CDC

Investment works

Guidance

Business integrity guidance for venture capital fund managers

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Disclaimer

This introductory guidance is for Venture Capital (VC) fund managers based in the emerging markets in which CDC Group invests. As we increasingly make VC investments in Africa and South Asia, we are keen to support fund managers to entrench business integrity risk management in their investment strategies, approach and processes, and to help them plan ahead in a way that makes their investment platforms and portfolios more impactful and resilient while generating financial returns. This guidance was created by our Business Integrity team, and draws from their experiences, and lessons learned from engaging with and supporting VC fund managers.

Who is this guidance for?

- VC fund manager teams who oversee business integrity and compliance or corporate governance functions more broadly, such as Business Integrity Officers, Compliance, Finance and Legal teams, managing partners and Operations or Investment Officers.

What does this guidance cover?

- Our definition of business integrity
- Value additionality connected to good business integrity risk management practices
- Overview of typical business integrity risks in VC investing
- Overview of business integrity risk management approaches at both the fund manager and portfolio levels

Legal disclaimer

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Business integrity and risk management for VC funds

1.1 What is business integrity?

Business integrity is an approach that recognises businesses need to operate in a transparent and ethical way in order to be successful.

Our Business Integrity team focuses on the following areas of risks which, if well managed, enable fund managers to deliver both financial returns and development impact as per our mission:

- Corruption
- Money laundering
- Terrorist financing
- Fraud
- Breaches of sanctions regimes
- Tax evasion and other criminal conduct
- Reputational risks

This guidance aims to introduce VC fund managers to typical business integrity risks inherent in their markets, strategies and investor bases, and to provide an overview on how to proactively manage these risks.

1.2 The value of good business integrity risk management

	Reduce losses	Create operational efficiency	Enhance brand value
Fund manager level	– Limit financial losses caused by business integrity incidents connected to the investor base and portfolio performance. – Enable improved financial returns. – Improved commerciality. Adopting a phased approach for embedding business integrity risk management in the early stages – and scaling over time – will result in less expense and legal or remedial costs as the investor base and portfolio grow.	– Improve portfolio resilience. – Create better employee retention at both manager and portfolio levels. – Future-proof against interventions from regulators that negatively affect or disrupt the fund's strategy.	– Safeguard reputation through good risk management, and robust and transparent operations. – Attract investment from global commercial/DFI/impact investors seeking to invest in fund managers aligned on business integrity.
Portfolio level	– Limit the potential for financial loss caused by business integrity incidents. – Enhance bottom-line profitability. – Minimise regulatory fines and risks. – Protect investment. – Improve business resilience and continuity.	– Reduce bottlenecks in decision-making. – Streamline processes, and create room for strategic thinking and innovation. – Enable faster responses to crises. – Create better employee retention.	– Improve quality of services. – Build customer trust. – Transparency, strong ethics and good business integrity programmes create better returns. – Enable greater employee retention and satisfaction. – Attract investment for follow-on capital, exit or IPOs. – Enable global market access.

1.3 Risk management for VC funds

Across the investment cycle, good business integrity risk management practices can be seen as financially value additive, increasing business resilience and ultimately returns. But what does Risk Management really mean?

Risk management is the process of minimising or mitigating the risks faced by the fund manager. This includes identifying and putting in place mitigation measures to keep the risk within the parameters of the defined and accepted risk appetite. Fund managers should consider business integrity risks at two levels: fund manager level and portfolio level. Business integrity risks require different approaches to mitigation at these levels, but they are equally critical to manage.

Risk

"An uncertain future event that could affect fund managers' ability to achieve their objectives"

Fund manager level

Fund managers should have resources in place to identify and assess their exposure to business integrity risks connected to the investor base and also the investment strategy/portfolio, and put in place proportionate processes designed to minimise these risks.

Portfolio level

Portfolio-level risks connected to VC funds investing in early-stage companies are distinct from those associated with private equity (PE) investments in more 'mature' and established companies. In early-stage companies, business integrity risks and opportunities may be perceived to be lower but, as these companies grow in size and market presence, their risk profiles evolve and business integrity risks may increase in magnitude and scope. For example, heightened risks may be related to new strategies, sectors, markets and customer types. Furthermore, with successive fundraising rounds the shareholding, and related influence and legal leverage that a VC investor has in relation to portfolio companies will change too (whether increasing or decreasing).

These evolving circumstances require fund managers to take a phased and proportionate approach to business integrity risk management at the portfolio level. Fund managers need to develop adequate risk management and monitoring frameworks that match and mitigate the additional levels of risks as the portfolio evolves.

VC fund managers may have the additional challenge of having less dedicated resourcing at the fund level, meaning that the monitoring and managing of evolving portfolio risks could be more difficult if business integrity considerations are not fully integrated in the manager's investment approach and culture from the outset.

1.3 Key risk factors and challenges in VC investing

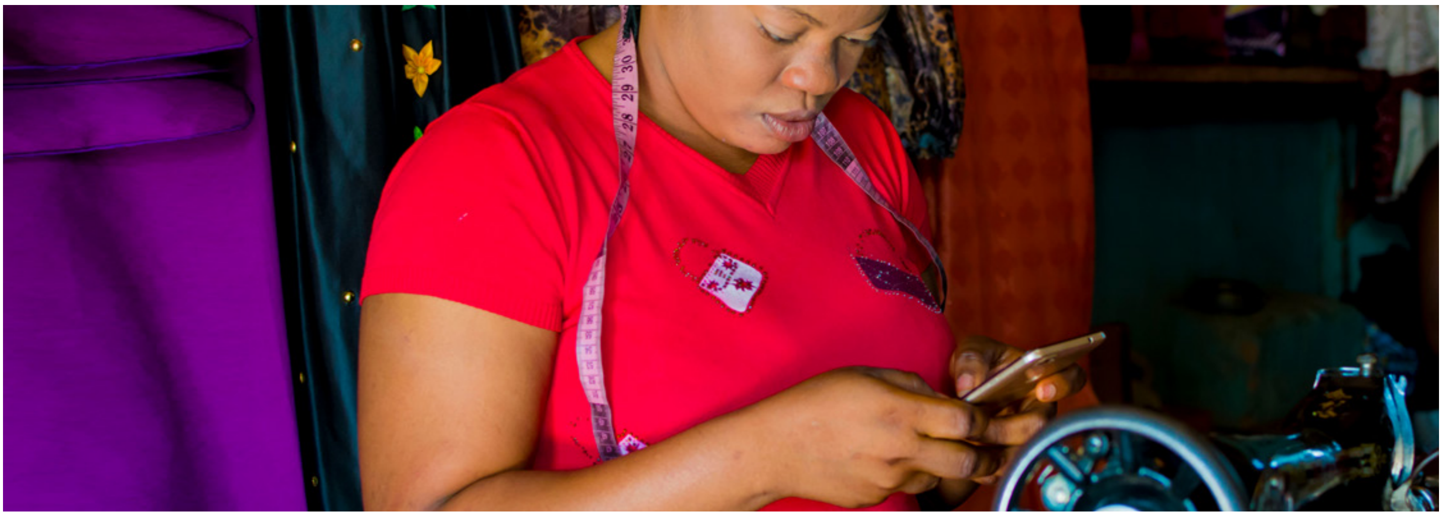
Across the investment cycle, business integrity risks can arise at the fund manager and portfolio levels and there are certain risk factors and challenges to be considered at each level.

