

## Protecting Yourself Through Due Diligence and Ongoing Vigilance

*“I’ve known him for years. I trusted him. I can’t believe he took advantage of me like that!”*

*“How could so many rich, smart people have been duped?”*

*“Why didn’t we see this coming?”*

*“How can I ever trust anyone connected to Wall Street?”*

*“I will never invest in the stock market ever again!”*

Recent headlines scream at us about lives and institutions wrecked by one scam artist or another. Forensic psychologists suggest parallels between some of these scam artists and serial killers. In both cases, anger radiates toward the perpetrators, while their victims direct recriminations inwardly. People are overwhelmed by feelings of bitterness, sadness, and helplessness. The public demands vengeance and justice even before any trials have taken place.

In times like this, perhaps the best we can do is to learn what we can from these bad experiences so that we can avoid becoming prey once again to those intent on separating us from our financial capital.

It has been stated that operational risk in a management firm is more significant than the financial risks they took when explaining fund failure. While nothing can protect us with certainty, we can take a number of steps to dramatically improve our chances for avoiding ruin as a result of a financial scam.

### **1. Remain objective - understand your “investor emotions.”**

- a. Greed is the primary driver of “too good to be true” scams. It’s tempting to be seduced by promises of better-than-market rates of return, or lower volatility. Keeping up with the neighbors or doing better than colleagues or friends may also contribute to a willingness to take blind risks.
- b. Fear can spring up among the investment “herd” and cause immediate and dramatic reactions (often over reactions) that result in precipitous market price declines as people rush to get their money “out of harm’s way.”
- c. The emotional pendulum can swing from greed to fear almost instantaneously and unpredictably.
- d. The negative feelings associated with losing a sum of money have a proportionately greater impact than the positive feelings associated with gaining the same sum of money. The emotional reactions to losing a significant amount of money are similar to the stages of grief. These stages aren’t always linear. Following is a listing of stages of grief and some of the common investor reactions to financial loss that relate to them.
  - i. *Denial* - “They’re the experts. They send us huge reports every month so they must know what they’re doing. It’s not a real market break. It is just a temporary setback.”
  - ii. *Anger* - “Why didn’t my broker/adviser see this coming and get me out? How could those greedy Wall Street people get us into a situation like this again? How dare they use our tax dollars to pay

Wall Street bonuses and corporate bailouts?” Anger may be a response to feelings of shame, frustration, guilt or other emotions. Some anger is focused inward, relating primarily to personal accountability for decisions to trust advisers blindly, go with the flow, or own up to greed-based choices. Some is directed outward, looking for someone to blame rather than looking for how to make better choices in the future. Sometimes anger may provide a good stimulus to change patterns of decision-making and improve accountability measures. At other times, anger may be recycled over and over like a gerbil on a circular treadmill going nowhere.

- iii. *Bargaining* - “If I change my portfolio/adviser things will get better. “If I get out of this, I’ll never take another chance on a ‘sure-fire’ investment scheme.”
- iv. *Depression* - “I’m doomed. My family’s financial future is wrecked. How will we ever afford to pay for our kids’ education? I won’t be able to retire as planned. I’ve let everyone down.”
- v. *Acceptance* - “The markets and the economy have always gone through cycles and this is just another painful downward part of the cycle. Downward movements have always been followed by recoveries, so my best move is to make small adjustments in my life that will allow me the flexibility to bridge the gap until the recovery takes hold. I have to play the cards as they are dealt the best I can and realize that I can’t do anything to make the past better.”
- e. Losing out on or not participating in an opportunity can feel like losing even though you didn’t actually lose any money.
- f. Over reaction to irrational fear or focusing on self recrimination due to an actual loss (or being scammed) can keep you out of the market just when you need to be there in order to achieve your long-term goals. If you overreact, you may reduce your perceived exposure to an immediate or short term risk but inadvertently increase your exposure to a greater risk, that of not being able to achieve your long-term goals.
- g. Don’t rely too much on the “buzz” or glamour associated with the manager, the investment opportunity or other investors (or rumored investors).
  - i. Imagining yourself on the red carpet with celebrity co-investors can cloud your judgment.
  - ii. If the promoter relies too much on dropping the names of other investors, clients, or acquaintances it may mean that there is too little to recommend the investment opportunity itself.

## **2. Learn to vet your investment opportunities**

- a. Can you see all of the elements of the entire investment chain, from the person or firm that promotes the opportunity, to the firm that holds or reports on the funds, ultimately to the firm or person that makes decisions about trades and leverage on your behalf?
  - i. Understand the risks others will expose you to.
    - 1. Has the investment strategy been explained so that you can understand it?

