

Case 2.7

The Fund of Funds: A Focus on Fraud and Inherent Risk Assessment

Synopsis

As total assets reached \$617 million in 1967, The Fund of Funds (FOF) was the most successful of the mutual funds offered by the Investor Overseas Services, Limited. In the late 1960s, FOF diversified into natural-resource asset investments. To do so, it formed a relationship with John King, a Denver oil, gas, and mineral investor and developer, whereby FOF would purchase oil and gas properties directly from his company, King Resources. By the 1970s, FOF was forced into bankruptcy.

It was later uncovered that King Resources had dramatically overcharged FOF for the properties that it sold to FOF. FOF's bankruptcy trustee sued Arthur Andersen for failing to inform FOF that they were being defrauded by King Resources. Arthur Andersen was ultimately found liable and forced to pay around \$70 million in civil damages, while John King was charged and convicted for masterminding the fraud against FOF.

Background

The Investors Overseas Services, Limited (IOS) was a Canadian company headquartered in Switzerland that offered diversified financial services, which included the management of mutual funds. IOS was founded in 1956 by Bernie Cornfield, a former Philadelphia social worker. One of IOS's most successful mutual funds was its Fund of Funds (FOF). The FOF was also a Canadian company that had operations directed from Switzerland; however, its corporate records were maintained in Ferney-Voltaire, France. FOF's total assets reached \$617 million by the end of 1967.¹³¹

FOF incorporated FOF Proprietary Funds, Ltd. (FOF Prop) as an umbrella for specialized investment accounts that were managed by investment advisors. FOF Prop's investments were heavily concentrated in American

¹³¹ "I.O.S. Lists Records Sales of Investments Programs," Special to the New York Times, *New York Times*, Feb. 23, 1968. Accessed from ProQuest Historical Newspapers, The New York Times, 52.

securities. Each investment advisor had a duty to act in FOF's best interests and to avoid a conflict of interest. In addition, each was compensated based on the realized and unrealized (paper) appreciation of their portfolios.¹³²

Challenges Faced by IOS and Its Affiliates

During the mid- to late 1960s, IOS and its affiliates began to face several difficult conditions. The industry had become increasingly competitive as new funds entered the field. In addition, the entire industry was negatively impacted by a decline in stock market prices. The industry was also impacted by significant regulatory changes; that is, a number of national authorities had put more regulatory controls on fund selling.¹³³

In 1966, the SEC brought charges that IOS had violated U.S. law by selling unregistered securities. As part of its settlement with the SEC, IOS and its affiliates, agreed to the following restrictions:¹³⁴

- Will not engage in any activities subject to SEC jurisdiction.
- Will cease substantially all sales of securities to U.S. citizens or nationals, wherever located.
- Will not buy more than 3 percent of the stock of any registered investment company.
- Will dispose of its interests in Investors Planning Corp. of America, a registered broker-dealer, and Investors Continental Services, Ltd., a wholly owned Investors Overseas subsidiary and also a registered broker-dealer.
- Will withdraw the SEC broker-dealer registration of five investment companies owned by FOF.
- Will not acquire a controlling interest in any financial organization doing business in the United States.

¹³² The Fund Of Funds, Limited, F.O.F. Proprietary Funds, Ltd., And IOS Growth Fund, Limited, A/K/A Transglobal Growth Fund, Limited, Plaintiffs, v. Arthur Andersen & Co., Arthur Andersen & Co. (Switzerland), And Arthur Andersen & Co., S.A., Defendants, No. 75 Civ. 540 (CES), United States District Court For The Southern District Of New York, 545 F. Supp. 1314; 1982 U.S. Dist. Lexis 9570; Fed. Sec. L. Rep. (Cch) P98,751, July 16, 1982. Available from LexisNexis Academic.

¹³³ Clyde H. Farnsworth, "Beleaguered Empire," *New York Times*, April 27, 1970. Accessed from ProQuest Historical Newspapers, The New York Times, 53.

¹³⁴ "Investors Overseas Ltd. Agrees with SEC to Leave U.S. Securities Field," *Wall Street Journal*, May 25, 1967. Accessed from ProQuest Historical Newspapers, The Wall Street Journal, 8.

FOF Expands into Natural Resource Assets¹³⁵

FOF's strategy for dealing with the SEC sanctions and the prospect of a potential stock market downturn in the late 1960s was to diversify its holdings into assets less affected by the stock market, such as natural resource assets. So, to set up an investment account that specialized in natural resource assets, the officers of FOF contacted John King, a Denver oil, gas, and mineral investor and developer. In February 1968, a formal contract designating a subsidiary of King's company, King Resources Corporation (KRC), as an investment advisor to FOF Prop was circulated between Edward Cowett, the chief operating officer (COO) of FOF, and Timothy Lowry, counsel for KRC. The agreement was not finalized and, ultimately, no written investment advisory agreement was ever entered into by the parties.

