CONNAUGHT ACTION GROUP NEWSLETTER No 1 (3 August 2012)

CONNAUGHT INCOME FUNDS – SUSPECTED MAJOR FRAUD

SUMMARY

The founder members of the Connaught Action Group suspect either gross negligence or more likely widespread fraud and criminality in respect of the Connaught Income Fund Series 1 ("the Fund" or "the Partnership") which according to the Limited Partnership Agreement is properly called "**The Guaranteed Low Risk Income Fund, Series 1**". We concentrate in this newsletter on Series 1. There may well be similar problems with other Connaught funds which are linked to Tiuta plc (as explained below).

There has been much speculation that the Fund is part of a wider "ponzi scheme" involving the Tiuta plc and its subsidiaries. It appears that ways have been found to divert assets from the control of the Fund and in particular, the Fund has made unsecured loans to Tiuta plc and its subsidiaries contrary to the Investment Memorandum. Investors are concerned that monies invested by new investors were used to pay "interest" to existing investors and to repay outgoing investors. A proper investigation of these allegations is required by independent fraud specialists. In our view, investors should be free to appoint an independent insolvency practitioner to wind up the Fund.

In view of the very large numbers of questions that arise, the Action Group is asking investors to attend the forthcoming meeting of investors in the Fund on 13 August 2012 or alternatively to submit questions to be raised at the meeting and to appoint proxies to attend and vote at the meeting on their behalf.

ALLEGATIONS OF WRONGDOING

Background

The Fund appears to have been sold and distributed by Connaught Asset Management Limited (an unregulated firm) ('CAM') and Blue Gate Capital Limited (an FSA regulated firm) as a low risk investment (a fund investing in short-term bridging finance with sensible loan to value ratios secured on saleable property assets). We query how CAM as an unregulated firm could bring be engaged in promotional activity as the promotion of any fund is a regulated activity. It may be alleged that Tiuta plc (a regulated firm) promoted the Fund but this does not seem to have been the case.

The Limited Partnership Agreement stated that "*The purpose of the Partnership is to carry on the business of investing in short term loans secured by a first fixed charge on real estate with the principal objective of providing investors with a high fixed rate of interest."* **Prima facie, it now appears that the Partnership has no enforceable security over any assets.** Please click here for a copy of the Limited Partnership Agreement.

It now appears that the Investment Memorandum is misleading and ambiguous in many places. Please click here for a copy.

It says under the heading *"Investment Objective": "The Connaught Income Fund will... [provide]... a revolving credit facility [to Tiuta plc]... to invest using strict lending criteria set out on page 16 of this document."* The Investment Memorandum gave the firm impression that most of the monies raised would be lent out on very low risk lending or low risk lending.

This turns out to be entirely misleading because we are now given to understand that the criteria related to the **number of loans** not **the proportion of monies lent**. It was also misleading because of the degree of high risk lending to developers and others.

Again, the Investment Memorandum was misleading because it said the Fund would not lend initially on certain types of high risk lending. The use of the word "initially" raises a fundamental issue. **Investors were not told at any time that the risk profile of any investment in the Fund had changed very substantially from very low risk lending or low risk lending to exceptionally high risk lending.**

We now understand that there was a material omission from the Investment Memorandum because **the auditors of the Fund raised concerns about the 2009 accounts and failed to approve the 2010 and 2011 accounts. This should have been disclosed to investors.** It appears that monies from new investors may indeed have been used to pay off departing investors.

