



Due diligence is central to effective risk management. But there's more to it than running the numbers. Having **a good understanding of human behavior** strengthens your process and reduces the chance of overlooking a significant piece of information.

A close-up photograph of two hands clasped together, one hand resting on top of the other, set against a dark, textured background. The hands are wearing a grey suit jacket and a white shirt cuff.

# DUE DILIGENCE

three experts express their views on two little words with big consequences

*Commonfund's Compliance Team posed several questions to these experts, who are:*

**Jules Kroll**, principal and cofounder of K2 Global Partners, which provides specialized risk services and solutions to corporations, sovereign nations and individuals. The founder of Kroll Associates, he is the acknowledged founder of the modern investigations, intelligence and security industry. In the early 1990s, he gained worldwide renown for his firm's success in finding assets hidden

by Jean-Claude Duvalier, Ferdinand and Imelda Marcos, and Saddam Hussein.

**Richard Leggett**, Chairman and CEO of Business Intelligence Advisors (BIA), a leading behavioral intelligence research and advisory firm. Founded in 2001 on the principle that intelligence solutions developed for national security purposes can be applied to the private sector, BIA has developed a groundbreaking suite of service offerings allowing organizations to collect and evaluate critical information.

**Richard Zeckhauser**, Frank P. Ramsey Professor of Political Economy at the Kennedy School of Government at Harvard University. He is also chair of the Investment Decisions and Behavioral Finance Executive Program at Harvard and is a senior principal at Equity Resource Investments, a private equity real estate firm. He is a leading expert in the field of economic behavior under uncertainty and is a major contributor to the field of behavioral finance.



In the wake of the financial crisis and a range of scandals and outright frauds in the past few years, risk management has become an increasingly high priority for institutional investors. One activity central to effective risk management is due diligence. While there is an enormous body of knowledge surrounding the process and goals of due diligence, less attention has been paid to the human dimension. In this article, Kroll, Leggett and Zeckhauser offer useful insights into the science of behavioral analysis.

**John Mearsheimer, in his book, *Why Leaders Lie: The Truth about Lying in International Politics*, identifies what he calls the spectrum of truth. He maintains that there's truth telling, deception, lying, spinning and concealment. Do you believe there's a spectrum of truth?**

#### **Richard Zeckhauser**

I think there is a spectrum, unfortunately, and it depends on the circumstances. If you're good at asking questions, however, there's only one truth to be revealed. In my experience in the financial world, virtually no financial firm tells the whole truth. So it's very important for the interlocutor to push harder to get at the whole truth, and that's usually what the adversarial process does to enable an investor to get the truth out of publicly traded companies.

In a piece of research that we did recently, we looked at what you could detect about a corporation's future performance from the announcements that it makes at the end of the quarter. We looked at whether there was any additional information to be gleaned from the words that are used—for instance, how many times the company used favorable words, unfavorable words or whatever else. Yet nothing was revealed; you couldn't predict its earnings for the next quarter any better.

Then we looked at what you could learn from questions and answers in analysts' calls, and we discovered that you could learn an awful lot because no matter how carefully you train the corporate CEO or CFO to answer questions, he or she is going to reveal something when those questions are asked.

**What are some techniques that people can learn when asking questions to discern whether someone is spinning, concealing or outright lying ...or whether they're telling the truth?**

#### **Richard Leggett**

What we talk about is actually a spectrum of communication. We believe that the two poles of the spectrum are, on the one end, "I'm telling you the complete and outright truth," and on the other, "I'm lying to you with malicious intent." The majority of communication in the world falls somewhere in the gray middle.

We've actually created technology to help do this on an institutionalized basis. Looking at earnings calls as an example, we score every question and answer to rate the quality. We talk about "quality" because lots of times somebody's not lying. They just might not be in a position where they can share information. It could be a regulatory or governance matter that prevents them from being more candid. Or they might not know the answer, and they don't want you to know it.

To get to your question, we've created what we call a behavior assessment methodology that allows one to identify deceptive behavioral indicators, both verbal and nonverbal. These tend to consist of patterns of behaviors that emerge in how someone chooses to answer a question. Once you've identified those behavioral indicators, it's important to marry them with strong strategic interviewing techniques, i.e., the way you ask questions. So, it's important to first understand how to spot those signals and then, once you've identified them, how you actually go after answers. A lot of it comes with preparing in advance and

having a good strategy for going into an interview, and then knowing when to pursue a series of follow-up questions. So, for example, there's a difference between asking the question, "Do you expect redemptions this quarter?" which is a pretty open-ended question and something along the lines of, "What's the highest level of redemptions that you anticipate this quarter?"

