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FROM GLOBAL REGULATION & POLICY

Alternative Investment Fund Due Diligence – Better Safe Than Sorry

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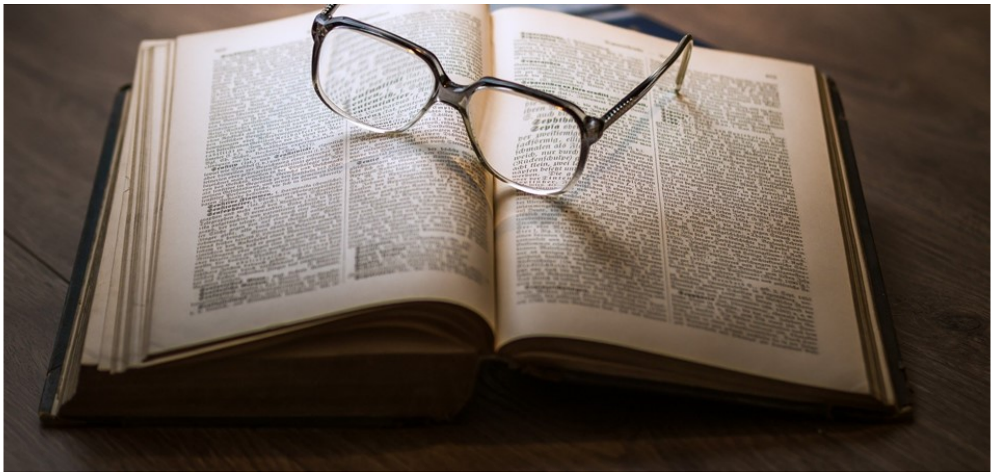

What is an Alternative Fund? It is any fund that invests in assets other than listed stock, listed bonds, and cash. Alternative investment Funds can invest in assets such as real estate, timber, shipping, auto leasing, art, or even tulip bulbs. Due Diligence is the process of doing the required research to make fully informed choices about anything, including an investment. Professional Due Diligence is not a noun, it is a verb. Admittedly this a bit of hyperbole. Why the exaggeration? Because as both a licensed investigator and a Certified Due Diligence Professional, I see the corpses of fund frauds, oversights, and errors, knowing they could have been avoided or prevented.

For The Investors Looking In

Looking on the web and in some books on fund Due Diligence, the first due diligence exercise advocated is rating the fund or looking at the fund's returns and then conducting an in-depth analysis of the fund's returns against other funds in its class. This should be, in fact, the last step as you are looking to buy before you even know what you are buying.

The very first step is to check to see if the fund is duly incorporated, registered as a fund, and if the fund manager is licensed. If they are not, then why bother? My company was hired to conduct a comprehensive due diligence assessment on a fund, and we called back in 30 minutes to advise "don't bother." Why? The fund was incorporated, but not licensed or registered as a fund, and the fund had been operational for nine months!

The next step is to read the prospectus, the subscription agreements, and the investment manager’s agreement. Sales literature and presentations are about sales. It is perfectly acceptable for the material to possess a level of

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puffery as well as pretty charts and pictures. However, you are investing in a fund that has structure rules, so set the puffery aside, and read. If you can live within the rules and the terms are acceptable, we go on to the next step. The directors, auditors, lawyers, custodians, and administrators of the funds also need to read these agreements every year. As a group, it is their collective duty to compare the contents of the documents against the investment choices and proscribed governance standards. One failed fund we looked at was a fund of funds that stated clearly that no more than 10 per cent of funds would be invested with any manager or in any class of funds for diversification and to avoid a concentration of risk. This sounds reasonable and prudent. The post-mortem indicated the cause of death was caused by the manager breaching the governance limitations agreed upon in the prospectus and investing 90 per cent of the fund with a single manager, who was trading just derivatives, not listed equities as required by the prospectus. Thus, in the end, it was the combination of funds extracted from the directors, auditors, lawyers, custodians, and administrators that made investors whole.

