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Protecting Your Nonprofit's Money in the Post-Madoff Era

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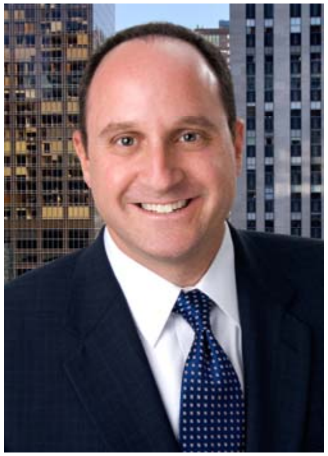

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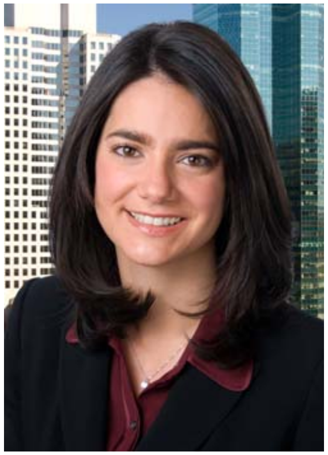

Doreen S. Martin

How to Prevent Embezzlement in Your Nonprofit Organization

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Examples of Nonprofit Embezzlement:

- On April 13, 2010, the former program director of **Tremont Community Council Home Attendant Program** pled guilty in federal court to embezzling $900,000 from the organization. Over a four year period he made multiple unauthorized wire transfers from a Tremont account to a personal account in his name, and wrote multiple checks payable to himself on the Tremont account. The wire transfers and checks totaled in excess of $570,000. The former program director also made unauthorized wire transfers totaling approximately $135,000 from the Tremont account to an architect to pay for renovations and other architectural work at a nightclub in the Bronx and at a residence in New York -- both of which he owned. He also had hundred of thousands of dollars transferred from the Tremont account to accounts held by a Manhattan law firm and one of its principals -- $258,000 of that money was later transferred to the program director through checks drawn on an escrow account in the law firm's name. He faces a maximum sentence of 10 years in prison and a maximum fine of $250,000 or twice the gross gain from the offense.

- On April 6, 2010, a Program Aide for the Anti-Gang Violence Youth Initiative of **Hope Gardens**, was arrested on charges of falsely submitting documents to obtain $4,080. Upon instruction from the then-director of Hope Gardens, the Aide allegedly delivered a final cost report to the Office of Criminal Justice Coordinator. The final report included an expense report that represented that Hope Gardens had expended $4,080 providing karate classes for 20 young people and the expense report was supported by documents including sign-in sheets that recorded their purported attendance. The sign-in sheets that were submitted were altered photocopies of genuine sign-in sheets. The director (now deceased) instructed the Aide to alter and submit the sign-in sheets. The Aide has been charged with Attempted Grand Larceny in the Third Degree and Offering a False Instrument for Filing in the First Degree, class E felonies -- punishable for up to four years in prison.

Examples of Nonprofit Embezzlement:

- On April 28, 2010, the Attorney General filed a lawsuit against New York State Senate Majority Leader, Pedro Espada, founder and CEO of **Soundview Health Care Network** -- a non-profit dedicated to providing health care to underprivileged patients. The lawsuit alleges that Espada siphoned $14 million from the organization. Espada is alleged to have used Soundview as his personal and political piggybank: Soundview allegedly paid for $80,000 in restaurant bills for 650 meals for Espada and his supporters; Soundview allegedly paid for trips for Espada, his wife and his family to Las Vegas, Miami and Puerto Rico; Soundview allegedly paid for an unlimited line of credit on a corporate American Express card -- from 2006 to last year Espada supposedly charged more than $450,000 in items he later identified as personal; Espada created a janitorial service, put his son in charge of it and is accused of rigging bids to make sure that the company won the Soundview contract -- worth $400,000 annually; Soundview also purportedly provided Espada a housing allowance of $2,500 per month to pay for a Bronx apartment. The Soundview board was filled with Espada's family and close associates.

