

Alternative Investment Industry Diligence Gap Analysis Initiative

Send comments to: ImpactAlts@ADISA.org

ADISA invites you to participate in an industry effort to advance the overall consistency and quality of the Alternative Investment due diligence process. We know that any significant and lasting positive change will only occur if we work collaboratively to create, adopt, and place into action the lessons we have learned and continue to learn as an industry. We are asking for industry input to create cross stakeholder collaboration in creating an evolving guidance for the betterment of the Alternative Investment industry. Please socialize this document with as many industry participants as possible and **provide comments by September 20, 2021**¹.

Important Contextual Notes:

1. We recognize that there are 4 distinct gateways that need to collaborate to deliver the best possible products and outcomes to our clients or protect them from accessing sponsors and/or their products that have higher risk profiles: (1) Sponsor/Product Manufacturers (2) Sponsor law firms (3) Independent Due Diligence Providers, and (4) Product Distributors (BDs/RIAs/Advisors.) By looking at all 4 areas we believe we will have the greatest potential to have the most positive and lasting influence on the Alternative Investment due diligence process.
2. As we work to create guidance for what historically may have been minimized (aka “Gap”) considerations², we also cannot overemphasize the importance of heeding what some people call red flags and others call gut feelings. For example, if there are sponsors who are pushing the boundaries of legal and tax issues which are open to the public what happens with respect to areas that are not visible by the public? The health of our industry is part science, part art, and part common sense. We need to ensure an increased and more consistent awareness and abidance of all three of these diligence indicators. The mission of this Gap analysis is to shed light on these diligence indicators and the necessary collaboration amongst the 4 gateways to create a more consistent industry wide due diligence and distribution process.
3. This is intended to be Part I(a) of a series of Due Diligence Gap considerations - (Sponsor Review). This is *not* intended to be a comprehensive due diligence checklist, but one that focuses on considerations that often do not get the attention and follow-through necessary to create more consistent outcomes for our investors. Once we have gained general industry consensus and traction on the effort and format, the next step will be to look at Part I(b) Product Specific Gap considerations. To follow: Part II: Third Party Due Diligence Gap Considerations; Part III: Sponsor Attorney Gap considerations; and Part IV: Product Distributor Considerations.
4. Refer to the attached “Alternative Investment Betterment Initiative Movement” for additional details and commonly asked questions.

Thank you for playing a part in this important industry-wide initiative! **Give comments to ADISA staff; all items are also found on Standards, Education and Publications Committee at:**

<https://www.adisa.org/about-adisa/committees>

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² Initial guidance for this Gap due diligence initiative comes from a year long working group of due diligence officers, sponsors, broker dealers, and independent third party and education experts. Case studies on programs were prepared to find commonality of key considerations between programs that resulted in fraud or misconduct and those that have generally met expectations.

Part I(a): Sponsor Reviews

Topic: Management Team Depth and Experience (Operational Process/Operational Balance)

Concern:

There have been many instances of program sponsors coming into the retail investment industry with limited to no experience in the investment strategies, structures and/or asset sectors they are responsible for implementing. There have also been many instances in which established sponsors have expanded into new areas they may not have adequate experience.

Focus:

1. Does the sponsor have experienced management teams supervising the key aspects of the sponsor's operations (asset sourcing and selection, asset management, finance, accounting, information technology, investor/selling group member relations, legal/compliance, etc.)?
 - Consideration – The sponsor should have fully qualified individuals in key positions who have demonstrated experience in their assigned duties for the current strategy. Ascertain what areas of operations these key personnel support and how their experience aligns with their role within the company. Does the sponsor have the same employees responsible for several key operational areas which could make it difficult for them to effectively fulfill each responsibility? Where there are internal shortfalls, have third parties been engaged? Is staff experienced in the same strategy as the current program (at both the operational and investment level)?
 - Tips - Request and review 3rd party due diligence reports on the sponsor entity which will look at the aforementioned items plus likely ascertain their financial condition, management structure, legal history, and other relevant information. Additionally, obtain bios and interview key personnel with respect to their experience and roles within the company.