	Fund manager level	Portfolio level
Capacity	Fund managers typically have small teams and large portfolios. This limited bandwidth may restrict the support they can provide to portfolio companies along with their ability to conduct pre-investment business integrity risk assessments and post-investment monitoring.	Early-stage companies focus on testing and refining their business model and obtaining more capital to fund their expansion. As a result, business integrity risks are often overlooked due to resource and capacity constraints, and focus on the market.
Evolving business model	At an early-stage, fund managers might not have formalised procedures and processes in place. Some of the risks relate to pre-onboarding checks which, if not completed, could result in increased money laundering, political and sanctions exposure.	During the early stages of development, the whole business model can shift direction in response to market demand, potentially opening new and unforeseen business integrity risks and opportunities. Unexpected changes in strategy can cause issues if the company's products or services are not adapted for new sectors with inherent business integrity risks and challenges.
Regulatory environment	In emerging and frontier markets, VC fundraising and investing are themselves subject to evolving and increasingly stringent regulations. This means fund managers need to work with reliable third parties, such as fund administrators and law firms, to ensure regulatory compliance at the fund manager level.	VC-backed companies often use disruptive technology or business models that may not be effectively regulated by existing legal frameworks. There is also a risk of company strategies diverting into areas that could breach a fund's exclusion list, or pose regulatory and reputational risks. For example, face-recognition technology used by the military or for surveillance purposes, or gaming software used by gambling firms.
Reputation	Fund managers are exposed to potential reputational risk, for example stemming from relationships with high net worth investors (HNWIs). A proportionate/risk-based investor due diligence approach is recommended, which can include adverse media checks as well as reference checks through the VC/PE network on investors to understand their reputation and track record.	While having less capacity and expertise to manage business integrity issues, VC-backed companies are also more susceptible to reputational risk. Adverse media reports can have a debilitating effect on a pre-profit company seeking investors and new market opportunities. Companies are particularly vulnerable to negative reputational impacts during the early stages of growth, given the significant influence these can have on fundraising efforts and customer acquisition.
Fundraising	Limited partners (LPs), including development finance institutions (DFIs), and other responsible investors, increasingly expect fund managers to demonstrate a meaningful approach to responsible investment and the management of business integrity risks.	As the portfolio company grows and risks evolve, a reassessment should be conducted at every fundraising round (such as co-investor risk). Each new funding round should be used to verify that previous requirements have been fully addressed and to confirm an improvement.

1.4 BI risks in the investment cycle

Start-up journey

	VC fund	Seed	Series A/B (early-stage)	Series C+ (growth)	Exit
Risk	Fund manager risks such as money laundering, tax, sanctions, PEP and reputational risks evolve	Increasing portfolio-level business integrity risks: bribery and corruption, money laundering, fraud, tax evasion and regulatory and reputational risks			If sale to PE/VC fund or other strategic and corporate investors (growth capital): – Exit KYC checks on purchasing entity – Sanctions screening – PEP screening – Conflict check
Mitigants	Develop investor due diligence including: – AML approach – KYC checks – Sanction screening – PEP screening – Further checks on the investors who have been identified as higher risk (adverse media checks, conflict checks)	– Conduct KYC checks into promoters/UBOs – Implement a phased and proportionate Business Integrity Due Diligence (BI DD) and risk assessment approach	– At each fundraising round: conduct risk-based KYC checks into co-investors – Refresh the phased BI DD and risk assessment – Review BI DD approach when other investors lead rounds – Implement a risk-based business integrity framework and monitoring	– New fundraising round: conduct co-investor KYC checks in line with specific requirements of the jurisdiction of investment – Refresh the phased BI DD and risk assessment – Input to and review BI DD led by other investors – Develop key BI policies and controls based on risk – Conduct BI portfolio monitoring and reporting	If IPO: – Understand the requirements of the listing process in the jurisdiction stock exchange where listing – Support the company in demonstrating to potential buyers how business integrity risks have been mitigated



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Deep dive into key risk areas for VC funds

2.1 Overview of business integrity key risk areas

This section introduces some of the typical business integrity risks that fund managers in our target geographies may face, but this is not an exhaustive list of such risks. The section covers:

- Money laundering
- Sanctions
- Bribery, corruption and fraud
- Regulatory risks

This section outlines the risks in more detail, and provides fund managers with guidance on risk management approaches and potential mitigants.

The suggested approaches can also be used to tackle other business integrity risks identified.

2.2 Money laundering

Money Laundering (ML) describes the process by which the true origin and ownership of the proceeds of criminal activities are disguised.

Any transaction which facilitates the use of criminal proceeds, directly or indirectly, can potentially constitute money laundering (subject to the specific laws of the jurisdiction in question).

Why is anti-money laundering (AML) important for VC funds?

Due to the flow of funds involved in VC transactions, it is important for the source and origin of funds to be established to reduce the risk of the investment process being used as a means of conducting money laundering.

In VC investing, money laundering risks are predominantly in respect of:

- Limited Partners (LPs) into the funds; and
- Portfolio companies and their Ultimate Beneficial Owners (UBOs)/co-investors.

Money laundering risks associated with fund managers, and their underlying portfolios, include:

- **High-net-worth individual (HNWI):**

  HNWI is a generic term used to designate persons whose investable wealth exceeds a given amount, typically $1m. HNWIs may present integrity and reputational risks due to previous investments, a lack of transparency as to the source of their wealth, potential engagement in tax avoidance or evasion and potential political exposure, as well as a potential conflict risk if they have interests in multiple funds or companies. Risk-based due diligence on HNWIs is required to ensure there is clarity regarding the origin and use of their funds. This helps mitigate potential reputational risks, for example the damage of being associated with the "wrong" investor.