As an investor, one must thoroughly check the background of the investment manager and the directors before investing. The research should be updated at least annually. You might think that this is the job of the lawyer, or the auditors, or the administrator or the custodian, right? You might, but more often then not, they do not look into the investment manager's credentials other than that they are licensed. According to the American Management Association, one in ten resumes contains over claims, exaggerations or outright falsehoods on experience and credentials. Yahoo! CEO Scott Thompson was fired after it was discovered he had lied on his resume. Thompson claimed two 1978 degrees in accounting and computer science from Massachusetts' Stonehill College. Thompson later admitted he had never earned the degree in computer science. One licensed investment manager claimed a CFA certification, and while he had taken the first section of the training, he had never finished. Following up a few years later, I looked at his LinkedIn page. He now had an MBA from Wharton. Nope, that did not check out either. The investment manager had by then over US$1 billion under management. His credentials grew year by year. Even more frightening was a director of a large Wall Street Family of funds who was being sued in

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three different federal cases for investment fraud totalling some US$75 million. The litigation had been ongoing for three years. Do your homework with annual updates.

Now you have read the documents, checked for licenses and compliance, verified the credentials of the investment manager and the directors, only then is it time to make the substantial investment into analysing returns.

The duty of the fund's directors includes ongoing Due Diligence, matters of governance, as well as oversight and supervision. These functions are vital to the purpose and, thus, the duty of outside directors. So what is the first thing you look at as an investor? The directors' fees. If they are being paid US$5,000 or less and or serve on dozens of boards of directors, there may be an issue. US$5,000 is not enough for providing diligence service to the funds. It is the old Russian parable – "If they pretend to pay me, I'll pretend to work for them".

ESG is the new jingoistic term used in describing funds. ESG stands for Environmental, Social, and Governance. I am a bit dismissive of the term of an "ESG fund"; not that it is not important. It is important. It has become important because many governments, pension schemes, and corporations now require some or all of their investments to be in ESG funds. The idea is to do good and do well. My concern is that in a quick interview of several fund investors, fund managers, administrators, and custodians, not one could give me a cogent definition of what constitutes proper environmental goals, social impacts, and proper governance. The responses were abominably vague such as "We don't invest in oil", "We look for state of the art governance" (what is that?), and "sustainability is important to us". No – the "S" is for social, not sustainability.

ESG, for the meantime, seems to be a soft term. So let's use our due diligence skills to firm up ESG.

Most of the descriptors on environmental impact look to the impact of the companies in which the funds invest. Typically, the target companies discuss the impact on the environment by looking at and disusing their supply chain and weighing environmental impacts through a variety of means such as near sourcing, supplier emissions, etc. While this is important, it is insufficient. The second component that is most often lacking is the pre and post-impact of the investment. Measurements used for impact investment such as the Impact Reporting and Investment Standards (IRIS) and the Global Impact Investing Rating System (GIIRs) are gaining broader acceptance investment and evaluation, including third-party certification. Some investors and more progressive fund managers use their custom methods.

The social impact of investment has an acceptable standard call Social Return On Investment (SROI). Before dollar one is committed, SROI can produce a forward-looking methodology to estimate the value of the social good that is likely to result. Tracking such returns requires diligent impact assessment and measurement. What will be the social impact for every dollar invested? The measures, however broadly accepted, have shortcomings the fund manager must address. Common problems include a reliable monitoring system to correctly track impact, poorly defined indicator/outcome assessments, reporting impacts that lack comparability, and the high cost of implementing an SROI approach. These are genuine barriers to an SROI implementation; many fund managers therefore do not adopt the SROI approach or do SROI so poorly that it lacks meaning.

If the social impact is not measured with a stable and recognised metric, how can a fund say, with confidence, that they are making a difference?

Governance is a system of dependable managerial oversight. Poor governance is characterised by arbitrary, haphazard decision making, ad-hoc administration, continued crisis management, and providing the opportunity for the abuse of executive powers.

Good governance and oversight create predictable, open, and enlightened policy-making for a business or a fund that allows for open and transparent direction from management on issues such as investment choices, human resources, the rule of law, compliance, communication with all stakeholders including, regulators, service providers, and shareholders. Good governance also provides, as a benefit, extraordinary efficacy of operations directed toward the strategic goals of the company or fund.

