

# **An Action Plan for Investors to Further Safeguard their Assets**

## **Eisner**

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In the aftermath of numerous Ponzi and other fraud schemes that have caused substantial losses to investment portfolios, before making and to further safeguard investments, investors should understand and assess the risk of an investment strategy. In this article, we will (1) review some of the factors that have contributed to these losses; (2) identify lessons learned; and (3) suggest an action plan to help detect and, perhaps, prevent fraud from occurring in the future.

### **Factors Contributing to Investor Losses**

Recent events such as numerous Ponzi schemes and questionable investment asset valuations raise red flags about money managers who attained consistent rates of return or profits in good and bad markets above similarly situated investments. In the majority of fraud schemes, red flags that have contributed to the success of the fraudster were the

(1) willingness to accept without question and verification cash and securities account balances; (2) size and obscurity of the independent auditing firm; (3) unquestioned reputation of the asset manager; (4) request to reinvest cash profits, if any; (5) lag time between the end of a reporting period and receipt of monthly statements and annual audited financial statements; and (6) scant information about market value.

### **Lessons Learned**

Unfortunately, many investors have learned the hard way by suffering substantial losses that trust alone does not work. We have learned many lessons from these recent events. Among them are: (1) connect seemingly unrelated facts and red flags rather than ignore them, (2) question why allegations about an investment strategy went unanswered; (3) exercise continual due diligence; and (4) seek proof of the existence, value, and physical location of assets under management or in a fund.

In order to act on the lessons learned, investors should examine and evaluate with their legal counsel and a forensic CPA the terms and conditions of the current relationship with their asset managers in order to know whether they are sufficient to: (1) provide confidence that account statements accurately reflect the value of the assets and underlying transactions and (2) verify and reconcile asset account balances to reliable and independent information. For example, investors should read the prospectus to see if there is an "audit provision" of some kind. Moreover, investors should determine whether the asset manager represents that he is responsible to maintain a system of internal control which would require (1) an independent custodian; (2) transparent

value determinations made by an independent valuation firm; (3) timely reconciliations of trading activity with brokers and custodians; and (4) issuing timely statements to investors, including annual audited financial statements

### **Changing the Terms and Conditions of the Relationship**

Recent fraud schemes and events have shown that performing initial due diligence prior to making an investment without having the right after making the investment to perform continual due diligence or to invoke an “audit clause” may not be sufficient to further safeguard assets from possible misappropriation and conversion.

Notwithstanding that there might be practical and legal limitations for some investors to access and verify financial information about their specific investments, the time is ripe for investors to consider negotiating or renegotiating the terms and conditions of their relationship with money managers to further safeguard their investments.

Investors should insist upon the addition of best practices such as (1) diversifying and periodically monitoring custodians; (2) obtaining custodian statements directly from the custodians; (3) separating recordkeeping/bookkeeping tasks from custodianship responsibilities; and (4) reconciling custodian and investment advisor statements. If an independent custodian is not available, such as in the case of a limited partnership or hedge fund, then investors should have the right to continual due diligence by performing “agreed-upon procedures.” An agreed-upon procedures engagement is one in which a client engages an independent CPA to issue a report of findings independently derived based on specific procedures performed on subject matter that the parties agree are appropriate. The procedures are generally tailored to the specific subject matter. Some examples of these procedures include: (1) confirm with the custodian or broker all portfolio positions held at a date specific and all open (unsettled) investment transactions;

(2) confirm fail-to-deliver balances with the counterparty to the transaction and review subsequent collection and aging of these balances; (3) confirm any “commitments” such as endorsement of swaps; (4) review internal controls; (5) determine the propriety of expenses incurred by the asset manager; (6) verify market values of readily marketable securities; and (7) review methodology for valuing illiquid securities, focusing on inherently subjective methodologies.

### **Conclusion**

An “audit clause” or an “agreed-upon procedures” provision in the prospectus would enable investors to follow their money from checkbook to investment and to verify and reconcile asset account balances and values of their investment.

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