- **Ultimate Beneficial Owners (UBOs):**

  UBOs are persons who ultimately own or control a company (for VC, relevant for ownership of corporate investors and co-investors, and portfolio companies).

  Effective UBO screening therefore allows the potential beneficiaries of illicit or criminal conduct to be identified, and mitigate both money laundering and reputational risks.

- **Family offices & Trusts:**

  Family offices and trusts tend to have complex ownership structures that can be used to conceal the identity of UBOs and trust beneficiaries. This is particularly challenging when underlying investors are HNWIs who, given their profile and network, may have the ability to utilise offshore bank accounts and transfer funds globally on an anonymised basis.

- **Politically Exposed Persons (PEPs):**

  PEPs are individuals entrusted with (or formerly entrusted with) a prominent public position. The definition of a PEP extends to their immediate family or spouses. Due to their prominent position, PEPs require enhanced assessment given the heightened corruption and bribery risks through their role and connections, which typically manifests as an abuse of their entrusted power for private gain.

Fund managers can mitigate money laundering and wider business integrity risks associated with onboarding new investors or portfolio companies by conducting adequate and risk-based due diligence and 'Know your Customer' (KYC) checks. KYC is a regulatory requirement for VC funds, with the objective of identifying and verifying the ownership and control, and purpose, of the investment, alongside any integrity risks presented by the investment relationship at both a fund and a portfolio level. For high-risk entities and individuals, additional 'Enhanced Due Diligence' (EDD) checks, should be conducted.

Fund manager level

Fund managers should conduct pre-onboarding due diligence on the LPs investing in the fund, including KYC checks and screening, in particular:

- Identifying and verifying the identity of all LPs (such as obtaining a Proof of Identity and address), including the ultimate beneficiaries of trusts/complex structures involved in the fundraising round;
- Conducting sanctions and international PEP screening; and
- Meeting with the LPs and their representatives where possible.

Portfolio level

KYC checks should also be completed for all portfolio companies at the following times:

- **Time of investment:** VC fund managers should collect corporate documentation and identify and verify UBOs and controllers (individuals who have executive control and influence on the company's affairs, such as senior management, directors and promoters) of portfolio companies. Best practice is to seek to identify all shareholders, not only UBOs, where possible.
- **At each fundraising round**, fund managers should identify new co-investors in portfolio companies.

"One of my co-investors is involved in money laundering, what do I do?"

- A common offence under money laundering legislation relates to "tipping off". Tipping off means alerting a relevant individual (for example, the person suspected of laundering money or a close associate), that an investigation into the suspected money laundering activity is either in progress or pending.
- Any identification of money laundering should therefore be reported through formal escalation channels to minimise the risk of tipping off.
- Similarly, matters relating to suspected money laundering offences should not be discussed or investigated outside of the formal channels established within the business.

Enhanced due diligence

Enhanced due diligence may include:

- Requesting evidence about the source of wealth and, for investors, clarifying the rationale for investing in the fund;
- Requesting additional information and documentation to verify the source of the wealth, and in particular the source of the funds used by the LP to invest in the VC fund;
- Lowering the KYC threshold on UBOs from 25% ownership (typical regulatory requirement) to 10% (best practice);
- Conducting enhanced adverse media checks to assess reputation and track record (such as Google check, WorldCheck and searches of public government, regulatory and litigation websites);
- Conducting conflict checks; and
- Conducting further reference checks on individuals and entities that have been identified as higher risk due to a poor or inconsistent track record. These checks must be duly documented and saved on file.

What is high risk?

The following triggers can be helpful for fund managers to identify high risk investors and companies/UBOs/directors:

- Investors/UBOs are from high-risk jurisdictions;
- There is a lack of transparency around the identity of relevant parties and/or the source of funds;
- Involvement of PEPs;
- There are complex ownership structures and use of tax havens;
- Wealth has been accrued in high-risk sectors, for example mining and extractives or defence; and
- There are unusual transactions, or transactions that lack an obvious commercial or lawful purpose.

