

ACAMS TODAY

The Magazine for Career-Minded Professionals in the Anti-Money Laundering Field

Too good to be true?
Hedge fund AML risk, due diligence,
potential fraud and misbehavior

A man in a light-colored dress shirt and a striped tie is looking into an open, empty box. He has a surprised or concerned expression on his face, with wide eyes and a slightly open mouth. The lighting is dramatic, highlighting his face and the box against a dark background.

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There are few investment vehicles with less transparency than hedge funds. Lack of transparency, limited regulation and increased access to these funds by the general public create significant opportunities for insider trading as well as pure fraud.

The Madoff scandal opened the floodgates on identification of hedge fund fraud as poor market conditions and fear of fraud caused investors to seek redemptions and regulators to investigate — where they had access to affiliated parties. As 2009 closed with continuing coverage of the Galleon scandal, the most massive insider trading fraud discovered to date, 2010 opened with an article from the Associated Press reporting that Ponzi schemes were up almost 400 percent in 2009. There is no question that the last two years have taken the lid off of Pandora's Box on hedge fund fraud and misbehavior.

In the case of Ponzi schemes, most victims were referred to a fund by a trusted financial advisor, a friend with community ties or a family member. Many of these schemes survived years without detection. We all want to believe that family, friends and colleagues have our best interests at heart and that they are honest, upstanding citizens. Unfortunately, it's not always the case.

Firms that deal with large hedge funds and/or high net worth clients will complete significant due diligence prior to introducing their clients to a hedge fund, taking a hedge fund on as a client or placing firm funds with a hedge fund. However, small funds may fall outside of these procedures because they have not disclosed their activities to the broker dealer or bank housing their account or they are self-custodying assets. Anti-money laundering (AML) professionals can focus on key elements of typical due diligence to assist in early identification of potential issues.

Firm due diligence

Due diligence by the alternative assets group or a credit and risk function at a large firm is likely to focus on the background of the fund's managing partners, the legitimacy and track record of the investment strategy and the perceived risk to invested capital. To do this, an analyst will gather general information about the fund and its partners, as well as regulatory and legal history, performance of various funds under the groups control, specific funds offered and subscription documents, information about key personnel, valuation methods, operational details such

as number of trades and prime brokers, names of service providers and make-up of investors in the fund, etc. Firms that complete this level of due diligence generally integrate AML needs into their processes.

Significant exposure exists for firms that service smaller hedge funds and, due to the nature of their systems or processes do not identify and evaluate the risk of those funds. A small fund operating entirely in the retail space may show patterns such as regular round dollar deposits (subscriptions) by check or wire from multiple sources, wires to issuers and delivery of shares from said issuer and withdrawals (redemptions).

If an account is suspected of operating as an investment fund and has not been subjected to enhanced due diligence, requests for offering, subscription and partnership documents related to the fund are appropriate. If the client denies acting as a fund and/or refuses to cooperate, immediate escalation to business line management is appropriate. If the suspected fund cooperates, enhanced due diligence should be completed on the key personnel including managing partners and authorized signers.

Information gathered by the alternative asset or credit and risk department analysis may be copied and organized into the categories below. The focus of the review is not the legitimacy of the investment, but inconsistencies in information, gaps in expected controls and/or negative regulatory or legal history of key individuals and/or entities.

Fund details and strategy

- The name of the fund and its details including address, management company or managing partner, organization chart and key contacts
- Fund marketing materials
- The prospectus or offering memorandum, subscription documents and partnership or operating agreements
- Audited Financials
- Key Personnel

Service providers with key contact name, phone and address for each

- Administrators (Offshore and Onshore)
- Lawyers (domestic/international)
- Auditors
- Prime Brokers/Custodian
- Executing Brokers
- Marketers/Capital Introduction Services

Operational details and controls

- Who supervises daily trading at the firm?
- How many executing brokers are used?
- Who has the authority to direct money or asset movements? Confirm they are included in the list of key personnel.
- How are securities valued? If an outside firm is used, confirm they are listed in the service providers.
- Does the fund have a policy on conflicts of interest, a compliance manual and a code of ethics?
- Does the fund management company share common space with another financial services company? If so, gather information on the company and its relationship to the fund.
- How is viability of individual investments determined? Does the fund require audited financials for investments that it makes?

Areas of focus

Focus on key control points such as custody of the assets, suitability and legitimacy of service providers, affiliations between the fund, service providers and underlying investments, as well as the profile of investors. This should provide enough information to establish whether the activity is potentially suspicious and/or requires closer review.



AML CHALLENGES

Enhanced due diligence, which includes legal, regulatory and reputational risk, should be completed on all key personnel and service providers. Any negative findings should be evaluated in the context of the party's ability to influence trading or access to the assets invested.

Custody of the assets

In real estate, the selling agent's mantra for success is location-location-location. When dealing with the protection of assets from pure fraud, it's custody – custody – custody. A reputable third party custodian audited by an independent accounting firm ensures that the assets you place in the manager's hands are subject to an independent set of controls.

Funds which have close relationships with their service providers (e.g., under common or significantly similar control) can be higher risk. Common addresses, ownership, signatories or controlling parties should be noted and researched. Questions should be asked regarding the relationship between financial services companies sharing the same address.

