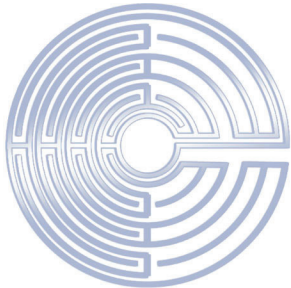


The International  
**FUNDS CONFERENCE 2K10**

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Global Transparency - Meeting the Challenge

L. Burke Files



**FE&E**

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# The International **FUNDS CONFERENCE 2K10**

Global Transparency - Meeting the Challenge

## **Cayman Comments on 2009 Handout**

Last year I was a speaker at this conference and prepared a very detailed handout on Future Areas of Conflict and IPCI (Intellectual Property and Critical Information), and I made some forward-looking statements. At this time I wish to review those statements, roughly in the context of our current topics -- regulation, disclosure, and transparency. I am also motivated to review the comments so that I am not accused of spreading false rumors.

### *Areas of Conflict*

Last year we discussed conflict and risk, and how conflict begins with risk. Much of this was an academic discussion on “fat-tails”, or heavy-tail distributions, and problems in computing risk by using tools that assume normal distributions. Even if the past supports our models, it’s always interesting to note how the models shift as what was the future joins the past. This past year has certainly been a bad year for those who place too much faith in models. I would like to mention one interesting development that’s relevant to our topic here today -- it has to do with the unwinding of the Madoff fraud.

It appears that the accounting firms who were auditing the various feeder funds that invested with Madoff made a startling error -- they apparently did not read the prospectus. The prospectuses used by some of these funds contained clearly delineated plans to deal with concentration of risk, in particular, the risk of having too much invested with any given fund or family of funds. A common limitation was not more than 10% in any fund. In reality, several had over 50% with Madoff, and one had over 90%. A common, and not unreasonable defense for the auditors is that it was a lie -- the auditors were lied to as well as the investors -- followed by a shrug of the shoulders. This will not work when the auditors failed to read or comprehend a key clause in the contract between the investors and the fund managers.

In a culture of victims, having deep pockets is a risk in itself -- and these firms have deep pockets. While failure to read the prospectus is a foreseeable risk, who could have foreseen the perfect storm of events it took to transform this risk into the liability it will undoubtedly become.

## ***Taming Risk***

Risk models created using mathematical tools that assume the future will resemble the past are inherently flawed. The possible risks we encounter include animal spirits, which are not domesticated -- and never will be. Yet, we still attempt to qualify and quantify risk by looking at the past. While the past does provide a good first approximation, we need to look to the future to comprehend risk. How many products and business sectors can you name that had great fundamentals ten years ago, and are on the point of extinction today? Without thinking about it too hard, I can offer a quick list. Strip malls, travel agents, bookstores, light manufacturing, newspapers, VCRs, typewriters, pagers, and photographic film. So what is next? Realtors, checks, movie theaters, retail jewelry, and electronics stores are all good candidates for extinction. And while every one of these changes displaces an army of specialists and workers, it would take volumes to even begin a discussion on jobs that had great fundamentals ten years ago. A concentration of laborers working in a single industry can jeopardize an entire city or region -- witnessed by the number of abandoned mining towns seen in our past, and possibly the city of Detroit in our near future. The risk of a location may be as simple as a new highway rerouting traffic, as seen in the ghost towns on the once vibrant route 66 in the U.S. Risk of location may be as unforeseeable as an unabateable toxic waste dump, or spill, as seen in the notorious Love Canal disaster. While location is suffused in politics, political realities change as demographics change. The viability of a location for our intended purposes, or its value, can be radically altered by the course of the political winds -- as we have witnessed several times in the history of New York City, and are seeing again today.

Looking forward, we need to assume that the Internet and improved distribution will make many more retail business models obsolete -- such as those that require specialized knowledge or have inefficient distribution channels. Other technologies will displace workers, and some geographic locations will become unsustainable in their present form, either because they have been abandoned or they have committed suicide.

While we attempt to understand risk, over the past decade the line between risk management and regulatory compliance has been blurred to the point where, in many organizations, it is impossible to determine if they are not one and the same. This may be the strongest statement I want to make here, because mere compliance is far too low of a standard for risk management.

## ***Intellectual Property and Critical Information - (IPCI)***

International agreement on what defines IPCI has, for another year, gone unresolved. I predicted this.