Request a call or visit with key principals to discuss their relevant work experience, investment background, track record on prior programs and projects, tenure and more. An on-site meeting to the home office of the sponsor may be one of the most valuable ways you can become familiar with the sponsor's operations, processes, and have the opportunity for the "art" of the process to step in. Meeting principals and key influencers associated with a program in person and seeing actual assets/operations may give you unique insight that may not otherwise be realized. Request references and/or the ability to interview individuals in the position to provide important insight such as prior selling group members, past program/project investors, their banks or lenders, attorney, accountants, vendors/service providers, and/or prior project partners. Seek references that did not come directly from the sponsor whenever possible. Make inquiries with these companies to verify character, proof of concept, and claimed experience and identify any issues, particularly any that may constitute red flags (e.g. prior instances of project/program failure or misconduct). Ensure that any red flags have been followed up on and adequate responses have been fully documented.

2. Is the sponsor appropriately staffed or have sufficient 3rd party relationships established (i.e., legal, compliance, valuation firm, etc.)?
 - Considerations – The sponsor should have adequate coverage within the core areas of its operations to fully support business of its managed programs. Are the key areas of operations

staffed with the sponsor's employees? If outside parties control certain facets of operations, does the sponsor have processes in place to supervise the work of the outside parties? If a program's investment activity represents a new line of business for a sponsor, is there anyone within the sponsor's organization that has experience within the new line of business? Personnel? Understand fully the valuation approach/method that is utilized by the firm (whether provided by a 3rd party or in-house).

- Tips – Request all department personnel charts and a list of 3rd party service providers utilized and work with the sponsor to learn how they were selected, the scope of the services being provided, and if the sponsor has any plans to bring any of these services “in house”.

Topic: Organizational Structure

Concern:

The organizational structure of sponsors can be complex, especially when there are multiple owners and/or if the sponsor is working with a joint venture partner. Understanding the ownership, structure and control within the organization is a prudent early step in the sponsor review process to understand who is responsible for decisions and what legal entities are involved.

Focus:

1. Review a copy of the operational agreement (and all amendments) for the sponsor and advisor/other entities to identify ownership percentages, control rights and decision-making aspects. Note: this should be a non-negotiable request; all sponsors must provide their organizational agreements without exception.
 - Consideration – The sponsor's equity ownership and governance should be verified through a review of a sponsor's organizational documents, capitalization tables, federal tax returns, and organizational charts. This review is needed to confirm who ultimately controls the sponsor's business. This exercise should be undertaken for the sponsor entity, as well as any subsidiary or affiliates of the sponsor. It is extremely important to review the organizational documents all the way up the chain. You have to understand how control can change and whether any other parties such as bridge lenders who do not have the investors' best interest at heart could take control.
 - Tips - Obtain the org charts up to the parent company level including a list of the owners. Verify asserted ownership and control through reviewing legal documents and notes to audited financial statements. Conduct online searches to identify entities and businesses that the sponsor did not disclose (e.g., Westlaw people map). Ask the sponsor to explain any items or relationships that do not make immediate sense. For pass through entities such as partnerships and sub-s corporations, you may consider obtaining the individual partner and shareholder financials as well as inquiries with regards to any personal issues that may affect the business.
2. Obtain background checks on persons in control/ownership and key financial positions, such as CFO (may utilize 3rd party reports). Verify claimed licenses and education.
 - Consideration – All persons in a control/ownership position should be willing to have background checks run on them.
 - Tips - In most cases you can leverage the 3rd party report providers for this information. If there is a significant time gap or if you have identified a particular challenge, ask for updated

background checks to be conducted. Pay close attention to relevant jurisdiction for each search (which states, counties, etc.).

