

THEMED EXAMINATION PROGRAMME 2006

EXPERT FUNDS – SUMMARY FINDINGS

The summary report detailing the Commission findings of its examination of the due diligence on Investment Managers carried out by Jersey based functionaries.

Introduction

The aim of the Commission in conducting a series of themed on-site examinations is to concentrate on a specific area of conduct taken across a segment of the industry. For the second half of 2006, the chosen theme was the due diligence on Investment Managers carried out by the functionaries prior to signing the declaration required under the Expert Fund Guide (the “EFG”) and in respect of their responses to the Commission’s “Dear CEO” letter issued on 29 June 2006.

Specifically, the Commission’s risk themed examination programme was designed to:

- Assess the types and efficacy of the due diligence procedures;
- Identify any potential weaknesses; and
- Highlight areas of best practice.

As with all on-site examinations, a business is assessed in terms of its performance against the relevant Laws, Orders and codes of practice. The objective in publishing summary findings from a programme of themed examinations is to share experiences as to how different firms seek to meet the requirements of the regulatory regime and to highlight any difficulties that are sometimes encountered.

Scope

The on-site examinations took place between 23 October 2006 and 1 December 2006 and encompassed an inspection of the functionaries in order to assess:

- the basis upon which the functionaries signed the declaration to the Commission that they had carried out due diligence in respect of the Investment Managers;
- whether the functionaries reviewed their due diligence procedures and findings in respect of the Investment Managers following receipt of the Commission’s “Dear CEO” letter; and
- whether a report was submitted to the board of the functionaries to report findings of such review and whether shortcomings were reported to the Commission as required by the “Dear CEO” letter.

Process

The due diligence conducted by 10 functionaries in relation to 36 funds administered by them was reviewed. The functionaries selected by the Commission were drawn from a cross section of the financial services industry and included independent fund administrators and fund administrators associated with law firms, banks, accountancy firms and other financial services providers.

These 10 themed examinations were in addition to other examinations conducted during 2006, where due diligence may also have been included in the scope of the examination. The Commission has therefore obtained an understanding of the standards across a wide range of funds service providers.

Results of examinations

We found a wide range of standards of due diligence procedures and documentation obtained in support of the signed Investment Manager declarations. Some functionaries viewed the due diligence requirements as a compliance procedure whilst others combined it with their overall risk management and client acceptance procedures.

In general terms, the functionaries who built the requirements into their overall risk management and client acceptance procedures had better quality procedures, better understanding of the requirements and higher quality documentation. We believe there are advantages in embedding due diligence within an overall risk management framework.

The common weaknesses identified during the examinations are as follows:

1) Lack of detailed steps undertaken under paragraphs 2.7 and 2.8 of the EFG

All the functionaries have some form of procedures to address the requirements of 2.7 to 2.10 of the EFG but they vary widely in their depth, interpretation and documentation that results from the process. The sophistication of the procedures and the quality of the documentation obtained can be attributed to a number of factors:

- The number of Expert Funds under administration and whether the establishment of Expert Funds was part of an overall strategy for fund administration or whether this had resulted through responses to approaches from sponsors or their lawyers;
- The level of compliance resource available;
- The perception by management for the need to obtain certain documentation depending on the status and perceived quality of their client, i.e. if a client is perceived as 'blue chip' as opposed to a start up concern with little or no track record then the level and quality of documentation is likely to be different; and
- The willingness of management to ask questions of the Investment Manager which may be perceived as 'difficult' in the embryonic relationship, especially on issues of solvency and investment management experience.

At a minimum, the relevant sections of the EFG are used as a checklist in order to ensure that the functionary has all the information it believes is required. These checklists are not retained on file.

A more common approach is for functionaries to use a checklist that includes a section listing the requirements of sections 2.7 and 2.8 of the EFG. However, there is often no guidance in the checklist on the steps that should be taken or considered in order to address these requirements. Furthermore, where such checklists are in issue, the responses are often 'Yes/No' in nature and do not permit a narrative explanation behind a conclusion which, to a third party such as the Commission, is critical to obtaining such understanding.