The conflicts with IPCI are, not surprisingly, ownership. Currently we are watching a

pivotal legal challenge to business process patents. The case of Bilski v. Kappos before the U.S. Supreme Court is a crucial test on business method patents. This case may be decided between the time this is written and the presentation. In either case, the outcome will have far reaching implications in the development of software and medical diagnostic techniques. Risk.

Another case, as an illustration, is the long running trade dispute between Brazil and the U.S. regarding cotton subsidies. The U.S. has been subsidizing cotton production since, at least, the 1930's. Brazil filed a complaint, and won a decision before the WTO's Dispute Settlement Body. After having won several appeals, and receiving no consideration from the U.S., Brazil now claims the right to \$2.5 billion in retaliatory sanctions against U.S. interests. Not surprisingly, the U.S. disagrees. Since Brazil's inbound trade with the U.S. is very small, Brazil has threatened to ignore U.S. patents on medicine and begin producing pharmaceuticals in Brazil that are protected by U.S. law and international IP agreements. This is an intelligent response in a trade dispute where Brazil seemed to have no leverage. An interesting element in this story is that the dispute is creating risk in industries that had no involvement. The risk is falling on industries that are only vulnerable because their assets are primarily IP.

#### *Domicile of a website*

Last year we were watching a Kentucky State Court attempt to seize all of the web domains of a licensed bookmaker in Australia, because the bookmaker took bets from Kentucky and the sites could be used by residents of Kentucky. Thankfully, this did not hold up.

As I said last year;

*“This is a trade war, under the guise of state law to block international commerce. Gov of Kentucky is conducting international foreign policy, and initiating a trade dispute by seizing the property of a company that is not in KY or the U.S., the registrant of the domains happens to be in the U.S. Wow!”*

Last year I considered the states use of a domain registrars location to claim jurisdiction as preposterous. Apparently, they were just testing the water. This year, we have the same argument being made by a higher authority. The U.S. IRS is using the fact that a U.S. firm was used to register domain names as one of its jurisdictional foundations to subpoena records from foreign credit card processors.

This highlights the fact that much here is still unsettled. Unless the registration of the domain name, Internet host, web server, card processor, merchant account, and the business entity are in the same jurisdiction – you have risk. You have the risk of many jurisdictions choosing to impose the laws of their domicile on your business.

## *Bricks to Clicks*

The migration continues from brick-and-mortar retail businesses to online outlets. But there has been another unexpected change drawing business away from traditional brick-and-mortar business. Call center jobs are no longer being outsourced overseas; they're being outsourced as domestic work-at-home opportunities. In developed nations there's no longer any economy in using overseas locations, where language and infrastructure remain issues, when domestic workers can furnish their own workspace and computers. The travel industry was an early adapter of this distributed work model, pioneered by Jet Blue, and which cruise lines now heavily use.

It wasn't that long ago that creating a call center required expensive switching equipment, PBX systems, leased phone lines, and proprietary telephony equipment. These systems only functioned within the operators leased space, which required desk space for every employee along with all of the other support equipment and facilities necessary to keep it functioning. The solution for this was, initially, to go offshore.

Today, any work-at-home employee can securely join a distributed telephony network if they have a functioning USB port and broadband access. In developed nations, most people have these resources – and if they don't, the barrier to entry is quite low.

So what does this rapid change in outsourcing solutions mean for Offshore? Copying what has been successful in other jurisdictions used to be a model for lateral growth. That's less true today than it was last year -- it is increasingly a model of risk. The cost of migrating opportunities around the world, or even repatriating them, is quite low. If offshore jurisdictions cannot maintain their advantages crafted into law, and be more innovative, they will face more and more competition. Contrary to the wishes of developed nations, offshore centers with an advantage crafted into law are growing, and will be increasingly less willing to "get along" in adverse economic climates.

Offshore financial centers must embrace the economic changes that are evolving in the world. The economy is moving from brick to clicks and if OFC wish to be part of this new economy they need to be prepared for what it will take to support the business and wealth of the future.

So, how did I do with my predictions? I got the direction right, but my time horizons and trend analysis was too long. It looks, retrospectively, to be a five-year analysis as opposed to a one-year analysis. Feel free to assess a grade, or fail me, and provide some comments. I appreciate all of your input, and am open to discussions on a wide array of peculiar and offbeat topics.