The main trust of the Investment Memorandum was that Tiuta plc (an FSA regulated firm) would manage a loan book for the Fund and the Fund would take security over saleable property assets. The Fund was meant to operate as a lender to persons requiring bridging finance on reasonable loan to value ratios and it would take a first fixed charge over the assets. Prima facie**, it now appears that investors were misled as it was not made clear that the Fund would lent to Tiuta plc ("TP") or any subsidiary of TP on an unsecured basis**. TP is a firm which is authorised and regulated by the FSA that provides specialist mortgages such as bridging loans. The risk factors in the Investment Memorandum and did not warn investors that all lending would be to a trading business on an unsecured basis without reference to lending on particular properties. The role of CAM as the 'asset manager' was to approve bridging loan applications and this gave investors the firm impression that the lending under the facility was linked to security. According to the Investment Memorandum, CAM was to 'ensure that loan security was to be registered to the limited partnership'. This does not appear to have happened in practice..

Tiuta International Limited ('TIL') was until recently a wholly-owned (and wholly unregulated) subsidiary of TP. It now appears that TIL managed approximately £106m of capital belonging to the Fund. The Investment Memorandum described TP (the FSA regulated firm) as the 'Specialist Partner'('SP'). Its role was 'to assist in the management of the Partnership's assets' (according to the LPA). **It now appears that investors have been misled because TIL acted as the SP**. It appears that TP guaranteed the obligations of TIL. It is not yet become clear why TIL actually performed the SP role and that the Fund's capital became generally comingled with that of TIL and TP. We do not understand how TIL could have undertaken the regulated activities of arranging regulated mortgage contracts (currently 5% of the portfolio) or debt for equity swaps in companies because the operator of the Fund, Blue Gate Capital Limited does not have the Part IV Permissions from the FSA to undertake this activity.

Approximately £20m of the Fund's capital would seem to have been lost or misappropriated. Additionally, many of the loans granted fell outside the lending criteria set out in the Investment Memorandum and a number of loans would appear to have been under-secured. Monies appear to have been lent to developers in respect of high risk lending (contrary to the firm impression given in the Investment Memorandum); to persons connected with the officers of TP and/or TIL (soft loans to cronies); and the facility granted by the Fund to TP was misappropriated to fund the running costs of TP and/or TIL including salaries and bonuses. If our grave suspicions are justified, this looks like **theft**. We further understand that from our sources that some of the security represented as good security relates to loans that have been repaid in the past few months. This appears to be **fraudulent**. The figure of £20m given above is subject to revision. As explained below, the parties currently involved in managing the situation are deeply compromised and this matter really should be investigated by the FSA and/or the police.

It is not clear whether Tiuta Assets Limited (in administration) or Tiuta Development Limited were also (undisclosed) SPs in relation to the Fund or whether they were SPs in relation to other funds.

There has been an abject failure of governance. It appears that Blue Gate Capital Limited (the FSA regulated operator) did not put in place sufficiently robust and transparent systems and controls. It approved the misleading Investment Memorandum as a financial promotion.

As a consequence, TIL is now insolvent; it is also clear that the Fund is insolvent, and is expected shortly to go into administration. Furthermore, since the Limited Partnership Agreement ('LPA') governing the operation of the Fund requires the Founder Partner, CAM and TP to make good any shortfalls should investors demand repayment of their capital, it is likely that both will soon also have to appoint administrators.

We have been given to understand by an investor that BDO LLP ('BDO') has informed him that it was contacted by a solicitor from Watson, Farley and Williams LLP ('WFW'), acting on behalf of TP and its subsidiaries ('the Group'), in February 2011 as TP's directors wanted better to understand the Group's financial position. BDO worked with the Group and an incoming interim financial director that it recommended over the next few months to gain a better understanding of the Group's balance sheet. Thereafter, BDO was further engaged to assess the Group's business model going forward. The findings were presented to the FSA in the summer of 2011. Thereafter, it was alleged by BDO that stakeholders including CAM and the FSA felt that ongoing monitoring of the Group's finances and performance would be appropriate, and BDO was engaged to report on these matters on a monthly basis. We have been informed by BDO that performance fell short of plan, as a result of which it was engaged by CAM to undertake a further analysis of the situation in the spring of 2012; it reported to CAM on behalf of the fund, and to the FSA, on 30 May 2012. Around that time, CAM acquired TIL.