3. Board controls, if applicable. If not applicable, what structure is in place around Controlling Persons who are responsible for making key company/fund decisions? This may also apply at the Fund level. Understand how the sponsor's board or other governing body is structured and how the individuals were selected.
 - Consideration – Determine if independent board members have a prior relationship with the company or other board members and if the board is fully qualified.
 - Tips - Requests bios on each of the board members. Also ask and document if the sponsor or any key executives have any prior or current relationship with the principals of the sponsor, business or personal (directly or indirectly). Review if the board members are also board members of multiple funds of the sponsor's and determine if there are any material conflicts of interest (e.g. too many interests if on many boards). Determine if compensation is reasonable.
4. Management controls –
 - Consideration – Are adequate written controls in place (administrative & internal). Does the sponsor have written operational and accounting practices? Is there an independent audit function or an audit committee?
 - Tips - what entity does the sponsor rely on to process transactions (Note: most sponsors will not have an SSAE report. While it's nice to have, it's not a standard practice at this time. Obtain a copy of the Sponsor's cybersecurity certificate.

Topic: Sponsor's Track Record (Depth of Enterprise Experience)

Concern:

Reviewing a sponsor's track record is a critical step in the due diligence process. Sponsors should be willing to provide a complete track record of all of their prior offerings, including those at prior entities; both good and bad.

Focus:

1. Identify all prior programs, including those with similar and dissimilar investment objectives, and current and prior employers. The prior performance needs to be reviewed closely. Review whether the prior performance is applicable given the person's position within the prior company/sponsor and ensure that prior failures where they were in roles of influencing responsibility are included.
 - Consideration - What was the role of key executives at each of these sponsors (current and prior)?
 - Tips: - Carefully identify all material adverse business developments (SEC Guide 5) for each of the prior programs, then assess materiality.
2. In the event of a poor performing program, ask what went wrong and how they have adapted or learned from that experience.
 - Consideration – does the sponsor present the full history (good and bad) or is performance cherry picked? If not, is this adequately disclosed?

- Tips: - Ask the sponsor to provide a full list of all prior entities for which they have raised any capital. Leverage 3rd party report providers' legal reviews to see if there are any prior business dealings or entities not being listed on their track record. Spend time reviewing the disclosures. If something is unclear, ask.
 - Consideration - Does the track record include similar fee dynamics? Prior performance should be based on net result to investors after fees and promotionals.
 - Tips: - Understand the difference between return on and return of an investment and if it is properly disclosed. A return of capital is not a 100% return. Track records for private placement sponsors will include funds with varying loads, fee structures, sharing arrangements, etc. Work with the sponsor to understand these dynamics.
3. Is historic performance directly related to the same management in the current offering?
 - Consideration – If not, is their performance directly related to the current management that can be reviewed?
 - Tips - Review their bios and learn what the roles of the individuals were for each of the items listed in their track record. Were they the decision maker or were they a more junior member of the team at the time?
 4. Does the sponsor and management team have a track record in both up and down markets (i.e., is their management team and/or business plan battle tested?)
 - Consideration – If not, does the management team have a track record elsewhere that can be reviewed with respect to decision making and results in both up and down markets?
 - Tips - Reconcile the length of the track record with the bios of the key individuals and review their roles during prior market downturns in their selected asset class.
 5. Is the sponsor's track record verifiable?
 - Consideration – Are the Sponsor's claims about prior performance verifiable?
 - Tips – Use third party sources such as closing statements, audits, and tax returns to verify gains in prior sales. Use financial statements (preferable audited or reviewed) to verify program earnings and distribution coverage). Interview prior investors/partners of the sponsor to confirm results in prior transactions. For prior dispositions, do any of them involve sales from one of the Sponsor's management programs to another managed program?
 6. Why is the sponsor choosing to raise money via the retail broker-dealer channel?
 - Consideration – Did another capital source dry up?

Topic: Business Plan / Investment Strategy

Note: If the sponsor is a large company with significant net worth/financial strength, may limit time spent with their business plan (outside of a fund specific strategy).

Concern:

Sponsors should be able to clearly articulate and provide support/backing for their business plan. Sometimes business plans can be open-ended and/or lack a core thesis that is supported by data.