## **Cayman 2010 - Global Transparency**

Today we will hear about many changes and proposed changes related to the Hedge Fund Industry, and what impact these changes will have on us as industry participants. One of those issues is the legislation of “transparency”, the current buzzword in solutions being crafted by many governments and regulatory agencies.

I wish just to take a few moments to discuss this trend, what is good about increased transparency, what is dubious about how this term is used, and the various actions of the governments who are using the term.

Here’s one definition of “transparency” I mined from Wikipedia and Webster’s.

Transparency, as used in the humanities and in a social context more generally, implies openness, communication, and accountability. It is a metaphorical extension of a “transparent” object, one that can be seen through. Transparent procedures include open meetings, financial disclosure statements, the freedom of information legislation, budgetary review, audits, etc.

It is an authentic way of conducting business or living one’s life. Authentic is a term I use that reflects more than just being honest, but also being forthright. It is an easy lifestyle to have and a hard one to fully embrace - very hard.

Like it or not our world is more transparent today than it was yesterday, and will be more so tomorrow. More and more of where we have been, academically, professionally, and physically, is readily available from public source documents, the web, or normalized in any number of massive databases. This does not even include all of the personal information we place on Facebook, MySpace, LinkedIn, Twitter, and other social networking sites -- as well as blog entries. The distance between countries shrank dramatically with the introduction of air transportation, and more with modern jet travel. As our commerce becomes digital and IP based, there is nothing physical to transport. As the Internet matures, distance has become, in many ways, insignificant.

I’m sure you’ve heard all of these metrics before, but I want to recap them here to create a quick timeline of the Internet, and to add some commentary. ARPANET was started in 1969. CompuServe offered email in 1979. It was in 1980 that the first Internet Service Providers started forming, TCP/IP Protocols were adopted for the Internet in 1983, Windows 1.0 was released in 1985, Yahoo was founded in 1995, Google was incorporated in 1998, and the Internet did not surpass 100 Internet Hosts until 2001. As of 2009, the number of Internet Hosts is near 700 million. The rate of change and access to information has been astounding. It was just ten years ago that markets were nearing the top of the Internet bubble – and we were saturated with information explaining how these new technologies would transform our lives. When the market bubble burst, many people believed that the promise of these

transformative technologies burst with it. In reality it was our misconceptions that burst.

The reality is that we did not understand how to make intelligent use of the technology. In the last decade developers have standardized and enhanced both the Internet browser and email services, which solved cross-platform issues. Database formats, graphic formats, and methods to access data have been standardized -- making it easier to share data and develop distributed applications. Open source software has been developed that makes access to these developments virtually free. All of these changes were necessary before we would see the widespread use of technology that we have today. The integration of hardware -- merging audio, video, and telephony with the PC has created a tool that can transform itself and emulate what at one time represented thousands of specialized hardware systems. The past ten years has brought us some very interesting tools, and has slowly transformed the way business and commerce are done. We are currently just beginning the next revolution -- intelligent application of the technologies.

*“Why does this magnificent applied science which saves work and makes life easier bring us so little happiness? The simple answer runs: Because we have not yet learned to make sensible use of it.” -- Albert Einstein, 1931*

This seemingly seamless integration of technology is what computer scientists refer to as transparency. What they mean by transparent is that the user does not perceive the process. The systems all speak the same language, and follow a standardized set of rules.

It is these same transparent information technologies that are creating transparency in all of our lives. Transparency should be considered a forgone conclusion for all of our futures. We used to be able to remake ourselves after an error in life. An ugly divorce, a business failure, or a rough and tumble adolescence could all be swept under the carpet by placing physical distance between where it happened and where you went to remake yourself. The information access and the storage capacity we possess today make such a transition nearly impossible. For those over forty, think of all the fun (excuse me, socially irresponsible, or better) things we did as adolescents. Those events and records are now behind us -- thankfully -- and we have been able to remake ourselves as adults. The next generations will not have this opportunity.

Technology has also made it easier for regulatory agencies to require disclosure. You no longer need to print cases of documents and distribute them to the requisite parties. They can be prepared in seconds, posted to a secure website, or distributed via email. The cost to the dissemination of disclosure has evaporated.

## **Secrecy and Privacy vs. Transparency**

An eternal truth is that we are more likely to try and get away with something when we

think no one is looking -- or if looking, could never find. In the private sector, I can think of a few dozen massive frauds as an example, and in the public realm I can think of no better examples than the hacked emails exposing the fraudulent science promoted by climatologists at the Climate Research Unit (CRU), and the embarrassing disclosure of MP expenses in the UK.