Governance can be tested with a few basic questions asked of the fund manager such as: Who is in charge of governance for the organisation? How is your governance aligned with the strategic goals of the organisation? What has your risk assessment shown? What resources have you committed to your governance model? You'll either get a clear answer, or you will get the outboard motor syndrome[i].

Fund valuation is also a subject that requires close attention. Alternative investment funds often deal with assets whose valuation is not readily assessable either in its parts or in aggregate. Assets are valued at cost, market, or replacement. The very same asset, for example, a commercial building, can have a significant difference between the cost of purchase, a market estimate, and the cost of replacement. However, assets are to be valued; this must clearly be stated in the prospectus and adhered to.

So what is a patent, a painting, a jet, a truck, a ship, an apartment, a forest, or a collection of mines worth? Valuation, no matter the science used to arrive at a number, is still an opinion market. Everyone has an opinion, some people have several opinions, but the prospectus will have one model for valuation, and the fund must adhere to that model.

If there is a question on the valuation of an irregular asset, obtain a professional third party opinion. Don't guess.

For The Fund Manager Looking Out

As a fund manager, you need to select competent and experienced professionals that are efficacious. They must be good at what they do at a proper and fair price. The second part of the process for each one of these professionals is their plans for business continuity. Once you have a group of professionals that is both knowledgeable and comfortable with your fund or family of funds, switching to a new professional is always time-consuming and expensive. A subpart of business continuity is the professional's book of business. Is the professional's book of clients more or less risky? There is also the question of business interruption as a result of hurricanes, volcanoes, labour strikes, civil disruption, or epidemics. Investors and regulators honestly do not care one iota if a volcano eruption has grounded a member of your team, or a hurricane has flooded them out of their offices.

A bit of proper KYC and investor due diligence will allow you to keep the money that you have undoubtedly worked hard to raise. KYC and investor Due Diligence is the duty of the fund manager – period. Depending upon the fund, the size, and the origin of the investment, different levels of inquiry are required. The point is – you have to clearly and convincingly know the ultimate beneficial owner and source of the funds. If you do not have the in-house capability, contract a due diligence professional to support your efforts. Also, KYC is not once and done. You must continuously screen the investors for updates and monitor the inflow and outflow of funds. The penalties, both short term and long term for getting it wrong, are severe. Money laundering with funds is real. Sometimes the money from investors is the problem. Launders, as investors, typically target open-end funds so the money can be invested and withdrawn over a period of time. Closed-end funds, with longer lock-up times, are excellent for investing and forgetting. The fund becomes an account to hold the dirty money for a few years. The closed-end funds are also targeted as the buyer and seller of assets. Let me explain. A seller is trying to sell a business for €5 million. The fund is not interested in the business until they hear of a buyer looking to buy a similar business for €5.5 million. The sharp fund manager smells a quick half a million profit and middles the transaction. The fund has just laundered €5 million for a €500K fee. This is but one example of the many ways a fund can be used to launder money.

To sum up, good Due Diligence is the prevention of unnecessary risks. Doing your homework before you buy an asset, doing your homework before you accept a subscription, ensuring all of the professionals are competent, capable and with you for the long term, allows you to put aside anxiety and focus in on returns.

Footnotes:

[i]. The outboard motor syndrome is when you ask a question, and the response is "but, but, but, but, but."