Focus:

1. Does the sponsor's business plan make sense in the current and/or expected market environment?
 - Consideration – What factors support the underlying business plan and could a reasonable investor understand the business plan and inherent risks?
 - Tips – Ask the sponsor to provide market research and/or studies to support their business plan. Is the information in the business plan accurate and complete? Are the assumptions used reasonable?
 - What are the tactics in place to protect investors' capital? Are there leverage limits or diversification objectives that provide guard rails?
2. Obtain an understanding of any required legal or regulatory issues within the sector.
 - Consideration – What risks exist here and how are they overcome?
 - Tips –
 - Oil and gas drilling – what limitations and/or regulations may impact their plan?
 - Real estate development – environmental/state, etc. controls that could impact their timeline or costs.
 - Special situations - If they are targeting a specific investment type like 1031s, Opportunity Zones or conservation easements, ask for a tax opinion.
3. Independent Expert Feedback
 - Consideration - Sponsors should be able to backup all factual statements made in the offering documents with factual support and not opinions. Further, when much of the offering is written in "the general partner believes that XYZ strategy delivers the highest returns in the real estate industry" then we need to be concerned.
 - Tips - Have independent experts reviewed the sponsor's investment strategy and opined to the sponsor's use of industry best practices as to the sourcing, evaluating, and selection of assets for a program?

Topic: Financial Analysis (Financial Viability/Accounting System Integrity)

Concern:

The financial position of a sponsor should be considered and although a strong position does not necessarily guarantee a successful future, it can provide some additional comfort in deciding to work with them.

Focus:

1. Financial Statements
 - Consideration – Audits are strongly preferred at the sponsor level. If financials are not audited, then who prepares the sponsor's financials internally and what controls does the sponsor have in place?
 - Tips – Are auditors in good standing with the PCAOB - (confirm directly). What internal control reports have been prepared by independent firms? Obtain the sponsor's financial statements and confirm that an unqualified audit opinion was issued. Ascertain that there is staying power

to achieve the offering business plan. If the sponsor does not have audits, then request to review financial statements and federal income tax returns going back 2 – 3 years.

2. Capitalization; Financial Stability

- Consideration - The sponsor has the net capital (i.e. > \$250K), liquidity, and cash flow that is sustainable at levels required to remain operational over a long term period.
- Tips - What sources do they have to add capital should they require it in the future (e.g. sponsors of public companies may have more options than private companies)? Obtain the sponsor's buy/sell agreement to understand the consequences of the triggering events. Be aware of businesses based out of community property states since there are some complexities.

3. Leverage

- Consideration – Obtain a full scope of their debt obligations including type (fixed/flexible), rate, principal and interest or interest only, maturity dates and if they have any recourse obligations. Also, review loan covenant obligations imposed by the lending agreements.
- Tips - Examine their fixed charge coverage ratio on interest and preferred dividends or preferred equity investors. Call lenders to ensure that the sponsor's loans are paid as agreed and verify that the sponsor is in compliance with all loan covenants

4. Sponsor's accounting books are segregated from the books of the managed retail programs

- Consideration - Each retail program should be treated as a stand-alone going concern business with separate accounts and financial records.
- Tips - Ensure loans or advances are not being made between various business concerns.

Topic: Third Party/Independent Due Diligence

Concern:

It is important to obtain 3rd party DD reports that bring depth of experience across the fund sector, structure and managerial concerns.

Focus:

1. Obtain a 3rd party report on the sponsor entity (or an offering specific report with significant information relation to the sponsor)
 - Consideration – This should be updated at least every 1 to 2 years, especially if there have been major management and/or ownership changes or if there has been a significant challenge/external influence to their business (i.e., hotel operators during Covid)
 - Tips – Areas of sponsor-level coverage should include:
 - Management/organizational structure including any changes since the last review
 - Background checks on key decision makers and a review of legal and regulatory challenges the sponsor may be facing
 - Detailed review of their track record and operating history (with testing of the prior performance undertaken by the due diligence provider).
 - Review of various operational groups within the organization

- Financial review and analysis (audits/reviews are preferred, consider federal income tax returns too if audits/reviews are not available).
- Legal document review and analysis
- Business succession plan

Reminder: Broker Dealers cannot rely solely on 3rd party due diligence and must provide evidence that they have conducted their own diligence, too.