Secrecy is the process of hiding information with the intent to use that information to your benefit. It's important that we have secrets, and keep some information private. Nations have a legitimate need for secrets, to craft informational and technological advantage over other nations. The same is true for companies who wish to keep their IPCI secret along with operational efficiencies and future plans. And people have legitimate needs for secrets as well.

Privacy is the concept of depriving others about personal information, thus selectively revealing who you are. Samuel Warren and Louis Brandeis defined privacy in the context of information and technology, with a focus on protecting individual liberty – a “right to be let alone” (Warren & Brandeis, 1890). While this definition prevails in North America, definitions and the meaning of privacy are closely tied to cultural norms. Privacy is not anonymity, and it doesn't have much to do with security. Privacy is a concept in social conduct as well as in law. When a person compromises their privacy, they normally do so in exchange for a perceived benefit. The 4th Amendment to the U.S. Constitution guarantees “the right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures.” This is probably the best statutory definition we have, for now.

Information that is private means that it is not secret -- it is private though it is accessible and is usable by a third party. For example, your tax returns are private -- but not accessible without your permission except by a court order. Driver's license information is private, and only available to you and a select cadre of government departments and private parties. As Warren & Brandeis observed in 1890, privacy rights are inextricably intertwined with advances in technology. This is clearly as true today as it was then, but current technologies are challenging the interpretation of that relationship.

Why so much discussion of privacy v transparency? Because for Mutual Funds, privacy concerns several aspects of your business, including your list of investors, your formula for providing returns, your strategy sessions, and communication on future investments. One requirement of proposed legislation on transparency is that you, as an industry, trade some of your privacy for an economic benefit. This benefit is supposedly conferred upon those who are licensed. A choice will have to be made on licensure; will the cost of licensure be outweighed by the economic benefit? If not, the follow up challenge will be how to restructure to be exempt from the future unspecified benefit of licensure.

Questions that need to be asked are, what is the economic benefit of transparency and

the associated regulations? Is the reward worth the cost of the infrastructure to aid in disclosure and punish those who do not disclose?

As fodder for thought, the U.S. is where you will find the most draconian disclosure rules. The year after SOX was passed the number of IPO's dropped, and the number of companies going private increased 22%. The number of publicly traded companies was already in decline, and now even IPO's are dropping to new lows.