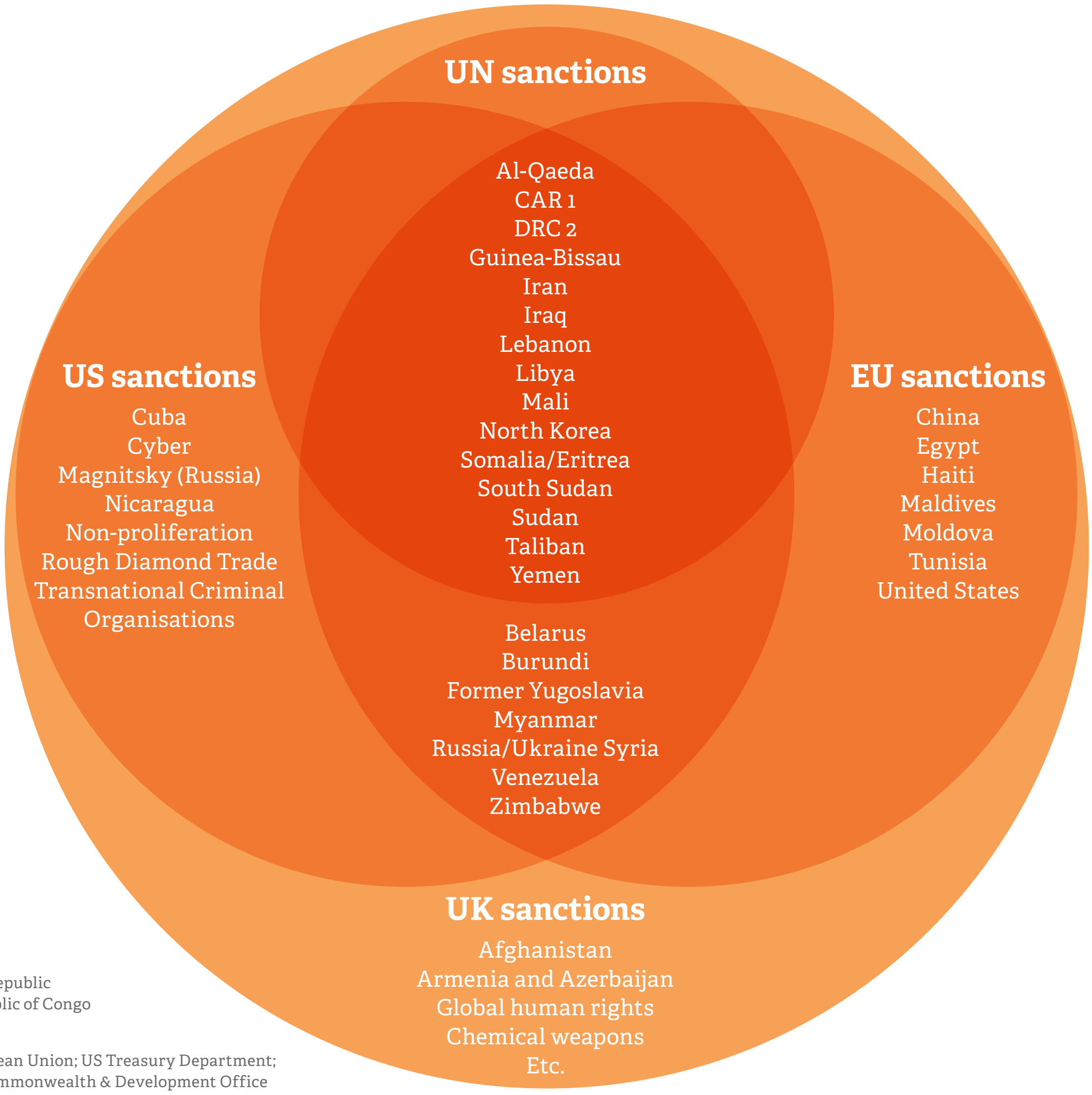
2.3 Sanctions

Economic sanctions are implemented by governments and supranational bodies (such as the United Nations or the European Union) against individuals, entities, and countries to influence behaviour or achieve a foreign policy goal, including countering criminal activity, human rights abuses, and terrorism. Sanctions typically impose restrictions on the provision of services or making funds available to, or require freezing assets of, individuals and organisations (known in the UK and EU as "Designated Persons").

Why is sanctions compliance important for VC funds?

Sanctions risks for VC fund managers primarily relate to their investors, and co-investors in portfolio companies, particularly HNWIs hailing from diverse jurisdictions, especially those subject to sanctions regimes. Portfolio companies with operations and supply chains focused in one jurisdiction are likely to present lower sanctions risks. Fund managers in our geographies should monitor evolving sanctions regimes such as China and Russia.

Global Sanctions Regimes (2019) - Non exhaustive



1. Central African Republic
2. Democratic Republic of Congo

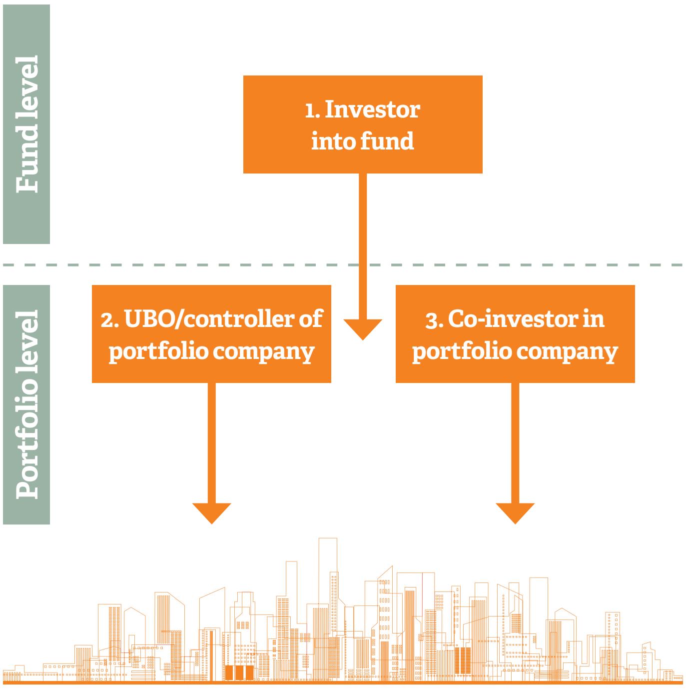
Sources:
Council of the European Union; US Treasury Department; GOV.UK; Foreign, Commonwealth & Development Office

What do sanctions risks look like in VC?

Sanctions risks can arise for VC fund managers due to the following factors:

- The screening of all direct shareholders, UBOs and controllers of all investors and portfolio companies can be difficult when dealing with large portfolios and with complex corporate or trust structures or group entities.
- As new co-investors come into fundraising rounds and need to be sanction screened, it can be resource-intensive to obtain confirmation from the portfolio companies that adequate screening has been carried out prior to business relationships being entered into.
- Where a portfolio company goes bankrupt or becomes dormant, a sanctions risk may persist. Risk-based monitoring is required to ensure there is no engagement with sanctioned individuals or entities.
- Sanctions regimes can be breached even in circumstances where there is no direct presence in the jurisdiction that the regime relates to. For instance, an LP may be based in a jurisdiction that is targeted by a sanctions regime. For this reason, risk-based monitoring of investors and portfolio company UBOs is required to ensure applicable sanctions regimes are not breached indirectly.

Three sources of sanctions exposure



To mitigate the risks connected to sanctions, the following controls should be considered by fund managers:

Risk-based approach

- Onboarding and ongoing screening against sanctions lists that apply to the fund in terms of risk exposure, jurisdiction, LP requirements and currency exposure (such as US OFAC where exposed to USD currency or US nexus).
- You can use screening databases (for example WorldCheck) or, if you have no access to such tools, publicly-available lists published on regulatory and government websites:

  UK Sanctions List and UK HMT List (for the latter, see Online Search Tool)

  UN SC Consolidated List

  OFAC Sanctions List Search

Different levels of screening

- **For investors being onboarded into the fund:** As a minimum, risk-based screening should take place at the onboarding stage and before a payment is made to, or received from, corporate and individual investors. DFI investors are considered low risk and do not need ongoing screening.
- **For portfolio companies, promoters, significant UBOs and controllers, and co-investors into portfolio companies:** As a minimum, screening should take place at the time of investment, and for each of the subsequent financing rounds.

What to do when you have a diluted shareholding and/or limited access to information and need to perform sanctions screening?