2. Review and follow up on 3rd party report findings

- Consideration – Look for comments/recommendations to determine if there were any questions raised or items of attention noted within the reports and observe if any requests were not fulfilled.
- Tips – Be sure to follow up on any red flags or items of attention noted and document it as well. Speak directly with 3rd party firms to address any material items noted and discover anything about the review that did not make it into the formal report. From a regulatory perspective, you can use the 3rd party reports to aid in your diligence process but not solely rely on it (FINRA NTM 05-48).

Topic: On-Site Due Diligence

Concern:

On-site due diligence is a critical step in getting to meet the sponsors. Oftentimes initial interactions are with just a small segment of the sponsor's team. Going on-site allows you to make a more in-depth assessment of the management team including learning their areas of expertise and their role in successfully implementing the business plan and outcome for the investment.

Focus:

1. Prior to first working with a sponsor, it is recommended to go on-site to the corporate offices.
 - Consideration – Meet with all key managers and personnel and review documentation that the sponsor wants to keep confidential due to its nature (e.g. audited financials for the parent of a sponsor entity; personal financials or tax returns relating to the sponsor's principals, or trade secrets or other proprietary information the sponsor wants to keep protected from the public domain).
 - Tips – For real estate or oil and gas reviews, interview the current property managers or operators of an asset while on site. If on site travel is not feasible then conduct virtual meetings. Set an agenda for the meeting and make sure all of the personnel you wish to meet with are available to meet with you.

Topic: Other Considerations [Will be more fully addressed in future Phase Gap Consideration Studies but will be mentioned here to provide advance insight into the 4 Gateway approach being taken in this initiative.]

Concern:

There are many other considerations when reviewing a sponsor and these are some of the notable items not mentioned above.

Focus:

1. Managing Broker Dealer / Dealer Manager
 - Consideration – Has the MBD shared their due diligence with your firm?
 - Tips - What criteria was used by the sponsor to select their MBD? What services are the managing broker dealer performing? Are they adequately reviewing the marketing materials before issuing the offering to the public?
2. Sponsor's Alignment of Interest with Investors
 - Consideration – Does the sponsor typically invest alongside investors and what is the net amount of the sponsor's contribution once asset mark-ups and other items of sponsor related compensation are factored?
 - Tips - Review any provisions in the offering documents and fund organizational documents to determine if the sponsor is making a contribution to the program after factoring sponsor compensation (e.g. cost-plus drilling contracts or equivalent in real estate).
 - Consideration – Are any of the sponsor's principals/co-founders being cashed out of the underlying business?
 - Tips – If the offering is a promising one, then why is one or more of the sponsor's principals being cashed out of the business?
3. Transparency / Disclosure Items
 - Consideration – What materials is the sponsor unwilling to provide access to? Is the sponsor willing to provide limited access (on-site, virtually) if the documents are not provided directly? Are there documents that are required under FINRA (ex. tax opinions) provided? If limited access is provided, are there further restrictions (time, ability to control the documents, etc.) that also limit the ability to review?
 - Tips – Work with third party firms to determine the reasonableness of a limited scope engagement given the underlying facts and circumstances, if applicable.
4. Affiliated Transactions
 - Consideration - Does the sponsor's track record include sales of assets among programs syndicated by the sponsor (if so, how many related party transactions were involved)? Does the sponsor allow business transactions to occur among the programs it manages? What analysis is undertaken to ensure that the transaction terms among the related program are fair and balanced?
 - Tips - Consider third party comments on these topics or inquire about them.
5. Are advisors/ reps driving the product approval process? *(Note: this might be something considered more closely at the offering-level, but this practice may also occur at the sponsor vs. offering specific level).*
 - Consideration – The sponsor, business plan and quality of the offering should be the focus.