ABOUT THE
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Mr. Files is President of Financial Examinations & Evaluations, Inc. He is an international financial investigator and due diligence expert who has run cases in over 130 countries and has visited over 100 countries. Mr. Files has tackled investigations running from a few hundred thousands dollars to over 20 billion. Along the way he became familiar with the knowledge of what people need to do, for due diligence, preventing corruption, and to avoid helping criminals launder money. He brings this experience of hands on investigating and problem solving experience to his lectures on Due Diligence, AML, and Anti-Corruption. Prior to founding FE&E, Inc. he served as the Director of Corporate Finance for American National an investment bank focused on development stage venture capital. He was also employed by Oppenheimer/Rouse as a commodities specialist trading customer accounts in Agri-Business and 24-hour gold, silver, and foreign currency trading. Mr. Files has authored six books, and many white papers and articles. He has been quoted in major publications including The Guardian, The Financial Times, Forbes, US Newsweek and more. He is the author of the award wining book Due Diligence For The Financial Professional 2nd Edition. Mr. Files serves on the board of directors for several private companies, funds, and non-profits. Mr. Files is active in several civic organizations. In the past Mr. Files has served as a member of the Arizona Governor's Board on Solid Waste Management, as an advisor to the Governor's Board on Economic Planning and Development. Mr. Files has also received a Commission and a Medal of Merit from the President of the United States.

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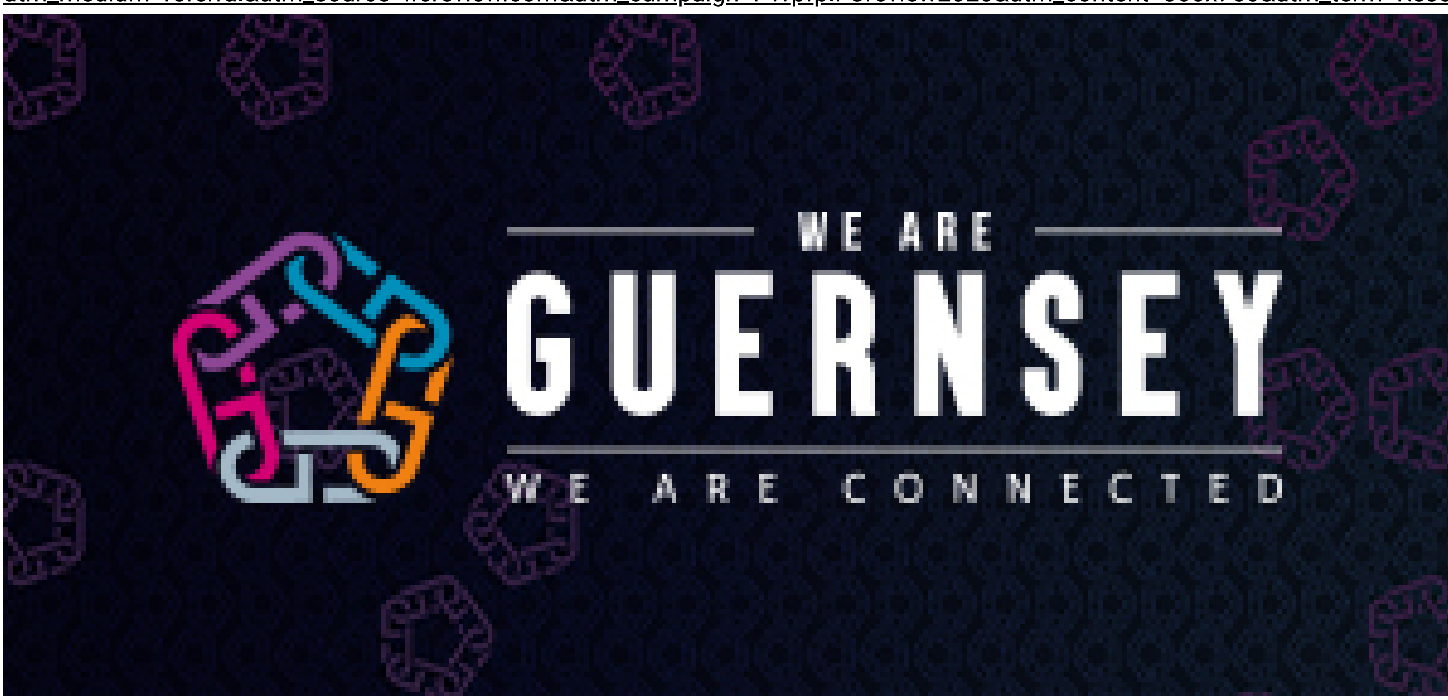

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