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Investment management fraud prevention

Having the "right" controls in place is imperative under increasing SEC scrutiny

Introduction

Investment managers don't have to look far for signs that the U.S. Securities and Exchange Commission ("SEC" or the "Commission") is intensifying its efforts to uncover fraudulent activity in their ranks. Aggressive enforcement, record whistleblower payouts, stronger pursuit of insider trading violations, and expanded scrutiny of asset valuation methods and reporting signal the SEC's determination to root out wrongdoing in the investment industry.

The Commission's recent formation of a special unit to focus on investment managers, along with demands for greater transparency from sophisticated institutional investors, are additional signs that investment managers may need to revisit and improve their antifraud controls. A recent Deloitte[1] Dbriefs webcast[2] highlighted the latest SEC enforcement actions and priorities affecting investment managers. The presentation also featured discussion about how investment managers can establish transparent practices to help mitigate this risk.

Fraud and misrepresentation: Growing regulatory targets

Recent developments suggest a likely increase in SEC enforcement activity, including closer attention to investment managers. Of the 686 actions taken by the SEC's Enforcement Division in fiscal year 2013, 140 – one in five – related to investment managers.[3] A closer look at the range of actions taken by the SEC indicates where attention is being focused and how the Commission has expanded its enforcement resources.

Whistleblower tips

Whistleblower tips to the SEC grew 8 percent from 2012 to 2013, and in 2013 the SEC received submissions from all 50 states and 55 foreign countries, which reflects the far reach of the SEC's whistleblower program. Total payouts to whistleblowers totaled nearly $15 million for 2013.[4]

Much of that total related to one case. In late 2013, the SEC awarded more than $14 million to a whistleblower whose information led to the recovery of substantial investor funds. The speed with which the SEC recovered investor funds signaled its resolve to pursue and prosecute whistleblower cases. In less than six months after receiving the tip, the SEC brought an enforcement action against the perpetrators and secured investor monies. In announcing the award, the SEC's Office of the Whistleblower expressed hopes that such payments will encourage individuals to come forward and assist the SEC in stopping securities fraud.[5]

Fraudulent disclosures and insider trading

The SEC has brought various actions regarding disclosure fraud and insider trading. Disclosure fraud comprises two categories: completeness issues (issues that arise when investment managers fail to disclose material information) and disclosure issues (i.e. disclosures otherwise complete but viewed as misrepresenting the facts and substance of the disclosure). The following are recent examples of SEC enforcement actions relating to disclosure fraud and insider trading:

- A financial institution was recently charged with defrauding investors by failing to disclose certain risks and misrepresenting facts about certain loans and underlying investment vehicles.[6]
- Charges were brought against another firm for failing to disclose the quality of similar underlying loans.[7]
- In an insider trading case, a stockbroker and a law clerk were charged with passing non-public information through a middleman to conduct trades.[8]
- In another insider trading case, a hedge fund trader was charged with acting on non-public information obtained from a consulting agreement.[9]

The SEC is also targeting both the perpetrators of insider trading and the firms where they work. For instance, in one case proceeds from the alleged scheme went to the hedge fund that employed the perpetrator. The Commission pursued both the alleged perpetrator and the fund for ill-gotten gains.

[1] As used in this document, "Deloitte" means Deloitte LLP and its subsidiaries. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

[2] http://www.deloitte.com/view/en_US/us/Events-Deloitte/aded37c012b94410VgnVCM 3000 003456f70aRCRD.htm

[3] http://www.sec.gov/news/newsroom/images/enfstats.pdf

[4] "2013 Annual Report to Congress on the Dodd-Frank Whistleblower Program," U.S. Securities and Exchange Commission

[5] Ibid

[6] http://www.sec.gov/News/PressRelease/Detail PressRelease/1370539751924#.U43-ZyhhstU

[7] http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540300002#.U43-rShhstU.

[8] SEC Enforcement Actions, Insider Trading Cases 2014, http://www.sec.gov/spotlight/insidertrading/cases.shtml.