2) Lack of a centralised file structure, filing of key documentation (including KYC), and cross referencing to the requirements of the EFG

In several instances the documentation obtained in support of the Investment Manager declaration and KYC received on the principal persons was held in separate locations and spread across numerous correspondence or working files. Centralising the filing of key documentation decreases the likelihood of misplacing documents or failing to notice that a key piece of evidence has not been obtained.

3) Failure to identify the principals of the Investment Manager

One of the fundamental issues encountered was the extent to which the Investment Managers were classified as clients. For example, the large private equity houses (which also act as the Investment Manager) were often treated as clients whereas with smaller institutions or companies, it was the administered entity, which was treated as the client. Consequently, for those Investment Managers that were not treated as clients, the KYC and compliance procedures applied tended to be ad hoc in nature, leading to inconsistencies in documentation obtained and procedures applied. There were also exceptions where no formal process of identifying the directors and shareholders had been undertaken and no KYC had been obtained.

4) Limited independent verification of due diligence information

The principal methods by which functionaries addressed their review of disciplinary sanctions or convictions of the Investment Manager and principal persons were through World Check (only one functionary used C6) and internet based searches, predominantly Google. We noted that in some instances World Check and Google searches were not carried out on the Investment Manager as an entity.

Other public sources of information used included Bloomberg and the FSA website. In relation to individuals regulated by bodies other than the FSA where disclosure of regulatory sanctions is not as extensive, the process of independent verification is more problematic. We also note that some functionaries drew comfort from copies of Personal Questionnaires submitted to the Commission and this issue is addressed specifically later in this summary of findings.

In a limited numbers of instances no searches of publicly available information were performed and the functionaries relied solely on either a) their previous experience with the Investment Manager or its principals; or b) the fact that they had been introduced by an existing client. Only one functionary used a third party in order to support its assessment of the Investment Manager.

5) Where the investment manager has a limited operating track record, a lack of information to support the functionary's assessment of solvency

The assessment of solvency proved to be one of the most difficult areas for functionaries. Because the Investment Manager declaration is in the form of a

negative assurance, many functionaries mistakenly believed that extensive and in-depth enquiries were unnecessary. In general, the preferred approach of the functionaries has been to obtain the latest financial statements (preferably audited) of the Investment Manager.

However, where an Investment Manager has been newly incorporated there is often little or no historic financial information and the entity may be thinly capitalised. In relation to global institutions categorised as 'household names' (which are perceived as having little or no credit risk) functionaries varied in their approach with some obtaining the most recently available financial statements and some taking the solvency point for granted.

In private equity fund structures the Investment Manager is often not a special purpose vehicle set up solely to act as investment adviser, but the principal entity within the private equity group. Given the commercial sensitivities surrounding financial performance in the industry, it is not uncommon for private equity groups to decline to supply financial statements. In such cases, practice has evolved whereby letters of comfort have been obtained from the Investment Manager's auditors.

6) A failure to correlate investment management experience of principals to the proposed strategy of the fund

This represented one of the greatest areas of judgement by functionaries. The primary forms of documentary evidence obtained took the form of CVs and Personal Questionnaires. In some cases the functionaries only produced verbal confirmation that the principals were suitably qualified based on their existing knowledge of them. Documentation of their assessment was often poor due to the 'Yes/No' format of responses given in the Investment Manager due diligence checklists.

Further, there was often no clear link between the information received and the proposed fund's investment strategy and, although it was clear in some instances that the experience of the principals of the Investment Manger was relevant, in others it was not. We also encountered a number of occasions whereby functionaries asserted that an individual was well known in a particular industry.

In relation to third party references we only noted one functionary that had obtained references from a well-known institution, which fully supported, in detail, the individual's investment experience.

7) Lack of process for ongoing monitoring of compliance by the Investment Manager with the terms of the EFG

Due to the relative infancy of the Expert Fund regime many of the funds we examined had not passed any periodic review dates. Also, many of the functionaries examined did not have in place any specific procedures for dealing with ongoing monitoring of the Investment Manager. Common methodologies for dealing with ongoing monitoring centred around reliance on trigger events to prompt an update of the due diligence held on file. Such

trigger events include a change in principal person or the launch of a successor fund.