A fund manager's access to information about a company's UBOs and controllers may change over time (for example, due to a dilution of shareholding), and they should seek to monitor sanctions risks by:

- Understanding whether the company and its key stakeholders are undergoing regular sanctions screening due to other mechanisms (for example through listed companies or companies with debt facilities with major banks.);
- Drawing on public record information to conduct 'best effort' sanctions screening; and
- Documenting the rationale for the approach adopted, and where risk profiles change seek expert support from a law firm.

While screening will provide visibility over the sanctions risk, your recourse for action may be limited. In this instance, it is important to establish whether the company has a process to monitor its shareholders.

What to do with failed companies and co-investors?

Even where portfolio companies have failed, there is still a risk of breaching sanctions legislation should those companies engage or interact with sanctioned individuals or entities. To ensure trading activities have ceased, 'light touch' monitoring should be conducted on a regular basis as above.

Case study: Safari Tech

Ada is the founder of Safari Tech (Safari), an early-stage investor based in Kenya, Africa. Safari is raising its first fund, focusing on tech-enabled ride-hailing platforms, which Ada believes fits the trend towards quick, convenient, and cost-effective transportation.

Fundraising

For the first fund, Safari aims to make 40 investments to build a highly diversified portfolio. After developing marketing material and pitching the fund's strategy, Ada attracted several investors including over 20 HNWIs, some family offices, some smaller corporate investors and a few individuals referred from a personal contact. All were based in different countries and the contribution from each LP varies from USD 100,000 to USD 500,000. As Ada took a closer look at her prospective investors, she noticed that one investor was a family office with no clear disclosure of the identity of the ultimate investors. Another investor was a HNWI, investing through a trust incorporated in the British Virgin Islands. Upon conducting enhanced reputational and integrity checks, Ada was unable to find any details on the track record, history and reputation of this individual. She also spotted that some of the LPs are Russian businessmen with strong political ties in their respective countries.

Red flags connected to investors

Ada recognised there were potential red flags for money laundering, tax evasion and wider reputational risk (opaque trust structure based in a tax haven, lack of clarity on the UBO, lack of details on track record), and ran further checks. She requested the LPs provide proof of identity and address and, for the trust and family office, full disclosure of the ultimate investors. She also ran sanctions and international Political Exposed Persons (PEPs) screening through the WorldCheck database, having recognised that some of the potential investors were based in countries subject to sanctions regimes and politically well-connected. Unable to obtain all the information that she required through her due diligence, Ada asked the red-flagged LPs directly the purpose of their investment in the fund. Two of the LPs declined to respond and withdrew their interest in committing to the fund. With hindsight, Ada believes she may have just prevented the fund from being used as a means of laundering money.

Debarment

Two years later, Ada became aware that one of the HNWI investors, Mr Abo, had been blacklisted and debarred by the country's regulator following a five-year criminal investigation resulting in him being charged with corruption. The investigation focused on Mr Abo's role as a former CEO of an oil and gas conglomerate, when he was found guilty of paying bribes of USD 10 million for more than a decade, in exchange for government contracts. The payments were facilitated by the fact that one of Mr Abo's family members was the Minister of Energy in the country. Whilst Ada conducted standard KYC to verify Mr Abo's identity at the time of investment, she did not conduct enough reputational and reference checks to assess the risks connected to Mr Abo's track record and origin of wealth (accrued in a high-risk sector). As a result, she was then unaware of the ongoing criminal investigation that led to the debarment of Mr Abo and the reputational and regulatory risk that Safari faces. As the LP has been debarred, Safari is no longer permitted to send and receive any funds from Mr Abo, including drawdowns and dividends, based on the country's regulations. The association with this LP has caused significant reputational damage to Safari, and Ada has had to engage a costly law firm to help set up an escrow account where funds connected with this LP are held, and to freeze the remaining funds.

This case study is fictitious and is not based on any CDC investment.

2.4 Bribery, corruption and fraud

Bribery

Bribery involves the offering, promising, giving, accepting or soliciting of an advantage (financial or otherwise) as an inducement for an action which is illegal, unethical or a breach of trust. In the UK, bribery is defined and enforced by the UK Bribery Act 2010 (UKBA 2010). There are similar laws in all jurisdictions.

Corruption

Corruption is broadly defined as the abuse of an entrusted public power for private gain. However, corruption can also involve private actors. Acts of corruption themselves are broad in nature, but typically they include payments, benefit enhancement and/or cost reduction.

Fraud

Fraud includes both theft and unlawful loss through deception. Fraudulent conduct might involve dishonestly causing loss to another or exposing another to a risk of loss by means of a false representation.

Fund managers are typically not exposed to high bribery and corruption risks. At the portfolio level, early-stage start-ups are also likely to have limited exposure to corruption risks due to their small operational footprint. However, as companies scale, the portfolio-level corruption risks increase, and potentially rapidly.

Fund managers should adequately manage material corruption risks because:

- There could be financial loss due to fines;
- There is a risk of reputational damage;
- There is a potential for fund managers to be personally prosecuted where they are considered to be an accessory or co-conspirator, due to them being aware, or involved in, bribery and corruption in portfolio companies (for example majority shareholdings or board seats);
- Some VC-relevant sectors may be more vulnerable to corruption risks connected to supply chains, including B2B e-commerce, agritech and manufacturing; and
- The legislation across our jurisdictions differs. Some bribery-related laws focus specifically on public officials, while others target private sector actors and their obligations.

Key drivers for bribery and corruption risks across portfolio companies include:

- Pressure to aggressively market new products, and expand market presence, as companies rapidly grow can lead to corrupt and unethical sales practices. This risk may be especially prevalent when sales-based commissions are awarded to employees. This is more likely to take place at the Series B/C stage.
- Exposure to private and public procurement, including large-scale government contracts, as governments seek to access new e-commerce and tech-enabled platforms to support digital economies. This can lead to unethical bidding practices, facilitation payments and the inducement of procurement personnel, in an attempt to gain an improper commercial or business advantage.
- Increased bribery risk due to a lack of oversight on expense budgets and/or gifts and hospitality allowances. This risk may be heightened when such budgets and allowances are used by sales teams before companies formalise and establish adequate policies and processes.
- A start-up culture of conferences/networking/informal introductions, especially when combined with a lack of adequate anti-bribery and corruption training and awareness.
- Companies may use aggregated models that rely on multiple intermediaries and suppliers, posing associated corruption and integrity risks connected to onboarding and monitoring of third parties.
- As they grow, companies may have larger exposure to government interactions when applying for permits and licenses, leading to heightened corruption risks (for example, facilitation payments or requests for bribes). The risk increases when companies use intermediaries to deal with government bodies and applications for permits or licenses.