Generally, our firm has three types of clients. One is hedge fund and mutual fund managers. Another is investors, such as pension funds and endowments. The third is the audit industry. Now I know that everybody is always very, very busy. But it amazes me that when people get the opportunity to meet with either an investment manager or management team, there's very little upfront preparation. It's usually darting at the last minute and using some template that is thought to have worked in the past. That's what they follow, and there's not much strategizing and preparing. We hold that the single most important thing you can do before a meeting is to think about the issues you're trying to get at, prioritize them, attack the biggest ones first, and then pursue, pursue, pursue with good follow-up questions. And assign roles. If you're going to have two people in a meeting, make sure they know what each other's role is so that they are coordinated. You might end up with somewhat differing opinions, and that's okay; but if you're not coordinated, you're not going to get the maximum of that session.

**Commonfund was about to hire an emerging markets investment manager. In our normal due diligence process, the manager told us that he would not consent to a background check. In a telephone conversation, he lectured us on privacy. If a manager says to you that they don't want or won't consent to a background check, is that a red flag, or do you think it could be a legitimate claim of "I don't want my privacy invaded"?**

### Jules Kroll

It could be legitimate because the person felt it was legitimate—i.e., to him it was legitimate. But, I think, proceeding with that person without a background investigation is an act of gross negligence. At our own institutions, most of us probably went through some sort of screening. We have to go through lots of things simply because of what we do. If somebody is that sensitive, he or she ought to continue doing what they're doing, but I certainly don't want them handling my money. I would respectfully say that this person should subject himself to certain due diligence questions.

Things have changed in five years. Now, we've turned over enough rocks, and enough people who did anything from a poor job to a dishonest job have crawled out from under them. Those of us who are fiduciaries—in whatever way, shape or form that may take—are subject to certain standards that we must uphold. So I have no sympathy for individuals who are not fulfilling the duties and responsibilities of a fiduciary.

Another factor is that this manager focused on emerging markets, where different legal systems, business practices and cultural standards come into play. And you're often dealing across cultures—perhaps a U.S. investor going to a British emerging markets manager who is looking to invest in Africa. That's a trifecta.

**David Einhorn, the founder of Greenlight Capital, has written a book, *Some People Lie All Of The Time*, about uncovering fraud in public companies' financial statements. He concludes that there are several key contributors to the integrity of the capital markets, including government, media, underwriters, Wall Street analysts, credit analysts, audit firms, company managers and company directors. Who do you think didn't uncover the truth that led to the crisis of 2008? Is it all the government's responsibility?**

### Zeckhauser

I wrote a paper last year called "Causes Of The Financial Crisis: Many Responsible Parties." My conclusion: Many people



Jules Kroll



Richard Zeckhauser

could have intervened and possibly prevented the financial crisis but none of them did. I don't want to suggest that you can elevate probabilities to 100 percent. However talented people may be, however much we fix the system, there will still be remaining uncertainty.

Let's take the question of weapons of mass destruction. Whatever our intelligence was, we concluded that there was a reasonably high probability that Iraq possessed weapons of mass destruction. Then we had to make a decision. Now, my guess is that the people who favored the Iraq invasion would have still favored the invasion if there had been a 60 percent probability that weapons of mass destruction actually existed. And I believe the people who opposed the invasion would still have opposed it if they thought there was a 60 percent probability of weapons of mass destruction existing.

So, what you're going to have to do in many circumstances is make decisions where there's remaining uncertainty. The purpose of the system that we're searching for is the identification of potential deceptions with a probability of 80 percent, Bernie Madoff being a great example. You didn't have to be a wizard. You could say, "Bernie, show me your trading floor. Show me your best trader. Introduce me to your best traders. Introduce me to your analyst. Let's see what their backgrounds are." Any recent graduate of a business school program would say, "No, wait. A firm can't be this large without those people."

What you want to do with your actions is to push those probabilities downward from high to low. But there will always be remaining uncertainty—that's just the nature of the world.