Suitability and legitimacy of service providers

Any accounting firm that you rely on should be registered with the Public Company Accounting Oversight Board ("PCAOB"). This ensures that the auditor is qualified and subject to regular review and inspection to confirm that it complies with accounting standards. Inspection reports available on the PCAOB website detail how many offices, partners and professional staff a firm has. This information can be used to form a general opinion of the adequacy of the accounting firm's resources.

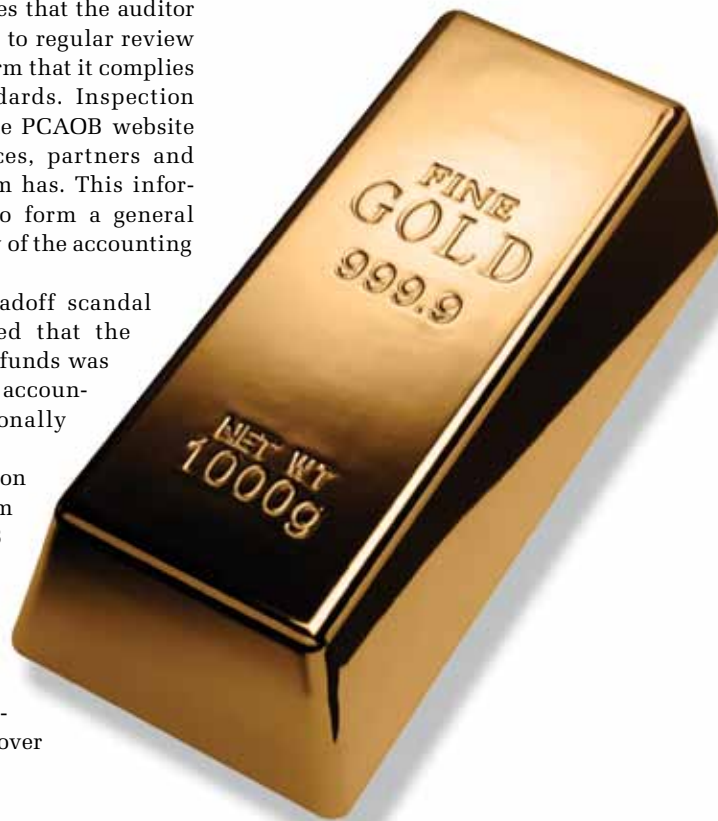
Shortly after the Madoff scandal broke, it was disclosed that the accounting firm for his funds was controlled by a single accountant who was occasionally seen in his small office.

While this information was gathered from review of PCAOB records, CPA registration, interviews and physical inspection of the CPA office, you can form some opinions from the comparison of inspections over

time. For example, on August 27, 2009, the Securities and Exchange Commission lodged a complaint against Michael Moore & Associates ("Moore") alleging that the firm issued false audit reports prepared by unqualified staff that failed to comply with PCAOB standards. The complaint alleged that Moore issued audit reports on 300 clients, most of which were shells or companies with limited operations trading on the pink sheets.

A review of the inspection reports available at www.pcaobus.org shows that Moore was inspected in 2005 and again in 2007. In 2005, the inspection report shows one office with a single partner covering 3 issuer clients. In 2007, the inspection shows one office with two partners and six professional staff covering 162 issuer clients. The exponential growth in clients in the absence of growth in offices and additional staffing should be considered a red flag. If further research identified the same lawyers and/or other service providers serving the same clients as Moore, additional investigation into those individuals should be conducted.

Third-party marketers or parties providing capital introduction services should be registered with a broker dealer. These individuals can be evaluated by reviewing U4/U5 data available from the brokercheck tool at FINRA. See www.finra.org.



Affiliated entities


Affiliation between the custodian and the money manager can be cause for concern.

Like Bernie Madoff, Paul Greenwood and Stephen Walsh controlled the broker dealer where their hedge funds were housed. Allegedly, Greenwood and Walsh, through Westridge Capital Management and WG Trading LLC bilked investors of approximately \$550 million between 1996 and early 2009 when a National Futures Association ("NFA") audit identified that \$794 million of the \$812 million identified as assets of the funds were personal promissory notes from the pair.

Service providers with clean records should also be investigated to determine if there are undisclosed associations to the entities that they service or to parties with close relationships to the entities that they service.

Quality and legitimacy of the investments

Hedge fund strategies are varied and complex. The AML function is not typically responsible for evaluating the legitimacy of an investment strategy and doing so may introduce inappropriate risk to the firm. Policies and procedures should exist for referring suspected investment funds to the appropriate credit and risk committee.

The AML function may review offering memorandum or prospectus in some situations. For example, when an account believed to be held by an investment fund has significant activity in low priced securities, the offering memorandum may identify if such investments are valid. Explicit inclusion or exclusion of such securities will allow the AML function to close or escalate an investigation. Additionally, the offering memorandum will disclose whether the shares are legally restricted and/or if there are limitations on sale or transfer. An assessment of the transferability of shares should be made by the group responsible for lifting restrictions on shares. The SEC has focused on identifying and litigating unregistered distributions over the past couple years. Careful evaluation of the circumstances of the sale is necessary to avoid charges of facilitating the sale of unregistered securities. 

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