BDO: Conflict of interest

Based on the above account, it appears that the Group become insolvent following an extended period during which BDO had been performing the role of investigating or reporting accountant. Given that the recipients of its reports included the FSA, I believe it is reasonable to believe that had its investigations highlighted potential insolvency, breaches of the LPA or of the asset management agreement between the Fund and the SP or any suspicions of negligent or criminal behaviour, the FSA would have acted immediately and decisively to protect investors' interests. That this did not take place leads me to question whether the work undertaken by BDO was performed to a satisfactory professional standard.

Should it transpire that BDO's work was negligent, it is likely that TIL or creditors such as the Fund will in due course seek redress from BDO for some or all of the losses that have been suffered. Under such circumstances, we are sure you will appreciate that we consider it a very material *prima facie* conflict of interest for BDO partners or employees to act as TIL's administrators.

We do not currently have documentary proof that any of the work undertaken by BDO was negligent. However, since there is no doubt both that BDO had been reporting on the financial performance of the Group for an extended period prior to its administration and that two of its partners are now acting as Joint Administrators, we consider it reasonable to believe there may be the basis for a claim and thus to object to the appointment unless BDO is able to demonstrate that the scope of work or the nature of the advice given was such that there could not possibly be grounds for a claim.

Obviously, it is our view that the FSA should seek to support the appointment of an independent firm of insolvency practitioners that is favoured by investors. One of the great issues in this case is the cosiness of relationships that may serve to obscure the true picture for the FSA and investors.

Report into loan book

BDO has commissioned a report into the state of the outstanding loan book. It is being produced by WFW and GVA Grimley Limited ('GVA'). At a meeting on 17 July, BDO informed an investor that the firm was introduced to the Group by WFW, acting as the Group's solicitors, in February 2011.

Given that it would appear that there may well have been extensive negligence, theft or both, by TP and/or its directors of the Fund's capital, and that there are problems with the security and documentation of a number of the loans, questions must arise about the work undertaken by the Group's solicitors. We do not have evidence that WFW has acted negligently or indeed that it undertook work in areas that could give rise to such concerns. But, as with BDO's previous

engagements, the fact that a prior fiduciary duty to the insolvent party, which is now under suspicion of malfeasance, can be demonstrated to exist, probably renders the firm unsuitable for engagement in connection with the subsequent investigation and certainly means that a thorough assessment of their prior involvement is required before any such engagement could be contemplated.

An investor has also asked BDO to clarify whether GVA has undertaken any previous engagements for the Group and if so whether any conflicts of interest might exist. For instance, it may have undertaken consultancy work for the Group, could have introduced borrowers to it and may have undertaken some of the property valuations (CAM admits that some of the valuations were inaccurate, probably fraudulent, contributing to the Fund's expected losses).

We are given to understand that BDO is unwilling to provide any evidence regarding the points raised above.

Management of loan book

We are concerned that CAM, an unregulated party, not yet having been placed in administration, is still managing the loan book. An investor has suggested to BDO that an alternative provider of this service who had clean hands, in the sense that he had no prior involvement with the case and enjoyed a reputation for competence, be appointed. We have identified such a party and we indicated that he was willing, through his firm, to undertake a review of the loan book without charge and manage it through to realisation for between £100,000 and £500,000, depending on the number of loans resulting in litigation. The problem that we have seen so often in the past is that insolvency practitioners charge huge sums to the gross detriment of investors. We would urge the FSA to consider whether to support investors in using a small but specialist firm of insolvency practitioners who would be willing to work with a firm that is engaged in the short-term lending market. This is a far more practical approach.

