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SPECIAL EDITION

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## Are My Assets Safe?

### Security of Client Assets at The Trust Company of the South

**I**n light of the Bernie Madoff scandal and the recent fraud charges levied against Stanford Financial Group, we think it is important for our clients to know how their assets are secure with our organization.

As more information comes to light, it is clear that none of the investors or institutions performed even cursory due diligence on Madoff, his operation, or the underlying investments (if there ever were any investments) before handing over their or their clients' money. In short, there was a lot of "trust" - with no verification. Those potential investors and advisors who did try to obtain answers to basic due diligence questions quickly became suspicious and moved on.

In the case of Stanford, it appears suspiciously high yields were offered to clients investing in certificates of deposit in a related offshore bank.

Summarized below are some of the key factors ensuring the safety of our clients' assets, the majority of which did not exist with Madoff.

>> Our clients' assets are held and safeguarded by independent third party custodians (Fifth Third Bancorp, Depository Trust Company (DTC), Matrix).

- >> Our investment offerings are transparent and diversified - our investment offerings are widely known and owned - and easily vetted by our clients.
- >> We use an independent third party trust accounting system for the detailed record-keeping of client accounts as well as separate third party performance reporting.
- >> As a fiduciary trust company, we are examined each year by the Office of Commissioner of Banks for the State of North Carolina.
- >> Our operations and internal controls are reviewed annually by an outside public accounting firm.
- >> We serve as the "back office" operations support for several bank clients. These banks performed their own due diligence of our organization and operations before engaging us. They require a separate audit of our activities specific to this operational support.
- >> Our firm is owned by shareholders who, with the exception of Bill Smith and his brother Jim Smith, are unrelated by birth or marriage. In addition, none of our employees are related by birth or marriage.

Most of the above factors are discussed in more detail on the following pages.

**F**irst, and most importantly, we use independent third party custodians to hold and maintain all of our clients' assets. Fifth Third Bank serves as the custodian for all DTC-eligible client assets (stocks and bonds). Our clients' mutual fund assets (including money market funds) are held at the respective fund company and cleared through Matrix Settlement and Clearing Services, a broker-dealer which serves over 300 financial institutions and maintains over \$100 billion in assets. The fact that Mr. Madoff did not use independent custodians is one of the linchpins that allowed him to pull off his scheme. This fact also caused many potential investors to quickly turn away.

Assets maintained in custodial accounts by custodial institutions are segregated from the assets and liabilities of the institution and are not subject to the institution's creditors. The custodian's role is to hold the assets for safekeeping, to collect dividends and interest and provide other similar services. Account ownership in the assets remains vested in the entities for whose benefit the institution is acting as custodian and the assets are not subject to the claims of creditors. In contrast, assets held in deposit accounts of a bank become liabilities of the bank. As such, deposits create a debtor-creditor relationship between the bank and the depositor. Similarly, if investors hold assets with an investment advisor, who does not provide separate custody, these investors become general creditors of the investment advisors.

Our custodians employ comprehensive safeguards and controls over asset trading and transactions in their daily operations. Each year the custodial operations of both Matrix and Fifth Third endure a Type 2 SAS 70 examination. Officially known as a "Report on Controls Placed in Operation and Tests of Operating Effectiveness", Type 2 SAS 70 audits provide independent third party verification by a licensed CPA firm as to whether control activities described by a service organization were suitably designed to meet specified control objectives and were in place and

operating effectively over a specified period of time. Note that SAS 70 audits have become much more prevalent and rigorous in recent years to comply with the Sarbanes-Oxley Act of 2002 (the Act was prompted in large part due to the collapse of Enron).

**W**e have a great deal of daily interaction with our contacts at both Matrix and Fifth Third. We monitor our custodians' service and capabilities and have a very high level of confidence in them to safeguard our clients' assets. If we ever have concerns about a custodian's service, we are free to, and will, move our clients' assets to the care of another reputable and capable custodian.

As mentioned above, our investment offerings are very transparent and diversified. We utilize mutual funds that are easily verified and vetted – and are tracked and reported in a wide range of mediums. We do not recommend that our clients invest in "black boxes" or exotic schemes that cannot be easily explained or supported. It has been reported that Stanford Financial Group invested in certificates of deposit issued by a related offshore bank. All Trust Company of the South investments are "arm's length" transactions with independent mutual fund companies or investment managers. We do not engage in related party transactions.

Unlike Madoff, we report to our clients on how their assets are invested through our use of an independent trust accounting system to maintain individual client accounts and transactions. We also use an independent third party for client performance reporting. In addition, clients can easily verify how any one of their investments is performing by looking in the business section of most newspapers or a host of other sources.

We use InnoTrust, the trust accounting and reporting system designed and maintained by InnoInvest Systems, LLC. It serves trust companies, trust and custody departments of banks, wealth management firms, and private banks. InnoInvest

Systems, LLC was founded in 1974 and is based in New York. We have representatives on the users group that provides ongoing feedback and suggestions for further enhancements to the InnoTrust system. This system has its own comprehensive internal controls and reconciliations that are performed with the range of activities and operations allowed by the system. In addition, an annual SAS 70 audit is performed on the system and we receive and review the results of this audit. The SAS 70 also addresses the security of the data.

Beyond the daily back-up of our data on the InnoTrust system, the data also resides with the system provider, Innovest Systems, so there is an independent source for detailed client account information should some catastrophe strike our facilities or people.

**C**lient accounts are reconciled daily with the custodial accounts of The Trust Company of the South at Fifth Third and Matrix. These reconciliations are monitored daily by our internal operations team. Any exceptions, though rare, are investigated and addressed promptly.

In addition to the controls and processes used by independent custodians and trust accounting system, The Trust Company of the South employs rigorous internal controls and separation of duties in managing client transactions and accounts. These controls minimize both employee errors and potential fraud. At least two people are involved with each client transaction – the person who enters the transaction and a second person who reviews the transaction entered into the system against the supporting documentation from the client. Once adequately reviewed, the transaction is authorized/approved by

the reviewer. Also note that the trust accounting system will not allow the same person to both enter and approve a transaction. Beyond the separate entry and authorization of each client transaction, all transactions (disbursements, deposits, trades, etc.) are reviewed daily by our principal in charge of client services.

## AUDITS

Our internal controls, processes and reporting related to maintenance of client accounts are reviewed each year as part of our required annual examination by the Office of Commissioner of Banks for the State of North Carolina.

We have separate audits of our internal processes and procedures by an independent accounting firm, Crowe Horwath LLP. The Crowe Horwath auditors responsible for and performing our audit specialize in reviewing and testing internal controls for financial institutions. In addition, we serve as the “back office” for several banks who to date have chosen to outsource their operations. These banks performed their own due diligence of our capabilities in their decision to engage our firm and require a separate audit by Crowe Horwath of the specific functions we provide to them.

An independent audit of the financial statements of The Trust Company of the South is performed each year by a public accounting firm. The auditors review and confirm our records of client accounts with the accounts of the custodians of our clients’ assets.

**We realize that this is a lot of information to digest but we wanted to communicate some of the important safeguards and controls in place to protect our clients’ assets. You have placed your trust and your money with us. It is our job to ensure that you continue with that trust.**

**Please contact us with any questions or if you would like to discuss further areas outlined above or any other concerns.**



The Trust Company of the South is a fee-only independent trust company and financial planning firm focused on serving the needs of affluent individuals, families, and non-profit institutions.

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