2. Does the historical investment performance appear “too good to be true?” Extraordinarily consistent returns require additional examination as do historical returns that are unusually high relative to the risks purported to be taken.
  3. Does the strategy rely on proprietary “black box” strategies that cannot be explained? Are they too complex to be explained or “too secret?”
  4. Have you or your advisers been asked to sign a “non-disclosure agreement” prior to getting access to information?
  5. Is the firm sponsoring the strategy or managing your money audited? Have you checked the auditor’s credentials?
  6. Have the historical performance averages been audited or verified?
- ii. Have you reviewed the manager’s latest 13F filing (required for investment managers who exercise discretion over \$100 million or more) to make certain that the actual positions managed are consistent with the purported investment?
  - iii. Know who is involved in every stage of your investment. Can you “see through” all the way to the last link in your investment chain?
    1. Who will manage your investment funds?
      - a. Are they registered or licensed?
        - i. With the SEC as a Registered Investment Adviser (RIA)?
        - ii. With FINRA as a broker-dealer or registered representative?
        - iii. Do they claim to be exempt from registration or licensing? If so, on what grounds?
      - b. What is their history?
        - i. Have they described their previous experience?
        - ii. What is the performance history of this investment strategy?
          1. Can back testing of the strategy be duplicated or verified?
          2. Are good conditions for the strategy likely to recur?
          3. Are the historical returns actual (live) returns or simulations?
          4. Are the historical returns portrayed net of fees?
          5. Has the historical performance record been subjected to a regression analysis to determine the most likely investment style that produced the returns?
        - iii. Have they been subject to prior complaints, sanctions or suspensions?
      - c. Will they be taking custody of your funds?

- d. Will your funds be comingled with others or held in separate accounts owned by you?
    - e. What is their fee structure?
    - f. Are their own funds invested in the strategy?
- 3. Who will have custody of your investment funds at each stage of the investment process, from initial deposit to final funding?
  - a. Banks or trust companies with FIDC insurance.
    - i. Domestic
      - 1. Investment Banks
      - 2. Commercial Banks
    - ii. Foreign
      - 1. What country?
      - 2. What laws apply?
      - 3. Are there legal remedies easily available to U.S. citizens?
    - iii. Broker-Dealers
      - 1. Have SIPC insurance
        - a. May carry excess insurance
          - i. How much?
          - ii. Who is the insurer?
    - iv. Insurance company
    - v. The sponsor/manager may take control of your funds and hold them in their own account(s) co-mingled with other investors.
      - 1. Intermediaries
        - a. Your funds may flow into one legal entity (corporation, trust, LLC, etc.), be comingled with other investor funds and then flow into another legal entity or entities as an investment.
      - 2. Who are your fellow investors? How many are there? What are the requirements for gaining access to the investment?
      - 3. What is the legal structure of the investment?
      - 4. What taxes will you be subjected to? Will you receive a K-1 or 1099 at the end of the tax year?

**4. Understand the regulatory environment.**

- a. Which agency, if any, regulates or licenses the people or firms involved in the investment opportunity?
  - i. The SEC regulates investment advisers (Registered Investment Advisers – RIAs) and the adviser will provide a form ADV for your inspection.
  - ii. The Financial Industry Regulatory Authority (FINRA, formerly the NASD) regulates brokers and broker-dealers. Many custodians are regulated by FINRA and are members of SIPC (Securities Investor Protection Corporation).
  - iii. Some investment opportunities and managers/sponsors are exempt from regulation and available only to “accredited investors” whom the government believes are sophisticated and able to protect themselves from unscrupulous operators and schemers.

5. **Understand the legal structure of the investment or management agreement.**
  - a. Are your funds commingled with other investor's funds in a limited partnership (or LLC)?
    - i. Who is the general partner (or LLC manager)?
    - ii. Is the entity or investment opportunity registered under the securities act or do they claim exemption from registration? On what grounds do they claim exemption?
    - iii. Who does the accounting for the partnership? Are they qualified?
    - iv. Is the entity audited? Does the auditor follow the standards issued by the Public Company Accounting Oversight Board (PCAOB)?
    - v. Are the accountants for the partnership qualified and independent?
      1. Who in the investment opportunity chain has fiduciary obligations? Do you understand what these obligations are?
      2. Have you been asked to sign a non-disclosure agreement? If so, why?
  - b. Track your cash flows.
    - i. Do you have a paper trail for all cash flows?
    - ii. Do you have immediate access to your funds?
    - iii. Are your funds locked up for long periods of time?
    - iv. Do you have small windows of time each year in which to withdraw funds or long notice of withdrawal periods?
  - c. Can you verify the reporting that comes from your manager by comparing it to the reporting that comes from an independent custodian or administrator?
6. **Gauge the independence of participants.**
  - a. Is the promoter independent from the investment manager?
    - i. How is the promoter compensated?
  - b. Is the investment manager independent from the prime broker or custodian?
    - i. What fees are charged by the investment manager?
    - ii. What fees are charged by the independent administrator or custodian?
7. **Is there an independent third party administrator or fund administrator that reports on holdings and values?**
  - a. Get another independent opinion on the investment opportunity.
    - i. Is the second opinion provider qualified to render an opinion?
    - ii. Does the opinion provider have anything to gain by recommending that you proceed with the investment?
8. **Who will report on your investments and what kinds of reports will you receive?**
  - a. Performance reporting.
    - i. What method of performance reporting will be used?
    - ii. What benchmarks will be employed for comparisons?
  - b. Tax reporting and auditing.
    - i. Who will prepare the tax reports (typically 1099s or K-1s)?
    - ii. Is there an independent auditor qualified to audit the investment opportunity? Does the auditor follow the standards issued by the Public Company Accounting Oversight Board (PCAOB)?
  - c. Who will report periodic asset values?
    - i. Is the reporting entity independent of the manager?