On 19 July an investor wrote to BDO raising the following issues concerning CAM: competence (CAM had signed off on loans that fell well outside of the Fund's claimed lending criteria and on loans that had not been correctly secured; it had also failed to spot the comingling of the Fund's capital with that of TP and TIL) and conflict of interest (as a result of the above, I believed that CAM employees and directors should not have access to the documentation, which should be preserved for any potential civil or criminal cases

We should explain that CAM's Chairman, Mike Davies, was compliance officer of TP between 2008 and 2010, a period that overlaps with his directorship of CAM (March 2003 to present), and that it is widely accepted that the conduct of TP was at best grossly negligent and at worst criminal. It is alleged to us that the principal (ultimate) shareholder in CAM is a Mr Nigel Walter, who has been disqualified (allegedly) as a director in multiple jurisdictions and may also have been effectively barred from involvement in FSA-regulated activities. We have not found evidence that he is disqualified in the UK or any official ban by the FSA after a disciplinary process, but there may be queries over his involvement in so-called "land banking" investment schemes. It is widely rumoured that he acts as a shadow or de facto director of CAM.

Mike Davies claims that CAM has been appointed by BDO to manage the loan book. He has stated in a letter to an investor:

'It is the decision of BDO to appoint Connaught as its agent in winding down the loan book and not a decision of the General Partner or any other Connaught entity. This decision was made by BDO based on the knowledge Connaught has of the loan book and the Fund structure but also because Connaught is being contracted on a basis that covers the cost of the wind-down team only, a cost to the Fund of less than 1%...'

'the Connaught team managing the wind-down of the loan book consists not only of Jon Durie, who has some years of experience managing a portfolio of short term loans for another lender, but also Phil Mabb who has existing experience in the wind-down of a similar loan book and has been recruited specifically to perform this task, plus the fund management team who have very detailed knowledge of the loans presented to the Fund by Tiuta.

Oversight of this team sits with me and I am sure the advisors to whom you wrote will be comforted to know that I have 38 years of experience in banking and mortgage compliance, including being head of risk for a bank for 15 years and compliance director for a long term lender. Until very recently, and my retirement from a particular firm, I was an FSA

approved person and still maintain some contact with the FSA, not only in relation to Tiuta…'

Our concerns in relation to this decision are as follows:

1. CAM is clearly not competent to manage the loan book, given its many failings in that respect to date;

2. With the strong possibility of civil and perhaps criminal cases being pursued against CAM, TP, TIL or individual employees or directors, it is clearly reckless to leave any of those entities or individuals in charge of the Fund's money, or of documentation relating to past loans;

3. The proposed fee, 'less than one per cent', compares unfavourably to the estimate the investor provided 20 days earlier to BDO of £100,0000 to £500,000 – at most, less than 0.5 per cent;

4. The award by BDO of a loan book management contract potentially worth up to £1 million to CAM, the entity that appointed CAM to the role of administrator of TIL, looks very much like the payment of a valuable consideration in recognition of the insolvency appointment, a breach of section 63 of the Insolvency Code of Ethics;

5. Perhaps most serious of all, were one to take the view that arguable cases may exist for the pursuit of damages claims by or on behalf of creditors against CAM and BDO, one might also conclude that in appointing each other to positions that provide access to sensitive documents and power with respect to the pursuit of civil claims, each has sought to protect both itself and its counterparty, to the detriment of the ultimate creditors, namely investors in the Fund.

To date, BDO has neither confirmed nor denied that CAM has been appointed to manage the loan book. However CAM has unambiguously claimed to have been engaged, and in the absence of a denial from BDO we have to assume that its claim is correct.

NEXT STEPS

1. We would like investors to demand answers to the common questions raised by investors at the forthcoming meeting (click here for details).

2. We would like investors to vote in favour of winding up the Fund using an independent insolvency practitioner (click here for details).

3. We should appreciate it if investors and IFAS would write to the CEO of the FSA to demand that it will investigate, with some urgency, the claims that we have made in this newsletter (click here for draft letter).

Clearly, we would want the FSA to take steps to secure evidence of wrongdoing which parties may wish to destroy at this time.

