real problem in focus groups, interviews and work observations). I (and/or the few people I might also involve) are constant which means that there isn't the need to sift through dozens of differing perceptions.

4. We're faster. We can respond to requests quickly, and return all calls within four hours which means to you that there is no need to worry about a bureaucracy, delays and unknown people on the other end of the phone.

5. Since we handle fewer concurrent projects than larger firms, our attention is focussed on the job at hand. This means that you don't have to "compete" with another dozen or so of our clients, which may be larger, paying more or are more time-demanding. We structure our work so that every client receives maximum attention.

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6. Your investment is controlled. There is no "meter running." We work for a fixed, value-based, project fee. Large firms can't afford to do that as readily because of all the people involved and their own insistence on measuring their success by billable hours. We measure our success by client objectives reached, not in "time units".

7. The expertise that larger firms use is often white-labelling for them by a pool of consultants available in the marketplace at any one time. We select our consultants from practising subject matter experts which means that you obtain the same or better expertise for less money, because;

8. Inevitably, we are less expensive. There are economies to using someone who can base their fees on each situation and not on a pre-determined service scale or need for reaching a practice quota. This means quite simply better value to you.



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