- ii. How often will you receive reports?
- iii. Will you receive reports directly from the custodian in addition to the manager/promoter?
- iv. How will non-liquid investments be valued?

**9. Is the investment suitable for you and your portfolio?**

- a. Does it fit your risk profile? Do you know your own risk profile?
  - i. Your need to take risk in order to achieve long-term goals
  - ii. Your capacity to accept investment risks
  - iii. Your emotional tolerance to investment risk
- b. Do the cash flow characteristics of the investment opportunity meet your needs?
- c. Do the tax characteristics of the investment opportunity fit with your personal tax situation?
- d. Are you planning to commit the right proportion of your investments to this new opportunity?
- e. Have you reviewed prudent fiduciary practices as they may relate to the proposed investment?

**Conclusion**

The Prudent Investor Act 3<sup>rd</sup> Restatement reminds us that there are no imprudent investments per se; rather each should be considered as a potential part of your overall investment strategy and risk budget. Similarly, there are no absolute good or bad elements in the outline above, rather they form a basis for evaluating several of the operating and structural characteristics of an investment opportunity which should then be considered along with a variety of other financial risk factors in order to make prudent decisions about whether the investment should be included in your portfolio.

It may be helpful to use the vetting tool we developed from the topics covered as a starting point in your own due diligence process. Each topic element is presented as a statement or question with two boxes that can be checked to represent whether or not you have adequate information about the element and whether the information you have gathered tends to indicate the level of structural or financial risk in the opportunity you are considering. You can evaluate the information you have on the topic and make a judgment as to where your potential investment opportunity might lie on the continuum. By scanning the entire range you can get an idea about the characteristics of the opportunity, the places where you require additional information, and may be able to see whether or not the investment should be included in your overall investment program.

Once you have made the decision to go ahead with the opportunity you will still need to remain vigilant and continue to collect and check information you receive to remain confident that all is as you expected. Make sure you receive all of the promised reports and check them for accuracy. Doing proper research before investing and remaining aware and curious during the life of an investment can help you remain confident about your investment decisions.

## Element Risk Evaluator

<b>Element Description</b>	I have the information I need about this element and it seems to represent an assumable risk.	I am not sure I have the information I need about this element, or it seems to represent a high risk.
<b>1.</b> Are you remaining objective – do you understand investor (your) emotions?		
<b>2.</b> How well can you see details about the entire investment chain from the person or firm who promotes the opportunity, to the firm that holds or reports on the funds, ultimately to the firm that makes decisions about trades and leverage on your behalf?		
<b>3.</b> Who will have custody of your investment funds?		
<b>4.</b> Which agency, if any, regulates or licenses the people or firms involved in the investment opportunity?		
<b>5.</b> Are your funds commingled with other investor’s funds in a limited partnership (or LLC)?		
<b>6.</b> Is the promoter independent from the investment manager? Is the investment manager independent from the prime broker or custodian?		
<b>7.</b> Is there an independent third party administrator or fund administrator that reports on holdings and values?		
<b>8.</b> Who will report on your investments and what kinds of reports will you receive?		
<b>9.</b> Is the investment suitable for you and your portfolio?		
<b>Totals</b>	# checks    times 4 =	# checks    times 2 =

**Instructions:** Gather all of the information you can about the investment opportunity and the people and firms involved. Evaluate the information by reading the relevant sections of the outline and then judge whether the element you are evaluating represents a relatively high or low risk and enter a checkmark in the appropriate box above. Total the number of checks in each column and multiply the total for column 1 by 4 and column 2 by 2. Add those results together and divide by 9 to get the average score. A score of 36 would represent the least operating risk; a score of 18 would represent the highest operating risk, and a score of 27 would represent moderate operating risk.

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