The draft letter to the CEO of the FSA requests that the FSA obtains from BDO as a matter of urgency the following:

1. Documentary evidence of the nature and scope of the work that it undertook into the financial position and business model of the Group prior to TIL going into administration;

2. Confirmation of whether it has appointed CAM to manage the loan book;

3. If such an appointment has taken place, a detailed explanation (as a matter of urgency) of why it believes that

   (i) There is no conflict of interest;

   (ii) CAM is competent to undertake the task and

   (iii) There is no risk of further misdirection of the Fund's assets or the compromising of documentary evidence that could be of value in any future criminal or civil action;

   Obviously we would wish the FSA to express the view that BDO and CAM are not appropriate parties to appoint themselves to their current roles as it leaves a very strong perception of a cover up in the eyes of investors.

4. A detailed breakdown of any prior involvement of WFW and GVA with CAM, TP and TIL and an explanation of why, in the light of these previous engagements, it was considered appropriate to engage the firms to undertake the loan book review.

We urge investors to write to the CEO of the FSA to demand that the FSA investigate this matter and require BDO to arrange an early handover to a new

administrator with clean hands, with the involvement and agreement of the principal creditors, and that you ensure that BDO immediately returns any documents and fees that it may have uplifted from TIL or other entities mentioned in this document and ensures that its appointees CAM, WFW and GVA are stood down and do the same. Click here for a draft letter to the CEO of the FSA.

We also believe that TP (regulated by the FSA) is insolvent since it provided a guarantee to the Fund which it cannot fulfil and yet it continues to trade. We also believe that Connaught Administration Services Limited, the general partner of the Fund, is insolvent and yet it continues to trade. As mentioned above CAM is insolvent due to its liability as a Founder Partner. We have reason to believe that the directors of such companies are guilty of wrongful and/or fraudulent trading.

CONCLUSION

We believe that the Fund has been grossly mismanaged and that it is not appropriate for BDO to accept CAM's proposed appointment of Messrs Dartnaill and Cohen (two partners of BDO) as Joint Administrators. BDO does not appear to have clean hands.

Furthermore, we believe that we have provided reasonable grounds for questioning their conduct since appointment. They have appointed TP's solicitors, and possibly their valuers and consultants, to review the loan book, and there is evidence to suggest that they have engaged CAM, the competence and integrity of which must surely be highly questionable, to manage the loan book, for a fee that is significantly higher than that quoted by a 'clean hands' alternative manager.

The collapse of the Fund has yet to find its way into the financial press, but we suspect it will soon do so – probably around 13th August, when a meeting of the partners / investors is due to take place. We further understand that there is due to be a meeting of the exempt unit trust (a feeder fund in the Fund) on 20th August to arrange for it to be wound up. The meeting of investors in the Fund has all the hallmarks of being deeply unfair to partners / investors as partnership agreement requires 75% of the **total** partners / investors to pass any resolutions, such as to replace CAM or to wind up the Fund with an insolvency practitioner chosen by investors. It appears that the unfair provisions of the LPA mean that it is exceptionally difficult for investors to take steps to protect themselves. We would implore investors and IFAs to write to the CEO of the FSA to intervene in this matter as set out in the draft letter (click here). It is not in the interests of investors for CAM or the general partner to enforce such grossly inequitable provisions. We express the hope that the FSA will intervene as a matter of urgency on the side of investors to require the unilateral abandonment of such prejudicial provisions.

Finally, we should point out that we are urging investors and IFAs to write to the CEO of the to demand that any professionals engaged to unwind the current situation, investigate how it occurred and pursue any parties guilty of misrepresentation, negligence, fraud or theft should come with clean hands. We believe it is time for the FSA to secure the evidence and take steps to protect the interests of investors from parties whose interests may diverge significantly from the FSA's statutory objectives. We also believe it is time for the FSA to mount its own investigation unless it is leaving the investigation of allegations of theft and fraud to the Police.

The Connaught Action Group
3 August 2012