- On April 1, 2010, the Executive Director of the **Iowa Association of School Boards** was terminated because she requested and accepted a salary increase of over $100,000 without Board approval. The Executive Director was caught because one of the Board Members, against the Executive Director's instructions, communicated with the auditors and verified that the Executive Director gave herself a salary increase without Board approval. Upon closer investigation, it was discovered that Executive Director: provided raises to a few employees while other employees were being terminated for financial reasons; prevented IASB's auditing firm from providing the Board with information necessary to carry out its fiduciary duties -- going so far as to direct an attorney to threaten the auditors if they attempted to communicate with the Board; violated Board policy by failing to utilize competitive bidding for projects where expenditures were over $10,000; and failing to obtain Board approval for projects with expenditures over $75,000. Iowa's Legislature's Government Oversight Committee has issued a subpoena to the Executive Director.

When Does Employee Fraud Occur?

Three key factors:

Motivation

- Economic factors such as personal financial distress, substance abuse, gambling, overspending, or other similar addictive behaviors may provide motivation.
- The current national economic recession may serve to increase the incidence of such financial motivations.

Rationalization

- The employee finds a way to rationalize the fraud.
- Such rationalizations can include perceived injustice in compensation as compared to their colleagues at for-profit enterprises, unhappiness over promotions, the idea that they are simply "borrowing" from the organization and fully intend to return the assets at a future date, or a belief that the organization doesn't really "need" the assets and won't even realize they are missing.

Opportunity

- The employee has sufficient access to assets and information that allows him or her to believe the fraud can be committed and also successfully concealed.

Why are Nonprofits Frequently the Victims of Embezzlement?

- Management and Board Members are more trusting.
- Looser financial controls than for-profit businesses.
- A belief that audits will catch any fraud.

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What Internal Controls Can Prevent Embezzlement?

1) **Set the Tone**
   - Management must set good examples of fair and honest business practices.
   - Establish a corporate code of ethics.
   - Create a fair and open environment.
2) **Conduct Background Checks**
   - Background checks on new employees and volunteers are important.
   - They can reveal undisclosed criminal records and prior instances of fraud, allowing you to avoid a bad hire in the first place.
   - They are also fairly inexpensive, and should be made a part of your hiring process.
3) **Double Signatures and Authorizations**
   - Multiple layers of approval will make it far more difficult for embezzlers to steal from your organization.
   - For expenditures over a pre-determined amount, require two signatures on every check and two authorizations on every cash disbursement.
   - Consider having an officer or director be the second signatory or authorization for smaller organizations.
   - With credit cards, require prior written approval for costs estimated to exceed a certain amount.
   - The person using the credit card cannot be the same person approving its use.
   - Have a Board member or officer review the credit card statements and expense reports of the Executive Director, CFO, CEO, etc.

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What Internal Controls Can Prevent Embezzlement?

4) **Require Backup Documentation**
   - All check and cash disbursements must be accompanied by an invoice showing that the payment is justified.
   - If possible, the invoices or disbursement request should be authorized by a manager who will not be signing the check.
   - Only pay from original invoices.

5) **Never Pre-Sign Checks**
   - Many nonprofits do this if the Executive Director is going on vacation.

6) **Segregation of Duties**
   - *Money Coming In:* No single individual should be responsible for receiving, depositing, recording and reconciling the receipt of funds.
   - *Money Going Out:* No one person should be responsible for authorizing payments, disbursing funds, and reconciling bank statements.
   - If the organization does not have enough staff on hand to segregate these duties, a board director or officer should reconcile the bank and credit card statements.

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What Internal Controls Can Prevent Embezzlement?

7) **Fair Bidding Process**
   - All contracts should be subject to at least three bids, and approved by a manager uninvolved in the transaction.
   - Large contracts should be reviewed and voted on by the board.

8) **Fixed Asset Inventories**
   - Conduct a fixed asset inventory review at least once per year to ensure that no equipment (computers, printers, etc.) is missing.
   - Record the serial numbers of the equipment and consider engraving an identifying mark on each item in case of theft.

9) **Audits and Board Level Oversight**
   - External audits can be helpful in ensuring that the fraud prevention measures are being followed and are effective.
   - Be aware that a typical audit cannot be relied on to detect fraud.

What Internal Controls Can Prevent Embezzlement?

10) Encourage Whistleblowers

- Provide a means of anonymous communication.
- Employees may not report theft or mismanagement if they believe their job is in jeopardy.
- Employees must have a manner in which to contact a board member in the event something needs to be reported.
- Board members must be prepared to take these reports seriously, keep the reporting employee protected and contact legal counsel.