However, in a presentation at a meeting of the FOF Board of Directors in Acapulco, Mexico, on April 5, 1968, Mr. King suggested to the Board of FOF that they establish a proprietary account with an initial allocation of \$10 million that should be invested in a minimum of 40 natural resource properties. In the presentation, King described the role of KRC as follows: "that of a vendor of properties to the proprietary account, with such properties to be sold on an arms-length basis at prices no less favorable to the proprietary account than the prices charged by KRC to its 200-odd industrial and other purchasers." The Board approved the idea, and the National Resources Fund Account (NRFA) was established.

The clear intent of FOF was to use King's expertise, as it did that of other account advisors, to locate and purchase speculative investments in oil, gas, and mineral assets. FOF had no means of valuing the assets proposed for investment and no means of participating in any work requirements. FOF's dependence was encouraged by King in two ways: King's own corporate documents represented that KRC was an investment advisor to FOF, and its prospect summaries barely outlined the geologic and financial information that would be necessary for an informed, independent investment decision.

¹³⁵ The Fund Of Funds, Limited, F.O.F. Proprietary Funds, Ltd., And IOS Growth Fund, Limited, A/K/A Transglobal Growth Fund, Limited, Plaintiffs, v. Arthur Andersen & Co., Arthur Andersen & Co. (Switzerland), And Arthur Andersen & Co., S.A., Defendants, No. 75 Civ. 540 (CES), United States District Court For The Southern District Of New York, 545 F. Supp. 1314; 1982 U.S. Dist. Lexis 9570; Fed. Sec. L. Rep. (Cch) P98,751, July 16, 1982.

Yet, investments in natural resource interests were different from other FOF Prop investments in one important aspect: the interest purchased in every natural resource transaction was a portion of an interest that was owned or had previously been owned by a member of the King group.

KRC's Pricing Policy

As FOF's COO, Cowett's general understanding of the pricing policy was stated in a memorandum written on April 19, 1968: KRC would offer properties to FOF "from time to time and on a more or less continuous basis," the terms of sale are to be "no less favorable than those offered by [KRC] to other non-affiliated purchasers [and] all transactions will be arms-length in nature." Cowett also stated his understanding of the relationship and pricing policy in a letter dated November 11, 1970 (see Exhibit 2.7.1).

Exhibit 2.7.1

Letter Written by Cowett on FOF's Relationship with King Resources

- a. Without specific approval, no investment was to be made by the Fund in any resource property, unless KR or affiliated companies had a meaningful investment in the same properties ...
- b. KR was to have a 12-1/2 percent "net operating profits" interest in respect of any property acquired by the Fund ...
- c. The prices to be paid by the Fund were to be no higher than what would be paid by knowledgeable industry purchasers on a negotiated arms-length basis ...

I understood that KR and affiliated companies would, of course, in setting a price to be paid by the Fund for a resource property, add to the direct cost of the property a reasonable amount to cover investigative and administrative costs incurred as a result of the property acquisition program.

I also understood that KR or affiliated companies might perform drilling, coring, or other services in connection with property exploration and development; I was specifically advised by John King and/or Rowland Boucher that amounts billed for such work would generally be calculated on a cost plus 7 percent or 8 percent profit basis.

I might add that in the last few months I have been advised by FOF personnel that in several instances properties were acquired by KR or affiliated companies one day and vended (either that same day or almost immediately thereafter) to the Fund at a 10 times or 20 times mark-up. Such a practice was clearly contrary to the understandings

motivating FOF to enter into and to continue the relationship with KR.

- a. If KR could buy property at \$ x , this was a clear indication of the value of such property to knowledgeable industry purchasers.
- b. If a tract of acreage was purchased by KR for \$1 an acre, with a “turn-about” vending to the Prop Fund at a price of \$10 an acre for 50 percent of the position, such transaction would fly directly in the face of the underlying concept of KR having a meaningful investment in properties along with FOF....

Source: The Fund Of Funds, Limited, F.O.F. Proprietary Funds, Ltd., And IOS Growth Fund, Limited, A/K/A Transglobal Growth Fund, Limited, Plaintiffs, v. Arthur Andersen & Co., Arthur Andersen & Co. (Switzerland), And Arthur Andersen & Co., S.A., Defendants, No. 75 Civ. 540 (CES), United States District Court For The Southern District Of New York, 545 F. Supp. 1314; 1982 U.S. Dist. Lexis 9570; Fed. Sec. L. Rep. (Cch) P98,751, July 16, 1982.

Case Questions

1. Based on your understanding of inherent risk assessment, identify three specific factors about IOS and/or FOF that would be likely to impact your audit procedures if you were conducting an audit of IOS and/or FOF.
2. Please define what is meant by an “arm’s length” transaction. Given that all of FOF Prop’s investments in natural resources had also been owned (or were currently owned) by a member of the King group, do you believe that inherent risk related to these transactions should be elevated? Why or why not?
3. Consider the memo illustrated in Exhibit 2.7.1. If you were auditing FOF, would this memo impact your planned audit procedures? If so, what is the financial statement assertion that would cause you the greatest concern? Why?
4. If you were auditing one of the transactions between King Resources and FOF, what type of evidence would you seek to examine to determine whether the transaction was consummated on an “arm’s length” basis?