- Tips – Utilize 3rd party due diligence as a screening tool. The quality of the offering can, in part, be determined by the depth of information provided in the offering documents. This is particularly important for private placements. After reading the document, investors should be able to understand the business plan, fee structure, risks and other important dynamics. If you see any shortcomings, ask the sponsor to supplement or amend the offering documents for more details.

6. Public website review

- Consideration – Adequate disclosures based on their offering registration type (506b vs 506c), promising returns, implying high returns/low risk, unreasonable comparisons to low risk/mainstream investments, links to pages where there is more aggressive language?
- Tips - Are disclosures complete and in accordance with SEC & FINRA requirements? Be sure to click on all links to ensure consistency of tone/messaging.

7. Marketing approach / offering promotion

- Consideration – Are marketing materials for private placements submitted to FINRA for review? If not, is there full and fair disclosure including but not limited to balanced risk disclosures and sources for information being presented. Understand the sponsor's process for creating such materials. How are they promoting the offering: advisor/rep/investor seminars/dinners (review agendas); marketing materials/PowerPoint presentations (review for completeness, balance, and adequate disclosures).
- Tips – Listen to the language utilized by the sales teams and during presentations. Is it overly aggressive and inconsistent with approved marketing material language? Is what they are saying aligned with what the offering document says, especially as it relates to distributions and expectations for future liquidity. Obtain information on any training (at a minimum on the offering they are selling to your firm members) of wholesalers and national accounts professionals.

8. Broker/Dealer community confidence

- Consideration – Is the size of the selling group growing or shrinking? Has the size of the sponsor's offerings grown or shrunk?
- Tip – A reduction in the selling group or offering size could indicate that the BD/RIA communities have lost confidence in a sponsor based upon prior business results.

9. Insurance – Selling Group Member Level

- Consideration – Favorable answers to any question's insurance carriers require prior to coverage.
- Tips – Speak with your insurance carrier to obtain a list of items that would be of interest for them and include that as a list of topics to be addressed during the review (some key considerations may include: does the Broker Dealer have a formal due diligence committee that considers the Alternative products, what is the sourcing process for new products, and is there required advisor education prior to product sale).

10. Reporting

- Consideration – Are supplements and other investor communications expected on a timely basis?
- Tips - How are these communicated to BDs, reps and investors? Ask for samples of the sponsor's investor communication. Review for depth and accuracy of information. Are returns

being shown net to investors? Are they providing financial statements? Do they explain the good outcomes with the bad outcomes? Clients have entrusted their dollars to the sponsors and want clear, concise and accurate information.

11. Style Drift

- Consideration – Is there too much leniency in what sponsors can invest in? Have there been style drifts and are they material?
- Tips - What was the cause of the style drift and has it materially affected the investment thesis? If you determine the sponsor is being provided too much leniency, ask them to narrow the scope of what they can invest in via a supplement or amendment to the offering. For private placements, pay particular attention to the sponsor's reinvestment window for a particular offering. Typically, private placements are designed to capture a certain market opportunity; so, any ability to extend the offering via reinvesting proceeds from the sale of an asset may lead to style drift. Plus, reinvesting proceeds may be another opportunity for the sponsor to earn additional fees.

12. Subjective Items:

- Consideration – Any other considerations that give you pause?
- Tips – While oftentimes subjective, it is important to confirm and/or vet components of the sponsor's investment thesis or business plan.

*In April 2010, FINRA issued Notice to Members 10-22 ("RN 10-22"). In RN 10-22, FINRA reminded broker-dealers of their obligations to conduct a reasonable investigation of issuers and the securities such broker dealers recommend in offerings made under the Securities and Exchange Commission's Regulation D under the Securities Act of 1933 (also known as private placements). Pages 8-10 of RN 10-22 provide a list of recommended informational inquiries concerning product sponsors, an issuer's business prospectus, and an issuer's assets. While this GAP Analysis references certain items of information that are believed to be relevant to the informational inquiries set forth in RN 10-22, **this GAP Analysis should not be construed as a checklist of all informational items that may be material to a broker dealer's reasonable basis review and determination regarding a sponsor or its offered products.***