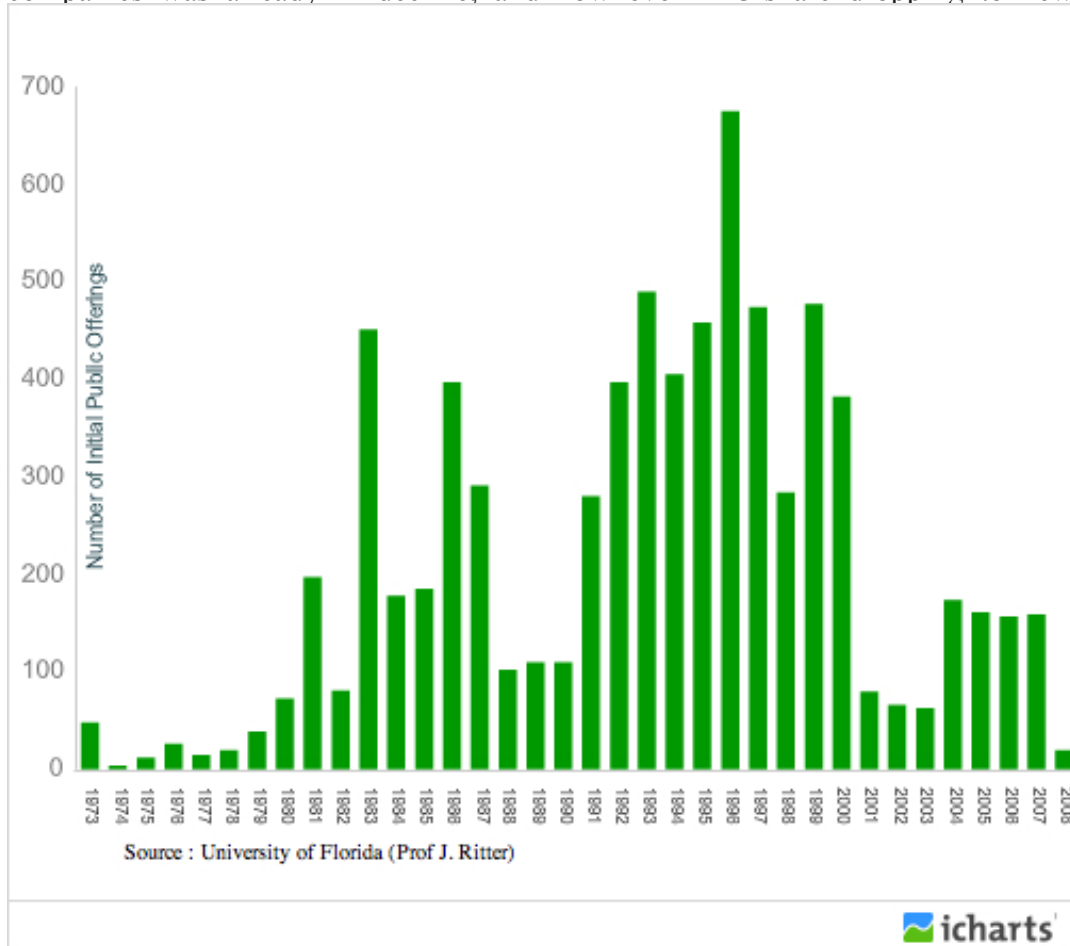


Chart: Number of Initial Public Offerings, 1973 – 2008.

## Risk and Transparency

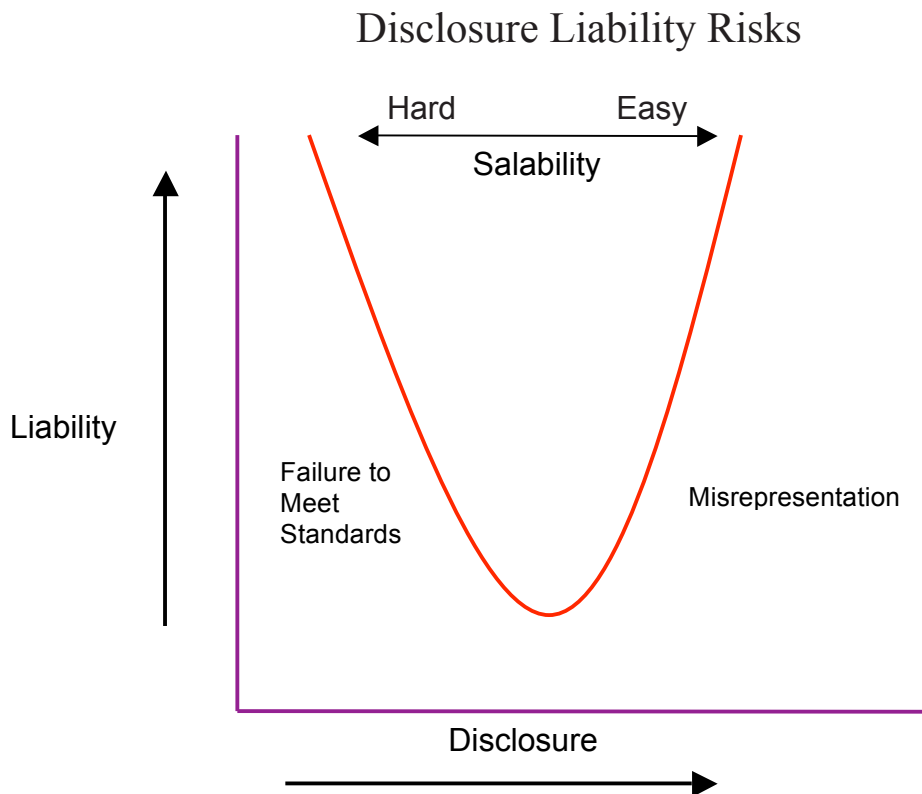
The best risk management practices will be open and transparent. Open and transparent allows them to be totally defensible.

The market recognizes risk and is, in fact, a barometer for risk. The market is a place where one assumes and accepts risks in exchange for reward. Metrics such as Maximum Peak Exposure (MPE), Credit Value Adjustments (CVA), Potential Future Exposure (PPE), and

Expected Positive Exposure (EPE) are all methods used to digest risk and its impact. The market knows this, understands this, and will expect both disclosure and open discussion. Those companies and funds that disclose and discuss how risk is assumed and managed demand the highest possible valuation by the markets.