2.5 Regulatory risks

Why is regulatory risk important for VC funds?

Due to the flow of funds involved in VC transactions, it is important for the source and origin of funds to be established to reduce the risk of the investment process being used as a means of conducting money laundering.

In VC investing, money laundering risks are predominantly in respect of:

- Fund managers should monitor the regulatory landscape – and the resultant emerging risks – and ensure these are duly managed before those risks materialise.
- At the fund manager level, regulations relating to investments and fundraising are evolving, but tend to be more progressive.
- At a portfolio level, VC-backed companies tend to use innovative and cutting-edge technologies or products. At times, these may be unregulated or not be effectively regulated by existing regulations, or subject to nascent/evolving regulatory requirements. Therefore, it may be difficult for companies to track and comply with new regulations, especially if they have limited capacity for oversight, presenting heightened regulatory risks.
- Regulatory risk is closely connected with corruption risks because companies' efforts to engage with regulators, either to obtain regulation or in an advocacy context, may put them in situations where they are incentivised to pay bribes or face demands for bribes.

Dual-use technology risks

One specific regulatory risk area for VC funds stems from dual-use technologies. This terminology traditionally referred to technologies or goods that could be used for both civilian or military purposes. But in the VC context, it refers to new technologies that may be created and deployed for one intended purpose but used for another (for example, drones meant for monitoring agricultural land, but are used for surveillance, or face-recognition technology used for mass surveillance). These pose regulatory and reputational risks as well as concerns around privacy and human rights violations.

Regulatory status risk

Companies using unregulated, evolving or dual-use technologies should be flagged as high-risk investments, and subject to adequate enhanced due diligence and monitoring to better understand the regulatory and reputational risk exposure, as well as the company's capacity to assess and manage risks (including sector or regulatory mapping and dual-use assessment).

Managing bribery, corruption and regulatory risks

To mitigate bribery and corruption risks at the portfolio level, the following mitigants should be considered by fund managers:

What is a phased approach?

- This can be done through (1) a phased risk assessment process to understand the evolving corruption risks based on the company's growth stage and, where applicable, (2) a milestone-based action plan which outlines priorities for implementation of BI controls based on the evolving risks and triggers (for example new markets, new exposure to government contracts, and reliance on third parties.).
- For each milestone, risk mitigants should be identified and mapped (see table below).
- This phased approach should be proportionate to the fund manager's access to and influence over a portfolio company. This makes sense where the manager has a board seat or majority shareholding, less so as a minority investor where a more light touch monitoring approach is appropriate.

Milestone	Mitigant
Regulatory approval	Board risk committee (or board member) oversight of regulatory approval process, regulatory mapping
Government contracts	Anti-Bribery and Corruption (ABC) policy and trainings Conflicts policy Procurement policy
Market expansion through aggressive sales targets (including sales commissions)	ABC policy/Code of Conduct and Gift & Hospitality controls and register ABC training to sales staff

What can I do?

A phased approach to risk assessment and risk management should be implemented to understand where corruption risks lie within the company's operations and value chain, and their potential impacts.

This should take into consideration:

- The stage of the investment;
- Key milestones; and
- The scale and materiality of business integrity risks in line with the size of the company and its operations.

Case study: Agriurana

Agriurana is an agritech business based in India, which has developed innovative drone technology to be used for monitoring irrigation and the health of crops.

Promising results and regulatory approval

Agriurana spent two years finalising the prototype, using its own farm and crops to trial the technology, which delivered promising results, including a 3.5% yield increase on the first harvest using the agronomic data gathered by the drones.

News of Agriurana's success travelled to neighbouring farms and to local political stakeholders who started showing interest in the technology. However, before Agriurana could put the product on the market, it needed to register the new drone technology, both to patent the idea and to comply with India's existing regulations. To move rapidly, Agriurana hired an independent agent to help complete all the relevant paperwork for the patent certificate and obtain regulatory approval from public authorities to use the technology. The rate agreed with the consultant was INR 200,000, which included INR 100,000 for the certificate itself, with an upfront fee of INR 50,000. Focused on the need to grow the business as quickly as possible, Agriurana's founders agreed to the consultant's rate, hoping this would allow the application to be processed faster.

However, Agriurana was unaware of this agent's unethical business practices, including using upfront fees to pay public officials to speed up the regulatory process. This amounts to a facilitation payment to a public official in order to expedite an administrative task and maintain business. In most jurisdictions, including India and the UK, such payments are illegal and considered a bribe. Luckily, after being warned of the agent's malpractices, Agriurana's founders decided not to hire him and took care of the paperwork themselves.

Interactions with government officials

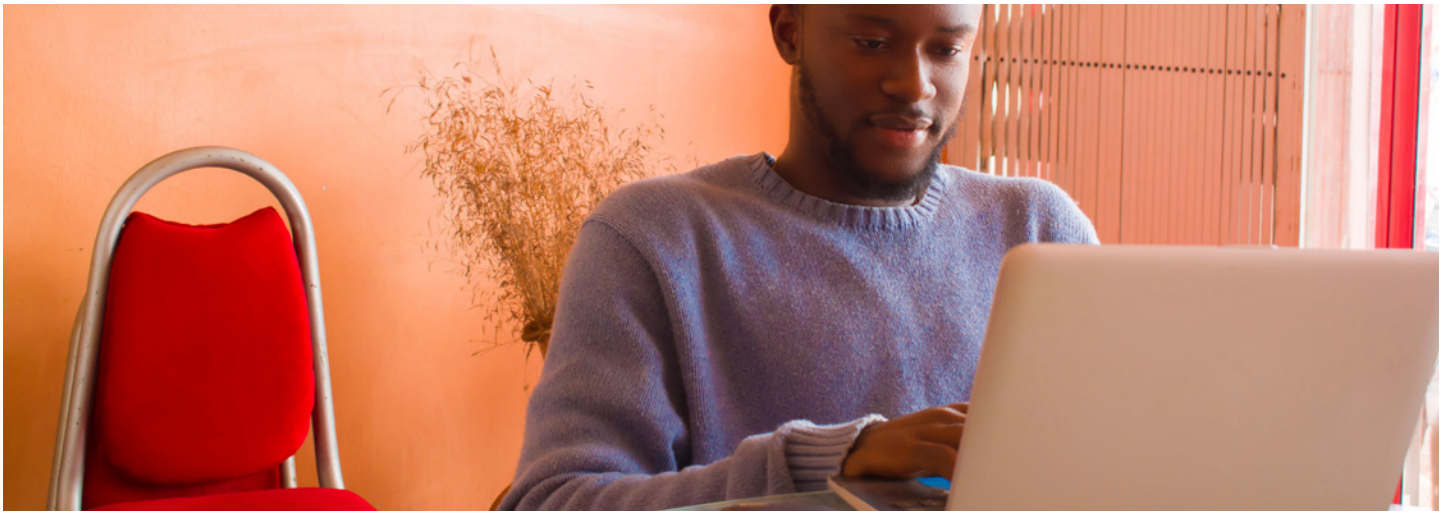
After receiving regulatory approval, Agriurana started selling its technology and doubled the size of the business, hiring 22 new employees, thanks to an increasing private customer base. Following further funding from investors, it partnered with the local government that hoped Agriurana's technology could support local farmers with their production. As the Agriurana team met with various local politicians to advertise their technology, they were faced with unusual demands from these politicians, who requested gifts and entertainment in exchange of business opportunities. This would reasonably be believed to influence business transactions and Agriurana's founders established a Code of Conduct for the company, including the requirement to register and obtain senior approval for gifts, entertainment and hospitality received or provided when certain criteria are met.