Due Diligence Considerations for Nonprofit Investment Fiduciaries

Rory Cohen, Partner, Venable LLP

May 19, 2010

Statutory Guidance

- Uniform Prudent Management of Institutional Funds Act
  - applies to charities organized as charitable trusts and nonprofit institutions
  - modernized UMIFA (see below)
    - rules governing expenditures
    - management of investment management function
  - incorporates many standards set forth in Uniform Prudent Investor Act (adopted in 1994)
    - applies to trustees of trusts, including charitable trusts
  - harmonizes standards for managing and investing institutional funds
  - added "prudent" to emphasize the prudence in management
- Uniform Management of Institutions Fund Act (UMIFA)
  - drafted in 1972; adopted by 47 states

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Prudent Management and Investment

- Give primary consideration to donor's intent
- Duty of loyalty – different standards for NFP corporations and charitable trusts
  - NFP directors – "best interests"
  - Trustees – "sole interests"
- Duty of care
  - Prudent investor / you are not a guarantor
    - reasonable care, skill and caution; portfolio approach
    - good faith and with care an ordinarily prudent person in a like position would exercise under similar circumstances
      - prudence under the facts and circumstances prevailing at the time of the action of decision
      - Consider the organization's risk/return objective
      - high standard for directors selected who have particular expertise or experience in investment management
  - Duty to minimize costs: reasonable costs to invest and manage, considering:
    - size of assets
    - purposes of the institution
    - skills/sophistication of investment committee
    - third party adviser costs should be reasonable

Prudent Decision Making

- In managing and investing an institutional fund, consider:
  (Section 3 of UPMIFA; substantially mirrors UPIA § 2(c))
  - general economic conditions
  - the possible effects of inflation and deflation
  - the expected tax consequences, if any, of investment decisions of strategies
  - the role that each investment or course of action plays within the overall investment portfolio of the fund
  - the expected total return from income and the appreciation of investments
  - other resources of the institution
  - the needs of the institution and the fund to make distributions and to preserve capital
  - an asset's special relationship or special value, if any, to the charitable purposes of the institution

Fiduciary Responsibilities

- Duty to investigate: reasonable efforts to verify facts pertaining to investment management
  - How are the assets going to be managed?
    - By board or subcommittee
    - Delegation to another officer (e.g., CIO)
    - Delegation to third parties (e.g., RIAs, BDs, banks)
- Modern Portfolio Theory: decisions about each asset in the context of the portfolio
    - e.g., consider risk and return objectives of entire fund
    - hedge funds, private equity, real estate funds
- Diversify unless due to special circumstances
- Dispose of unsuitable assets
- Develop investment strategy appropriate for the fund and charity

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It's All About Process

- Educate yourself
- Develop Asset Allocation Strategy
- Prepare and Maintain Investment Policy Statement
- Implement Investment Strategy
- Monitor and Supervise Implementation of Investment Strategy
- Procedures for Controlling and Accounting for Expenses
- Process is key:
  - Evidence competence: be able to illustrate awareness of fiduciary responsibilities
  - Substantiation:
    - document analysis
    - timing of reviews/analysis
    - details of reviews and analysis (e.g., issues reviewed, persons involved, supporting calculations; background research and analysis)
  - Have a process to review your process

Due Diligence In A Nutshell

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Firm/Firm History

- **Ownership structure**
- **Investment team**
  - backgrounds; lives outside the office;
  - education; prior employment history; experience of key personnel;
  - personal investments in the fund; amount of net worth/liquid net worth invested in the fund;
  - compensation/motivation/retention incentives;
  - office environment; turnover and terminations;
  - length the team has been together and individual investment experiences of key team members;
  - background checks of principals/investment decision makers;
  - litigation
- **Relative composition of onshore vs. offshore in the strategy and master (if applicable)**
- **AUM and AUM growth over time (and separately with respect to onshore and offshore funds)**
- **Capacity of strategy**
- **Investor composition (concentration; quality (high net worth vs. institutional; fund of funds and other platforms)**
- **Maximum/sizeable drawdowns**
- **Any predecessor firms liquidated or closed**