[9] Ibid, 2013.

Valuation issues

Recent enforcement actions and announcements point to increased SEC scrutiny of asset valuations as well, (see "A closer look at valuation issues"). In one case, the SEC announced that an investment manager agreed to be barred from the securities industry and pay a penalty for making misrepresentation about the valuation of a fund. The manager had valued the investment himself at a significant markup to the value estimated by the underlying fund's portfolio company. He then distributed marketing materials to potential investors proclaiming a misleading internal rate of return and made false and misleading statements to investor consultants and others in an effort to cover up his fraud.[11]

Similarly, the SEC appears to be focusing on potential asset overvaluation when funds are being marketed. Regulators are concerned that some managers are inflating the performance or exaggerating the quality of holdings by boosting their reported values during a fundraising period to attract new investors.[12]

Expanded enforcement resources

News reports in early 2014 revealed that the SEC is assembling a dedicated group within its Office of Compliance Inspections and Examinations (OCIE) to examine private equity and hedge funds. The OCIE is gearing up to inspect how investment managers value their assets, disclose fees, and communicate with investors.[15]

Establishment of the OCIE group follows the Commission's 2013 formation of a Financial Reporting and Audit Task Force aimed at detecting fraudulent or improper financial reporting. The task force performs ongoing review of financial statement restatements and revisions and analysis of performance trends by industry. Using technology-based tools such as text analytics to analyze SEC filings, the task force is focused on internal controls, failures to disclose material weaknesses, aberrational returns, and disclosures on valuation process and inputs, among other potential issues.[16]

Fraud prevention controls are even more important now

Increased SEC enforcement actions, constantly emerging disclosure requirements, and trading risks compel investment firms to maintain effective fraud prevention controls. Strong controls are essential to protecting the firm and maintaining investor confidence.

> For years, the SEC has communicated that it is focusing on potential asset overvaluation when funds are being marketed. Regulators are concerned that some investment managers are exaggerating the performance or quality of holdings by boosting their reported values during a fundraising period, then writing them down after that period closes.[13]

A closer look at valuation issues

Valuing privately held investments involves a high degree of professional judgment. The subjectivity inherent in professional judgment puts valuations at the risk of manipulation, a reality well known to investors and regulators who are increasing their scrutiny of the process.

Even with robust market data, some degree of subjectivity or variability will remain in developing a reasonable investment outcome. Assumptions that may otherwise appear aggressive – either to the upside or downside – may be reasonable under the circumstances. However, tweaking assumptions when fund managers are motivated to reach a particular valuation conclusion can lead to increased scrutiny by the SEC. The following are examples of conduct that may constitute, or can make funds and investment managers more susceptible to, potential valuation fraud:[14]

Falsifying performance or financial statements. Manipulation of reports and data makes a business' financial condition look either better or worse than it is.

Bias affecting objectivity and indication of value. Intentionally biasing the results of a valuation misleads investors. This type of manipulation can be hard to spot because subtle changes in assumptions, especially changes in individual assumptions that, on their own, still appear within the realm of reasonableness, can have an aggregate impact that can significantly shift value.

Unqualified preparers. Selecting preparers who lack knowledge of valuation leading practices, don't apply applicable valuation methodologies, or fail to provide adequate evidence for assumptions hinder attempts at oversight.

Insider rounds of financing or deal manipulation. In multiple financing rounds, existing investors can collude to manipulate pricing of new rounds.

[10] "Trading on Tips: SEC May Seek Disgorgement from Trader for Gains in Investment Fund," Judy Kwan, Lily Becker, and Penelope Graboys Blair, Orrick Securities Litigation and Regulatory Investment Blog, February 26, 2014, http://blogs.orrick.com/securities-litigation/2014/02/26/trading-on-tips-sec-may-seek-disgorgement-from-trader-for-gains-in-investment-fund/.