Dual-use technology

Fast-forward six months and Agriurana has a number of partnerships with local and state governments, and farmers associations. However, its name and brand became the centre of adverse media reported by a popular local newspaper. This followed an investigation published by a journalist who had linked one of the local governments allegedly using the company's technology for aerial surveillance on the local population. Without realising this was happening, Agriurana's technology ended up being used to illegally monitor citizens. Agriurana

engaged a contract lawyer to challenge the local government's use of its technology. However, the lawyer noted the contract allowed the local government the right to use the technology for unspecified "other purposes". Agriurana's management spent a significant amount of time managing the reputational damage. Agriurana later engaged a third-party consultant to support its remediation efforts and help manage the negative media coverage and reputational damage on their brand. As a direct result of this situation, a number of potential investors withdrew their interest in participating in the following fundraising round.

This case study is fictitious and is not based on any CDC investment.



03

Business integrity risk management

3.1 BIMS: Business Integrity Management System framework

The Business Integrity Management System (BIMS) is an integrated framework that covers key components of business integrity risk management.

The purpose of the BIMS is to provide a structured, consistent and sustainable approach to proactively assessing, managing and reporting business integrity risks. It also provides a framework for fund managers to demonstrate to key stakeholders that business integrity aspects are well managed and addressed.

Fund managers should have a proportionate BIMS that is aligned to their level of risk exposure, size, maturity, investment strategy and risk profile.

Each BIMS component is explained on the following pages.

3.2 Roles, responsibilities and oversight

Roles and responsibilities for business integrity should be clearly defined to strengthen the fund manager's risk governance and demonstrate alignment and commitment to sound business integrity practices to investors.

Business Integrity Officer

- A fund manager employee should be appointed as Business Integrity Officer to oversee the business integrity framework and introduce a single point of accountability.
- Responsibilities should include:
  - Promoting behaviours and standards across the fund manager;
  - Oversight for business integrity risk management and accountability for the BIMS;
  - Oversight for business integrity policies and controls development and implementation;
  - Monitoring fund-level business integrity risks, including LP onboarding;
  - Managing portfolio-level business integrity risks, through risk assessment and portfolio monitoring;
  - Monitoring the completion of business integrity; and
  - Reporting to LPs on fund- and portfolio-level business integrity risks.

Best practice

- Depending on the fund manager's size and risk profile, a Business Integrity/Risk Committee could be established. If there is no appetite to establish a standalone committee, the introduction of 'Business Integrity' as a mandatory agenda item for Board meetings should be considered to report on business integrity matters.
- Fund managers can get support from fund administrators and corporate service providers on business integrity-related controls (such as outsourced KYC/AML checks and sanctions screening), or support by a fund administrator's Money Laundering Reporting Officer (MLRO) for regulatory reporting and compliance.

3.3 Risk assessment

A business integrity risk assessment should build a comprehensive picture of the risks a fund faces, evaluate its controls and assess the likelihood and impact of these risks. Risk assessments can be conducted at the fund manager level, for example an AML risk assessment to consider the inherent risks connected to the investor base. More common are pre-investment risk assessments to identify and manage business integrity risks connected to portfolio companies.

What is not a risk assessment?

- Financial due diligence
- Legal due diligence
- External consultant report
- Reference checking
- Threat assessment

However, all these inputs can inform a risk assessment.

Considerations for VC fund managers

For VC funds, portfolio-level business integrity risk assessments should be phased and proportionate to the stage of the portfolio company. These should be refreshed on a regular basis.

For example, a business integrity risk assessment can help fund managers:

- **Identify** and articulate risks connected to a company;
- **Assess** the risks faced; and
- Manage and **mitigate** those risks.

Risk assessment - portfolio level

For VC funds, business integrity risk assessments should be phased and proportionate to the stage of the portfolio company, and drive adequate risk mitigation.

Early stage

- A business integrity risk assessment should be conducted to identify key areas of risk, including:
  - Money laundering, sanctions and reputational risks associated with the portfolio company's UBOs, co-investors and promoters/directors/controllers;
  - Integrity and reputational risks connected to the company's profile, track record and operations; and
  - KYC checks should feed into the risk assessment.
- The risk assessment should inform which risk mitigants need to be implemented to manage a company's inherent risks depending on the stage of investment and the scale and materiality of risks in line with the company's size. Based on the outcome of the risk assessment, fund managers should have in place a phased risk mitigation approach, with business integrity enhancements tied to specific milestones.
- The risk assessment should be refreshed as a company scales, and at key milestones (such as change of strategy, new market entry, regulatory approvals). At a minimum, the risk assessment should be refreshed at each fundraising round.
- Risk assessments should drive business integrity monitoring and annual LP reporting on business integrity risks at the portfolio level.

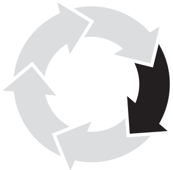
Maturing stage

- Risk assessments should inform the development of a business integrity framework at company level through phased action plans.
- Upon exit, there should be a proportionate risk assessment/KYC approach into purchasers.

Best practice

- Fund managers should obtain a 'Sign-off' of the business integrity due diligence and risk assessment from senior management or the Business Integrity Officer.
- The risk assessment and planned mitigants should be outlined in Investment Committee (IC) papers.
- Make sure that action plans are ready at final IC stage, where required.