Recommended best practice

As a result of the above findings, we believe the implementation of the following procedures would represent best practice:

- the development of a checklist detailing the steps required to be considered under each point and which evidences the rationale behind a decision. This should cross reference to supporting documentation in order to enable a clearer, more structured approach to the signing of the Investment Manager declaration;
- a separate, centralised due diligence file is set up for each Investment Manager;
- copies of World Check and key internet searches are placed on the KYC file. Further, where judgements are made on the information collated as part of the due diligence exercise, those judgements and the rationale to be documented on the KYC file;
- where historic financial information is not available due to the Investment Manager being newly incorporated, functionaries should consider obtaining a copy of its business plan and performance forecasts along with details of the assumptions made in their preparation. In instances where reliance is being placed on the principals behind the Investment Manager to provide funding and financial support, functionaries should consider obtaining a letter of comfort or guarantee from such principals. This should be received before the Investment Manager declaration is signed;
- KYC procedures are formalised. Functionaries should undertake a separate, discrete process of identifying directors and shareholders and, where applicable, functionaries should extend their current policy to include checks on the Investment Manager as an entity. Where functionaries rely on the reputation of the Investment Manager, such reliance is to be documented with supporting evidence through the use of trade journals and other independent sources;
- there is a clear link between the information supporting the principals' investment experience and the proposed fund's investment strategy, and this is clearly documented and referenced;
- references relating to investment management experience and credibility should be sought where possible, although we appreciate that referees may be unwilling to provide such comprehensive and candid references. We also recommend that functionaries assess the credibility of the referees— for example, contacting the referee directly to establish their authenticity;
- diarised periodic reviews performed as part of the risk or compliance reviews. Although we do not advocate a full re-performance of the entire due diligence, this review should be sufficient to enable the functionary to

sign the Investment Manager declaration, were it required to do so at that point. Further, we recommend that the functionary institutes some form of reporting regime such that the Investment Manager is required to confirm basic details concerning its directors and shareholders, and that it continues to comply with the provisions of the EFG on at least an annual basis.

Notwithstanding the above recommendations, in the Commission's view the level and depth of documentation obtained does need to improve, as there is currently a gap between the Commission's expectations as regards due diligence and industry practice. To this end, the Commission has produced a document named 'Draft Example Questionnaire for Expert Fund Due Diligence' which contains the type of questions the Commission believes should be asked by the local functionary when assessing the Investment Manager against the requirements of Sections 2.7 and 2.8 of the EFG. It should be noted that this document represents only the Commission's suggestions and therefore should not be treated as an exhaustive list. This report can be found in **Appendix A**.

Response to "Dear CEO" letter

All functionaries responded in different ways to the requirements of the "Dear CEO" letter. In all instances, it was noted that there were no known issues of concern with regard to any of the Investment Managers. Some functionaries had carried out extensive file reviews and obtained further documentation whereas in others the response took the form of a board decision that there were no issues, but without a documentary review. However, in a number of instances revisions to checklists and procedures were made.

What is clear is that a range of issues that were not identified as a result of the functionaries' own responses to the "Dear CEO" letter were identified in our on-site examinations.

Areas of clarification

Reliance on Personal Questionnaires

We note that several functionaries raised questions on whether any reliance, for the purposes of the functionaries' obligations under the EFG, can be placed on the fact that, where applicable, when the principals of Investment Managers have submitted Personal Questionnaires to the Commission that no adverse responses have been reported by the Commission.

In response, the Commission can confirm that no reliance can be placed on the fact that the Commission has not responded adversely, or at all, to the local functionary for the following reasons:

1. the Commission places reliance on the local functionary to carry out adequate checks on the Investment Manager and its principals prior to countersigning the Investment Managers confirmation. The Commission is therefore concerned that local functionaries are not meeting their responsibilities under the EFG; and

2. the Commission will only respond to the individual submitting the Personal Questionnaire. Where the Commission is in possession of restricted information, the Commission cannot communicate this information to the local functionary. In these circumstances, the Commission will seek to verify such information with the individual concerned and make its decision accordingly.