**The Dodd-Frank bill is requiring private equity and hedge fund managers to register with the Securities and Exchange Commission as investment advisers, and otherwise comply with the requirements of the Investment Advisers Act. Should we take comfort that the government is now involved in a greater part of the marketplace? And what is the role of the SEC in ensuring that there is integrity in the capital markets?**

### **Kroll**

The reality is that those parts of the financial markets that are engaged in regulatory reform are absolutely overwhelmed. We've been meeting with regulators now for months because we're involved in the regulated bond rating industry. I was part of a two-person presentation at the SEC recently on the subject of best practices in due diligence. It's very clear to me that the SEC just doesn't have the people power to conduct all the needed studies and implement a few hundred reform measures. Do I take comfort from it? No. These people are very well meaning and take their responsibilities seriously. But they just had these new responsibilities layered on top of existing responsibilities.

My other point is this: If you look at civil servants as opposed to political appointees, when do they get in trouble? They get in trouble when they take an action that becomes viewed as a mistake. Sometimes if you're in a position where you're taking an action that turns out to be incorrect, you're creating a level of exposure for yourself. These are people who are attracted to public service and they're proud of what they're doing. But, generally speaking, they are not risk takers.

**David Einhorn said in his book that the authorities really don't know what to do about a fraud when they discover it in progress. He points to the fact that the demise of Arthur Andersen resulted in a lot of**

**Spotting behavioral indicators is a matter of preparation, having an interview strategy and asking follow-up questions.**

innocent people losing their jobs, and he said that there's a bias for the government to not punish the shareholders of a company twice because if they fine the management, they're really fining the shareholders, who will suffer when the stock price falls. Do you think it's true that there's a government bias toward not finding the truth?

### Zeckhauser

No, I think the government does want to find the truth, but I would reemphasize what Jules said. These organizations are swamped. The SEC budget hasn't grown by much in the last 20 years. Yet, the size of the financial sector has grown 10-fold. The complexity of the financial sector has probably grown 100-fold. Laying on this notion of registering everybody will protect no one at all. It's time that might have been spent going after people who were doing something truly illegal. It's a little like expecting the people at the motor vehicles bureau to be out catching the people who are stealing automobiles. If you made them register bicycles, they would do an even worse job.

There are probably 1,000 investment advisers today in the United States who have done something illegal, like paying themselves money from a client's account. And that's going to get detected one time in 10. Now I certainly do not condone that, but that's not what I'm worried about. I'm worried about the major frauds—the big meltdowns—of the type that are committed with regularity every five or 10 years. We're not going to get rid of them, but what we want to do is to make them less likely and less costly. The last one cost the world an extraordinary amount of money, and we can't afford another disaster like that. If the work of people in the SEC only reduced that probability by a hundredth of 1 percent, their careers will have been well spent.

**In his book, John Mearsheimer concludes that national leaders lie more often to their own people than to other countries. Do you believe the same is true in the corporate world—that leaders of corporations lie mostly to their employees, or spin or conceal the truth from their own employees? If you**

**are performing due diligence and you meet with an investor relations person for a hedge fund, you could be hearing what they honestly believe is true.**

### Leggett

I have the job of being the CEO of BIA, which is full of people whose job is to get the truth out of others. We use the term "BIA indicators" or "behaviors." I throw off behaviors left and right. And I find that I catch myself, you know, on conference calls because as a leader of an organization you have a job of motivating and inspiring the team. And as a result of that, you are going to spin, so to speak, because you want people to buy into your vision. You want them to get behind you, and you want them to fight hard to have the organization win. So I think you're always going to have some element of that and I don't know that it's "lying" per se. I think that somewhere in the gray middle you have to be able to distinguish what is spin for motivational purposes and what is really concealing the truth because there is some underlying deficiency in the business. What we try to do is to help filter that. But I do think that if you are the leader of an organization you have a responsibility to your people to inspire them, to lead them, to get them to buy into your strategy. And every leader knows that things don't always go as planned. It's at those points in time where you really need to have your team behind you, and that's very different from presenting a completely false set of facts. That's malicious intent.

That's why I think a winning due diligence process employs a combination of these behavior assessment techniques and puts them to work consistently with each of the individuals you speak with during the due diligence process. In addition, building a network of external sources helps you to piece together a mosaic that ultimately gives you a clearer picture of what the truth actually is. If you stay with a single point for information, you are not likely to get the complete story. ||



Richard Leggett