3.4 BIMS policies – fund manager level



It can become more difficult for fund managers to adequately manage business integrity risks without formalising its approach. This can be done through a set of business integrity policies and procedures communicated and implemented across the organisation. We recommend developing and implementing the following processes.

Key requirements

Anti-money laundering:

- A KYC approach for LPs and portfolio companies (including UBOs/controllers) based on national requirements, depending on where the fund/fund manager are based.
- An EDD approach for high-risk LPs, portfolio companies and associated UBOs (such as HNWIs, family offices, trusts, PEPs).
- A risk-based approach to refresh KYC for portfolio companies at every fundraising round that identifies new co-investors.

Sanctions:

- Controls to ensure compliance with UK, UN SC and any other sanctions lists that apply to the fund manager in terms of jurisdictions, LP requirements, currency and risk exposure.

Anti-bribery and corruption:

- A clear anti-bribery and corruption statement.
- Reference to the prohibition of 'facilitation payments', including a definition and details of the expected actions to be taken in response to such demands.
- Guidance on gifts and hospitality and political and charitable donations.
- An approach to managing conflicts of interests at the fund and portfolio levels.

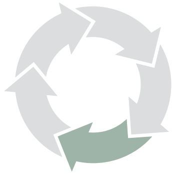
Whistleblowing

- A mechanism to provide a secure and accessible channel through which employees can raise concerns in confidence, without fear of reprisal.

Best practice

- Formalise business integrity policies and associated processes and controls.
- Communicate business integrity policies to fund manager staff through regular training and attestations. Where relevant, the policies should be communicated to external stakeholders.
- Create a repository (can be electronic) of policies and procedures to ensure easy access.
- Monitor and periodically review policies to ensure compliance with regulations, based on the evolving operations/investment activities at the fund manager level.

3.5 Communication and training



Business integrity communication and training is critical to ensure fund manager staff understand the requirements of internal policies, laws and regulations.

Early stage

Training

Staff should receive periodic training based on the business integrity policies and controls in place at the fund manager, including:

- Anti-bribery and corruption
- Whistleblowing, including the approach to report business integrity-related incidents and relevant whistleblowing point of contact
- Anti-money laundering (including sanctions where relevant)

Attendance of training sessions should be monitored by the Business Integrity Officer, reported to the management team and noted as part of annual business integrity reporting to LPs.

Communication

'Tone from the top' communication should be ensured through regular messaging from the Business Integrity Officer and senior management, emphasising the importance of integrating business integrity across the fund manager's activities.

Maturing stage

- Rolling training refreshers should be provided to ensure business integrity messaging is sustained, and remains relevant and current.
- As portfolio companies scale, fund managers should consider delivering bespoke business integrity training to the senior management of the companies. This should be tailored to the company's risk profile and need for capacity building.

3.6 Ongoing monitoring

Fund managers should have a proportionate approach in place to oversee and monitor business integrity risk management at the fund and portfolio level.

Key requirements

- Monitoring and periodic review of the adequacy of business integrity policies and procedures at the fund manager level.
- Proactive business integrity monitoring across the portfolio, based on the level of influence on – and access to – portfolio companies.
- Ongoing monitoring of portfolio-level business integrity risks through refreshing risk assessments at key milestones (such as fundraising rounds, regulatory approvals, new market entry).
- Ongoing reporting to LPs and other stakeholders regarding the implementation of BIMS, key risks and performance of portfolio companies (see our *ES-BI monitoring and reporting template*)
- Develop a mechanism to report fund- and portfolio-level business integrity incidents and issues to LPs.

Best practice

- Monitoring of business integrity and reputational risks related to evolving and changing regulations, such as:
  - Reputational risks related to dual use technology (including data capture/face-recognition technology used for surveillance – risk of privacy and human rights violations);
  - Heightened bribery and corruption risks as regulations are introduced to access relevant permits; and
  - Heightened fraud and cyber risks (such as identity theft) as technologies are established and strengthened.
- Light-touch monitoring for dormant and failed companies until trading activities have ceased.

3.7 Risk management at portfolio level

Business integrity risk assessments should inform which policies, procedures and controls need to be implemented at the portfolio level to manage inherent risks.

Portfolio companies are unlikely to fully comply with business integrity requirements at the point of investment. Portfolio-level business integrity risk management should be commensurate with the scale and materiality of identified risks, and should be in line with the size of the companies and their operations at each stage of investment.

However, fund managers should agree an appropriate phased timeline with companies to align with business integrity requirements and standards as they expand. For fast-growing companies, improvements might be tied to specific milestones.

Fund managers should take a phased approach to developing BIMS frameworks and related controls at the portfolio level. Below are some business integrity risk mitigants that fund managers can implement based on the stage of investment.

BIMS components	Seed / Early stage	Maturing stage
Roles, responsibilities and oversight	– Identify a company's employee as a point of accountability for business integrity.	– Review and strengthen corporate governance and board oversight.
BIMS policies	– Conduct KYC into the company's UBOs and controllers, and co-investors into subsequent fundraising rounds.	– Assist companies in developing (1) business integrity policies/codes of conduct which include relevant ABC requirements, including gifts & hospitality, facilitation payments, conflict of interests and charitable/political contributions, and (2) AML policies and controls if relevant for business model (e.g., fintech) and risk exposure. – Policies should be tailored to the size of the company in terms of employees and market presence. – Policies should ensure compliance with applicable business integrity regulations.
Risk management controls	– Introduce relevant ABC/AML/ sanctions clauses in investment agreements with companies and reporting obligations for business integrity incidents.	– Depending on the risk exposure, assist with the implementation of bespoke third-party risk management, procurement procedures, assurance activities (audit and quality checks) and conflict management. – Other risk areas to consider and manage based on technology-based business models can include cyber security, data privacy and protection, and fraud risk.
Training and communication		– Help companies implement a business integrity training schedule for their employees based on the policies and controls in place. – Where relevant, fund managers should deliver bespoke on training for senior managemen
Whistleblowing		– Assist with the development of a whistleblowing/ grievance mechanism for the company's employees. – Communicate the fund manager's complaint mechanism for portfolio-level stakeholders to report business integrity concerns.
Ongoing monitoring		– Develop a reporting framework for companies to report to fund managers on business integrity-related performance (such as training completion, implementation and audit of controls) as well as business integrity incidents and issues.

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