Reliance on existing permits

We noted where the functionary had inappropriately placed reliance on the fact that the Investment Manager held a permit issued by the Commission in respect of another fund, or where an Investment Manager acted for an existing fund holding a permit issued by the Commission.

The Commission can confirm that no reliance should be placed by a functionary on the fact that the Commission may have issued permits to either the Investment Manager or to a collective investment fund to whom the Investment Manager provides services in satisfying their obligation to perform due diligence in respect of the requirements of Sections 2.7 and 2.8 of the EFG.

Derogations

In a number of instances, it was clear that the functionaries had been granted derogations by the Commission but there was no explicit documentary evidence on the functionaries' files that these had been granted.

From the date of issue of this report, the Commission will now state that derogations have been granted in the covering letter enclosing the signed permits.

“Light Touch” versus “Different Touch”

Some functionaries expressed their belief that the EFG creates a “light touch” regime. This is a fundamental misunderstanding of the Commission’s policy.

The fundamental cause of this misunderstanding lies in the fast-track authorisation process, which has led some to interpret this as a “light touch”. The ability to have a faster authorisation process is due to the fact that the Commission is not performing its own due diligence on the Investment Manager and reviews on the fund documentation.

The Commission would like to emphasise that the EFG regime is a “different touch” regime whereby the responsibility for performing due diligence on Investment Managers (in accordance with different standards to those employed on alternative regime funds) has been passed back to the industry.

Section 2.9 of the EFG

We note that 2.9 of the EFG states “As part of the application process for establishing an Expert Fund, the Investment Manager should confirm in writing to the Commission that it satisfies the requirements set out in 2.7 and 2.8 above, *and provide documentary evidence in relation to the requirement at 2.7.4.*” [Our italics].

Although the Commission has never insisted on the provision of this documentary evidence, we retain the right to ask for it. The Commission always reviews the Investment Manager due diligence during on-site examinations in order to test compliance with 2.7.4.

Conclusion

The Commission found this themed examination to be extremely valuable in assessing the effectiveness of due diligence performed under the Expert Fund regime. Consequently it is intended to continue reviewing this area during 2007 examinations.

Any comments on the contents of this paper would be welcomed. We would also be happy to address any concerns or questions that the reader may have in this respect. Any such communications should be addressed to:

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APPENDIX A

Draft Example Questionnaire for Expert Fund Due Diligence

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| 2.7 | The Investment Manager should be of good standing and in particular should: |
| 2.7.1 | have had no disciplinary sanctions imposed on it by any supervisory authority in the previous five years; |
| | <ol style="list-style-type: none"> 1. How has the Jersey based functionary satisfied itself as to the identity of the relevant regulator of the Investment Manager over the past five years? 2. Has the Investment Manager changed its name in the last five years? 3. Is the Investment Manager listed on the relevant regulator's website? 4. Does the website disclose any actions or sanctions against the Investment Manager or its principals? 5. Have specific enquiries been made to the relevant regulator? If so, what are the results? 6. Has a search been made on the internet either through a subscription service (such as World Check or C6) or a free internet search engine (such as Google) using both the current name and any previous or trading names? 7. Are any other databases or information sources interrogated? |
| 2.7.2 | have no convictions for any offence under the legislation of any country relating to the conduct of financial services business or involving fraud or dishonesty or be the parent, subsidiary or an associated company of any company which has such a conviction; |
| | <ol style="list-style-type: none"> 1. Has a group structure been obtained which identifies the Investment Manager's parent, any subsidiaries or associated companies? 2. Has a search been made on the internet either through a subscription service (such as World Check or C6) or a free internet search engine (such as Google) using both the current name and any previous or trading names of the Investment Manager, parent, subsidiary or associated company? 3. Has the Jersey based functionary obtained copies of all the person questionnaires submitted by the principal persons of the Investment Manager? 4. Do these questionnaires disclose any issues relevant to 2.7.2? 5. Have any third parties been employed to undertake due diligence checks on the Investment Manager? If so, what are the results? 6. What internal resources available to the Jersey based functionary have been employed in order to determine whether the Investment Manager has had any convictions? 7. What publicly available information sources have been reviewed in order to determine whether any convictions exist? 8. Have the Jersey based functionary's own KYC procedures (such as receiving references) highlighted any issues relevant to Section 2.7.2? |