Conversely, losses sustained in vehicles that had less than transparent disclosures are still making headlines -- and are springboards for litigation. The difficulty is establishing what you knew, what you could have known, and when could you have know it. Many very smart people have miscalculated risks that look obvious to us today, but the risks were not obvious at the time.

What are absent from the headlines are those companies and funds making money and disclosing as little as possible. Without this we cannot calculate with any degree of certainty the optimum balance between disclosure and preservation of IPCI. After all, no matter how much we disclose there is never a safe harbor from litigation, and in practice it costs more to properly frame and discuss the risks. Over-disclosure, in the end, may not only cost more, but also expose you to additional liability.



The real underlying assumption is that with full disclosure in real time, we can somehow manage risk as a prudent person. In reality, our history of making choices show that, as humans, we are anything but prudent – we are likely to respond to a host of biases,

misperceptions, and misinformation that color our expectation -- and thus our decisions. After all, what is a failed investment? It is simply an investment that has failed our expectations.

### **Full Transparency and Litigation**

First of all, it's impossible to provide full disclosure -- since all risks cannot be known at the time of investment. It is impossible. I have on my desk, as I write, a 3.5 pound set of documents for Behringer Harvard Multifamily REIT I, Inc. It's a massive set of documents, disclosure, and information that is beautifully written, documented, and printed. I'm guessing that this sales and disclosure tome had to cost several million dollars to author and publish. Even after all of that work, there are five supplements correcting or updating information. If I've ever seen full disclosure for an REIT -- this is it.

However, this attempt a full disclosure poses another problem. That is, it serves as a solid foundation for litigation. Several securities litigators I spoke with really liked the investment, and made comments along the line of -

*“This is a no loss investment for me, whether they do what they say they are going to do or not. If I get a return along the lines of my expectation, I'll be happy. If not, and the investment appears to be failing or coming up short, I'll comb through the offering documents - because I will not read the many hundreds of pages before I invest - no one does - and I will look for where their representations at the time of investment are incongruent with their subsequent actions - as they always will be. No one can craft a prospectus with full disclosure and adhere to the model throughout the term of the investment. Markets change, and the economy changes, requiring adaptations in the management of the fund. But, it's sufficient grounds for litigation and recovery.”*

The calls for increased transparency assume more informed choices can be made and thus less fraud or risk of litigation. It is an over simplified presentation and possibly counter intuitive unless offerors and their managers and administrators are offered some form of statutory safe harbor.

### **Regulatory Regime Response**

To date, the response of the regulators is to require standardized contracts, and for these contracts to be traded in some form of OTC marketplace. While a marketplace is a proper place for these types of transactions, the desire of the regulators to standardize them makes no sense. Many of these agreements are used to manage risk, and manage *specific* risks. But standardizing the contracts makes more imperfect hedges than one may like and causes other problems when dealing with the management of risk and disclosure of risk. What

was once a risk that could be close to perfectly hedged is now imperfectly hedged risk, and may or may not add new risk as opposed to shifting risks.

It would be better, from the industry and corporate governance point of view, to have an independent marketplace ensure the viability of the agreements. Further, to disclose to the world what agreements being traded are, but not by whom. Thus the marketplace has full transparency on the economics, and the parties still have the privacy of their economic positions.

### **Hedge Funds and Full Disclosure**

More specific to this conference we have the idea of Transparency in the Hedge Fund industry. As mentioned before, there is no way all of the risks can be known thus disclosed. In my varied financial career I have been a fund manger, a fund administrator, a director of corporate finance, and a financial investigator with a specialization in intellectual property. In my career, I have never seen full disclosure. I have never even seen a disclosure document that, six months out, correctly anticipated all of the risks that subsequently became apparent.

Full disclosure, as regulators seem to be trending toward, means full real-time disclosure of all material events. But what is material tomorrow may not have been deemed material when it happened. Full streams of event disclosure data will also risk discontinuity of the information, and thus may constitute misinformation. Full disclosure trades risk the security of trade secrets, private algorithms, and proprietary trading relationships. A third party hostile to a fund, a competitor perhaps, may be able to reverse engineer your methods and render your IPCI useless. As I pointed out last year -- once IPCI is diffuse, it is of little use.

Finally, full disclosure does not give the manager or administrator a safe harbor from litigation. The risks are the same as those we observe with offering memorandums -- no one reads them until some part of the investment fails expectation. Full disclosure provides a foundation for litigation as opposed to information on risk management. Despite the incentives being proposed for increased disclosure, there is a balance we have to strike between too little, and too much – as risk lurks on either side.