Investment Strategy, Objectives and Process

- **Overview of strategy and portfolio construction process (top down/bottom up)**
  - sector and geographic exposures;
  - leverage: net and gross exposures (how these are determined);
  - average position size (for both long and short positions);
  - hedging techniques;
  - how positions are built;
  - fixed income portfolio characteristics (duration/yield/credit quality).
- **Investment process and idea generation**
  - how do you articulate your process?
  - do you clearly articulate your process?
  - case studies: is security selection/asset allocation consistent with your articulation of process?
  - quantitative and qualitative factors used to construct portfolios and in security selection.
- **Portfolio constraints**
  - sector/market/position/leverage limits;
  - liquidity (e.g., days to liquidate/types of holdings).
- **Value proposition/what's your edge? use of sub-advisors consistent application of strategy?**
- **Research capabilities/investment team specialization; securities expertise;**
- **Targeted returns; best/worst environment for strategy; strengths/weakness of strategy.**

Review of Performance

- **Review of composite and monthly track record since inception; is it sensible given strategy?**

- **Anything that might indicate strategy shifts? Any indication of smoothing?**
  - among strategies used;
  - instruments used;
  - sector or geographic exposure;
  - degree of leverage used.

- **Performance attribution (by sector/holdings/new issues); does it foot to client letters?**

- **Impact of leverage on returns;**

- **Relative performance versus peers; explanations of exceptionally strong and poor returns (relative and absolute); validity of explanations;**

- **Correlation of portfolio versus peers; comparison to indices.**

Operational Due Diligence and Risk Management Controls

- Valuation process/controls (mark-to-market; fair valuation; any third party review, approval or triangulation); how often is the portfolio priced? have there been any NAV restatements?

- Review of service providers: review of audited financial statements since inception – review qualifications and unusual footnotes; evaluate quality/reputation of auditor; brokerage allocation; prime broker (evaluate quality/reputation of prime broker); any changes to service providers?
  - do you self-administer? who delivers NAV statements to clients?
  - verification that assets exist

- Cash movement and controls (evaluate organizational structure/evaluate org chart/legal oversight/CCO);
  - separation of responsibilities; independent checks;
  - how strong is the CCO? Is the compliance function robust; independent; adequacy of resources dedicated to compliance

- Trade processing and reconciliation (administrator strength/reputation); review of policies and procedures; CCO meeting;

- Registered/unregistered investment adviser (if not, why?);

- Third party marketing arrangements;

- Risk controls and analysis:
  - how do you assess and manage risks (e.g., market risk, liquidity risk; counterparty risk, operational risks);
  - stress testing and scenario analysis (best and worst case environment);
  - volatility and value at risk;
  - portfolio liquidity vs. investor liquidity – any matching issues;
  - who are the fund's material counterparties?

- How frequently does the manager test and verify the effectiveness of controls? What are the manager's reporting and communication procedures? How quickly do issues get resolved?

- Review of portfolio management systems; consider robustness/location of redundancy systems, data storage, firewalls, trading systems, disaster recovery.

Conflicts of Interest Considerations

- Who serves as the chief compliance officer; Is the compliance function robust and independent? Does the CCO have sufficient authority?
- Is there a culture of fair dealing? What and to what extent are costs allocated to investors?
- Any related party transactions or use of affiliated broker or other service provider?
- How are prime brokers and other service providers selected? Does the manager utilize capital introduction services of prime brokers? How is best execution achieved/reviewed?
- Are there any side letters? How does the manager disclose the existence of side letters and types of terms that may vary?
- How transparent is the manager? Does the manager provide different levels of access (i.e., portfolio level positions, aggregated data)?
- Personal trading policies and procedures; error correction procedures; side-by-side trading/allocation procedures.
- Does the manager have information barriers? What are its policies to prevent insider trading?
- Will the manager permit access to its code of ethics, annual compliance review and/or regulatory audit letters?

Underlying Document and Structured Features

- Investor eligibility and offering restrictions;
- Key terms:
  - fee structure (management and incentive) and other expenses;
  - frequency incentive allocation earned;
  - liquidity (frequency, notice period, key man provisions);
  - lock-ups; gates; suspension rights;
  - non-standard terms.
- Review of offering documents, subscriptions agreements and organization documents;
- Scope and depth of risk and conflict of interest disclosures;
- Review of pitchbooks and other marketing documents;
- Form ADV (Parts 1 and 2) if applicable; section 13D, 13G and 13F filings, if applicable; review for bad boy disclosures;
- SEC and other regulatory audits/disclosures (Form U4 and U5, if affiliated with a broker-dealer).
- Review of changes to fund documentation;
- Level of transparency/frequency of reporting; investor letters; side letters/preferential terms.

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