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| 2.7.3 | <p>be able to pay its debts as they fall due;</p> <ol style="list-style-type: none"> 1. Have the Investment Manager's latest available audited financial statements been reviewed and an assessment made of the auditors? 2. Has a confirmation concerning the Investment Manager's financial status been requested from the Investment Manager's auditors? 3. Have up to date management accounts been obtained and reviewed? 4. Where historic financial information is not readily available due to the Investment Manager being newly incorporated, has a business plan including detailed budgeted projections together with assumptions been obtained? 5. Where reliance for funding and financial support is being placed on the principals behind the Investment Manager, has a letter of comfort or guarantee been obtained? 6. For newly incorporated Investment Managers, does the proposed new fund have a 'cornerstone' investor? What has the Jersey based functionary done in order to satisfy itself as to the future prospects of the fund to which the Investment Manager is providing services? 7. Has a business plan, including detailed budgeted projections been obtained and reviewed? What period does it cover and do the figures seem appropriate for the size of the firm? |
| 2.7.4 | <p>be established in an OECD member state or any other state or jurisdiction with which the Commission has entered into a Memorandum of Understanding (or equivalent) on investment business and collective investment funds, and it either;</p> |
| | <ol style="list-style-type: none"> 1. Has the home jurisdiction of the Investment Manager been compared against the list of acceptable jurisdictions or states as listed in the fund services business guidance note entitled "Jersey Expert Fund - List of States and Jurisdictions"? 2. Has the Investment Manager's certificate of incorporation been obtained to confirm home jurisdiction? 3. Is the principal jurisdiction of operation different to the jurisdiction in which the firm is incorporated? |
| 2.7.4.1 | <p>regulated in that state or jurisdiction; or</p> |
| | <ol style="list-style-type: none"> 1. How has the Jersey based functionary confirmed the identity of the relevant regulator? 2. Is the Investment Manager listed on the relevant regulator's web site? If not, how has the Jersey based functionary confirmed the Investment Manager's regulated status? 3. Have copies of the regulatory approvals been obtained? 4. Are there any specific relevant conditions/restrictions on the approval given by the regulator (e.g. not able to hold client monies)? 5. Is the Investment Manager regulated for the type of business being undertaken in relation to the fund's activities? 6. Is the firm fully regulated in its home jurisdiction if it is operating in another jurisdiction? |

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| 2.7.4.2 | granted approval to act in relation to the Expert Fund by the Commission, noting that if the Investment Manager is not regulated because the activity it proposes to undertake in relation to the Expert Fund is not a regulated activity in its home state or jurisdiction, provided the other requirements set out in paragraphs 2.7 and 2.8 are met, such approval will ordinarily be granted on an expedited basis; |
| | <ol style="list-style-type: none"> 1. Has the functionary verified that the Commission’s approval has been obtained in this case? 2. Are there any conditions to this approval? 3. How has the functionary determined that these conditions have been met? 4. What has the functionary done to ensure if there are any material changes to the information provided to the Commission that need to be communicated? |
| 2.7.5 | possesses relevant experience in relation to managing or advising on investors’ funds using similar investment strategies to those to be adopted by the Expert Fund; |
| | <ol style="list-style-type: none"> 1. Have CVs been obtained and reviewed for the principals and key investment management team of the Investment Manager? 2. Are the CVs consistent with the information provided in the personal questionnaires obtained for those principal persons of the Investment Manager? 3. If so, do these CVs demonstrate suitable relevant competence and experience of the principals and investment team? 4. What has been done to verify the accuracy of the information submitted? 5. Have the Jersey based functionary’s own KYC procedures (such as receiving references) identified any issues relevant to Section 2.7.5? 6. If so, are these individuals competent to provide advice/management in the specific strategies of the fund? 7. Has a corporate history of the Investment Manager been reviewed to ensure that the Investment Manager has a good background in providing advice/management to funds in general and in the specific strategies of the fund? 8. Have the track records of the principals and key investment team members been independently verified? 9. Has a review of news articles, trade journals or similar publicly available information sources including the Internet been performed? 10. If the Investment Manager has acted or currently acts for other funds with similar strategies, whether under existing CIF permits or other regulatory regimes, has the performance data been reviewed and independently verified? 11. Has an on-site inspection of the Investment Manager been undertaken? 12. Have copies of any audit reports on internal controls or similar e.g. SAS70, FRAG21 been obtained and reviewed? |