### **Final Remark**

This paper was assembled to supplement my brief remarks at this conference and to provide the participants more insight into my views. If you have any ideas you would like to share,

stories to supplement my observations, or disagreement with my arguments, it would be a pleasure to hear from you.

I've attached an article by Kevin Warmack on anti-money laundering (AML) programs. Mr. Warmack is an associate of The Lubrinco Group ([www.lubrinco.com](http://www.lubrinco.com)). I hope you'll find the article informative. AML programs create an exposure to liability – read, risk – if covered institutions cannot provide evidence that they have made efforts to comply.

## **Anti-Money Laundering Programs**

by

**Kevin L. Warmack**

On October 26, 2001, the United States enacted the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (the “AML Act”) as part of the USA PATRIOT Act (the “PATRIOT Act”). The AML Act requires financial institutions, including broker-dealers, to establish anti-money laundering programs and to educate every employee in the prevention and detection of money laundering by customers and potential customers.

Pursuant to the AML Act, the AML Program should at a minimum:

- Establish and implement policies reasonably expected to detect and cause the reporting of transactions;
- Establish and implement policies, procedures and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and its implementing regulations;
- Provide for independent compliance testing to be conducted by member personnel or by a qualified outside party;
- Designate an individual or individuals responsible for implementing and monitoring day-to-day operations and internal controls of the program; and
- Provide ongoing training for all appropriate personnel.

Similar to written supervisory procedures, the AML Program should be tailored to the business of the financial institution and its operations. The AML Program, like your written supervisory procedures, should be considered a “live” document in that the program is changed from time to time to reflect changes in the AML rules, regulations, and situations that the financial institution may run into in achieving AML compliance. To be effective, the AML Program should be specific in the persons responsible, what tasks should be taken to achieve compliance with the AML Rule or regulation, how often the task or review is to be completed, and there should be some method to document that the task was done and reviewed by the appropriate personnel. Finally, to ensure that the financial institution is prepared to effectively and efficiently comply with the AML Act, a knowledgeable independent party should review the AML Program and the firm’s compliance with the program annually.





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Prior to founding FE&E, Mr. Files was a partner in a regional consulting firm specializing in business management and financial and securities consulting. Mr. Files has also served as the Director of Corporate Finance for an investment banking company, American National Group, Inc., where his duties for the firm were to help select underwriting opportunities and to coordinate all of the functions of managing the underwriting of the company, coordinating with attorneys, accountants, transfer agents, printers, and other broker dealers. Mr. Files was also the President of a business and venture capital consulting firm, Crystal Resources, Inc., specializing in reorganizations and municipal financing for medium sized power plants.

Mr. Files was employed by Oppenheimer/Rouse as a commodities specialist. In this capacity he was responsible for managing and trading funds and customer accounts with 24-hour gold, silver, and foreign currency trading. Mr. Files has held Series 3, 7, and 63 securities licenses and has been a registered Commodity Trading Advisor and a Registered Investment Advisor.

Mr. Files is active in many civic organizations. He is a past Chairman of the American SouthWest Foundation, a non-profit political and economic think-tank. In the past Mr. Files has served as a member of the Governor's Board on Solid Waste Management, as an advisor to the Governor's Board on Economic Planning and Development and a former Commissioner of the City of Tempe Transportation Commission. Mr. Files has also received a Commission and a Medal of Merit from the President of the United States. Mr. Files has also earned a B.S. in English.

Mr. Files currently serves on the Board of Directors of EuroResources, Ltd., an international financial consulting company, as a Board Member of Tarsus Trust Company, Ltd., an international trust company, and as a Director of American / China, an agribusiness company. He has authored many articles, has appeared in OFC Review, Offshore Journal, El Mercado, Euro Business Magazine, and on National Public Radio. He has authored two books "Due Diligence for the Financial Professional"-1996 and "Counterfeit ID"-1993 along with many white papers and articles on things vaguely financial.

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Our professionals have authored several articles that have appeared in EuroBusiness, Security Magazine and Mergers and Acquisitions. Our professional staff have been interviewed and quoted in Chief Executive, Forbes, Newsweek, Robb Report, Boston Globe, Information Security, Entrepreneur, AFP Journal, IFC and the AMA Journal. Copies of many of these articles can be found at our web site under Publications.

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