[11] http://www.sec.gov/News/ PressRelease/Detail/ PressRelease/1370540662094#.U44BLyhhstU

[12] http://online.wsj.com/news/ articles/SB10001424052702304014504579250421766286110

[13] "The SEC's new guns," Lawrence Delevingne, Institutional Investor, June 1, 2011, http://www.institutionalinvestor.com/Article/2838546/The-SECs-new-guns.html#.U-PjuH0o5D8, accessed August 7, 2014.

[14] Fraud pursuant to the SEC's Final Rule on Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles in which the SEC adopted rule 206(4)-8 under the Investment Advisers Act of 1940. See http://www.sec.gov/rules/final/2007/ia-2628.pdf.

[15] http://www.reuters.com/article/2014/04/07/us-sec-privatefunds-idUSBREA360M420140407?_cldee=aGFubmFoLndlaW5zdG9jay1nYWxsYWdoZXJAY29yZGl1bS5jb20%3d

[16] http://www.sec.gov/News/PressRelease/ Detail/PressRelease/1365171624975#.U-PhmH0o5D8

Investment managers appear to recognize the need. In a 2013 survey of hedge fund professionals, nearly half (46%) believed their competitors likely engage in illegal activity, a third (35%) had felt pressure to act illegally or unethically, and slightly fewer (30%) had witnessed misconduct in the workplace.[17] Despite regulators' efforts to curb unethical behavior, these results suggest such acts remain common, and better anti-fraud controls are needed.

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The results of a recent Deloitte Dbriefs webcast audience poll suggest investment management firms have some work to do: Only 55% of 900 financial services respondents indicated that their firm has whistleblower policies and procedures in place that are communicated to employees and that management encourages participation in the whistleblower program.[18]

General antifraud actions

An effective fraud prevention program can often include controls such as:

A whistleblower program that employees trust. Top management should be engaged with and support the program. It should be well publicized, continually promoted, and easy for employees to use. Tips must stay anonymous and an anti-retaliation policy needs to be in place and enforced.

Employee training. Employees are trained annually on ethics and regulatory compliance to help ensure awareness of company policies.

Management monitoring and communication. Management continuously monitors fraud prevention controls and communicates policies regarding ethical behavior.

Data analytics to detect anomalous activity. Unusual activity can be detected through 1) specific checks, such as identifying unusual patterns among trades, or 2) a proactive, integrated enterprise fraud and misuse management approach to help uncover hidden patterns, trends, and schemes that traditional fraud detection methods may miss. Advancements in analytical tools have helped opened the door to better identification of such activity. For example, analytics can help enable investigators to flag likely insider trading sources based on the frequency of communications during an alleged illicit trading activity compared to a baseline time period.

Valuation-specific antifraud actions

Investment managers can help mitigate the risk to their firms from fraudulent valuations by addressing both the preparation and the review of valuations.

Consider the use of third-party valuation specialists. Credible third-party valuation specialists typically have more experience in applying valuation techniques than in-house resources. This can help fund management avoid the potential for or the appearance of bias. Third-party valuation specialists can provide objective advice about the reasonableness of valuation assumptions, methodologies, and conclusions prepared by in-house valuation teams, deal teams, or other professionals at the fund. Fund management can use such advice to help detect potential bias or fraud.

More than one valuation method. Using multiple valuation approaches remains a leading practice. This approach will not prevent fraud, but it may make it easier to detect. For example, a discounted cash-flow approach may provide a reasonable answer, but correlating that to a market approach may yield an unrealistic multiple – a red flag for either potential aggressiveness or a misguided valuation.

Experience with valuation theory and its real-life application. Review of the valuation by at least one other individual who is skilled at valuation theory and practice can also be a vital control to help identify potential fraud. Are assumptions in the valuation aggressive? Are they adequately documented and explained? While non-technical valuation roles are vital to the review process (internal audit, compliance, general counsel, etc.), these individuals may be more susceptible to bias than technical valuation specialists, whether in-house or external.