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| 2.7.6 | <p>satisfy the Commission’s general principles of corporate governance in relation to the span of control over a business as set out in Appendix 2 [of the Expert Fund Guide], meeting the four-eyes principle if the Investment Manager cannot handle client monies, and the six-eyes principle if it can handle such monies;</p> |
| | <ol style="list-style-type: none"> 1. Has the Investment Manager’s board structure been reviewed and is it compliant with the Commission’s policy on Span of Control? 2. Have the Investment Manager’s regulatory approvals (where applicable) been reviewed to determine whether the Investment Manager is able to handle client monies? 3. Has a review of the corporate governance policies and procedures been performed by the Jersey based functionary? 4. Are there any disclosures on corporate governance in the Investment Manager’s latest accounts? 5. If so, is there any adverse information contained with these disclosures? 6. Do these disclosures give rise to any concerns over the control of the Investment Manager? 7. Has the shareholders of the Investment Manager been identified to determine whether there is a shareholder controller? 8. Is there one dominant director of the Investment Manager? 9. Has an on-site inspection of the Investment Manager been undertaken? 10. Have copies of the latest compliance reports and audit reports on internal controls or similar e.g. SAS70, FRAG21 been obtained and reviewed? |
| 2.8 | <p>In addition, no Principal Person of the Investment Manager shall:</p> |
| 2.8.1 | <p>have had any disciplinary sanctions imposed on him by any supervisory authority or professional body in the previous five years; or</p> |
| | <ol style="list-style-type: none"> 1. Are the principals individually regulated and/or approved? 2. If so, has the relevant regulator’s website been reviewed to ensure no disciplinary sanctions have been issued? 3. Have specific enquiries been made to the relevant regulator? 4. Have copies of any personal questionnaires submitted by any principal persons, as identified in Section A 2, to the Commission been obtained and reviewed by the Jersey based functionary? 5. If so, has any principal disclosed any convictions or matters of concern? What has the Jersey based functionary done to investigate these? 6. What checks have been performed to verify the accuracy of the information in the personal questionnaire by the Jersey based functionary? 7. Has a search been made on the Internet or other publicly available information sources on the individual including any previous names or businesses with which he was connected? 8. Have any third party firms been engaged to perform due diligence on behalf of the Jersey based functionary? |

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| 2.8.2 | have been convicted for any offence under the legislation of any country relating to the conduct of financial services business or involving fraud or dishonesty. |
| | <ol style="list-style-type: none"> 1. Are the principals individually regulated and/or approved? 2. If so, has the relevant regulator's website been reviewed to ensure no disciplinary sanctions have been issued? 3. Have specific enquiries been made to the relevant regulator? 4. Have copies of any personal questionnaires submitted by any principal persons of the Investment Manager to the Commission been obtained and reviewed by the Jersey based functionary? 5. If so, has any principal disclosed any convictions or matters of concern? What has the Jersey based functionary done to investigate these? 6. What checks have been performed by the Jersey based functionary to verify the accuracy of the information in the personal questionnaires? 7. Has a search been made on the Internet or other publicly available information sources on the individual including any previous names or businesses with which he was connected? 8. Have any third party firms been engaged to perform due diligence on behalf of the Jersey based functionary? 9. Have any publicly available information sources e.g. court databases been reviewed to determine whether any convictions exist? |