Broader review circle. It is also important that review go beyond the investment committee. Investment committee review was common historically, back in the days of "lower-of-cost-or-market." Now it is leading practice to require that parties, such as an internal pricing committee or a third-party without a vested interested in the performance of the investment, also review and have the ability to challenge valuations.

Examples of other steps investment managers can take to help identify and address potential fraud include:

Verification of source material. Comparing forecast or market yield estimates against industry figures or public company results can help analyze their reasonableness. While some companies have outsized growth prospects and therefore high valuation multiples may be appropriate, such claims should be supported by external third-party data.

Identification of potential bias. Carefully assessing assumptions includes analyzing approaches taken to establish them. For example, when using a market approach to set enterprise value, are guideline companies being selected in an unbiased manner, or are the comparables "cherry-picked" to achieve a certain result?

[17] Labaton Sucharow news release, Tuesday, April 2, 2013, http://www.labaton.com/en/about/press/Hedge-Fund-Industry-Survey-Commissioned-by-Labaton-Sucharow.cfm.

[18] Results of online poll conducted during a Deloitte Dbriefs Webcast: "Fraud Prevent: Do You Have The Right Controls In Place?," broadcast April 29, 2014.

Assessment of rationale for subjective assumptions. Is a company's forecasted performance consistent with industry expectations or supported by historical performance? Has the company consistently hit its forecast or consistently missed its budget? Is an appropriate risk level reflected in the selected discount rate or rate of required return? Benchmarking against comparable companies can help determine if forecasts make sense and whether they are aggressive or conservative versus what other sophisticated investors might consider to be achievable.

Debt security valuation. For a debt instrument, what benchmarking has been done to establish a shadow credit rating? What is the credit worthiness of the company, the recoverability of the investment, and the collateral value? Are the assumptions well supported, documented, and consistent with the firm's investment thesis?

In addition to arriving at an appropriate valuation, investment managers should also provide a complete, accurate, and transparent disclosure of their valuation process, supported by clear documentation.

This enables stakeholders, whether those tasked with internal oversight, client investors, or regulators to understand how the estimates were developed, and where extra care, if any, may be warranted if a potentially contentious assumption is being made.

Determination of the best estimate for a difficult-to-value investment might be debatable, but that is exactly why those assumptions that require a significant amount of professional judgment should be well-explained, robustly documented, and transparently disclosed.

Protecting your firm and your investors

Investment manager vigilance is essential to help uncover and prevent fraud. By establishing an effective fraud prevention program, including controls to address potential valuation fraud, investment firms can be better prepared to protect investor interests, satisfy increasing regulatory demands, and address risks associated with investigations that can harm an investment firm's reputation.

Contacts

Leadership

Patrick Henry
Vice Chairman
U.S. Investment
Management Leader
Deloitte & Touche LLP
+1 212 436 4853
phenry@deloitte.com

Paul Kraft
U.S. Mutual Fund and Investment
Adviser Practice Leader
Deloitte & Touche LLP
+1 617 437 2175
pkraft@deloitte.com

Authors

Adam Weisman
Investment Management
Financial Advisory
Services Leader
Deloitte Financial Advisory
Services LLP
+1 212 436 5276
aweisman@deloitte.com

Mohammed Ahmed
Senior Manager
Deloitte Financial Advisory
Services LLP
+1 212 436 4703
mahmed@deloitte.com

Rachel Berk
Senior Manager
Deloitte Financial Advisory
Services LLP
+1 212 436 5934
raberk@deloitte.com

John Kim
Director
Deloitte Financial Advisory
Services LLP
+1 212 436 5342
jokim@deloitte.com

John Marshall
Director
Deloitte Transaction and
Business Analytics LLP
+1 617 437 3359
johnnmarshall@deloitte.com

We thank the following Deloitte professionals for their support and contributions to this report:

Kathleen Canavan, Senior Manager, Deloitte Services LP

Alan Numsuwan, Manager, Deloitte Services LP

Alanna Meisner, Lead Marketing Specialist, Deloitte Services LP

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