Due Diligence Background Checks

How background check indicators correlate with frauds & blow-ups

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With the ever-expanding list of frauds and blow-ups dotting the financial landscape, (notably Madoff, Galleon Group, MF Global, and now Peregrine), it is important to expand due diligence procedures in a way that will protect assets from character-induced frauds and blow-ups. The following research provides statistical justification for the use of background checks in the due diligence process by illustrating how they are a critical factor in the elimination of questionable candidates under consideration for investment.

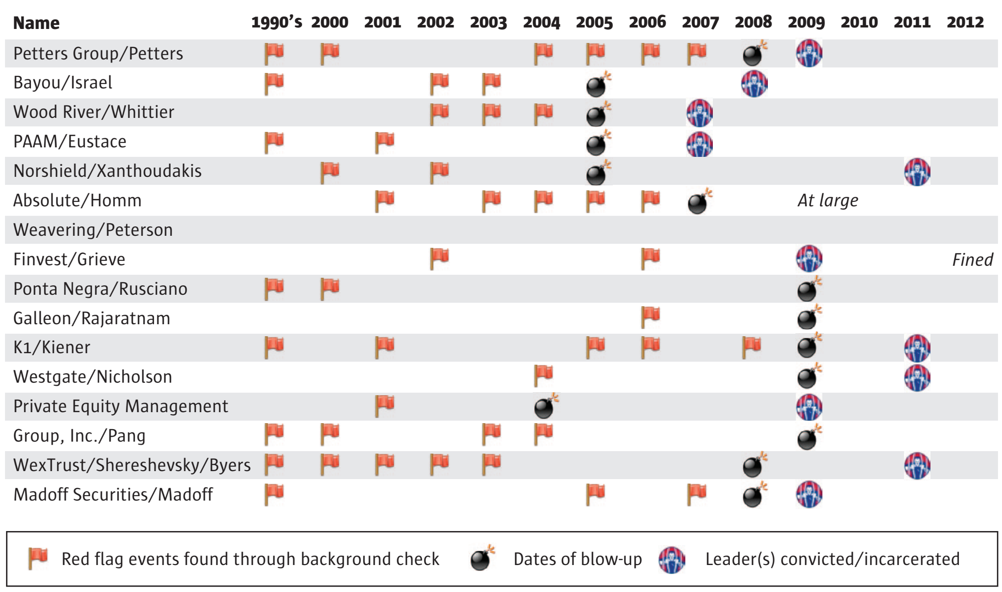
specifically, these checks can reveal red flags indicative of character flaws in management that can have substantial and devastating repercussions on the success of the fund and thereby, the investment.

Relying on a baseline consisting of well publicised frauds and blow-ups, this article will demonstrate how these blow-ups were a direct, or indirect, result of a discoverable character flaw on the part of management.

Finally, recent Check Fund Manager investigations on existing domestic private equity or hedge funds and their managers are examined to determine the incidence of red flags similar to those exhibited in the baseline of blow-ups, revealing a significant finding of 17%. This research demonstrates how investors can protect their own investments in alternative funds from future character-based blow-up risk.

Fig.1 Timeline of frauds and blow-ups

*Source: CheckFund*Manager.net/articles



Publicised frauds and blow-ups

The timeline graph (see Fig.1) lists 15 well publicised frauds and blow-ups. It also indicates the dates of red flag events that were found through a background check, dates of the blow-ups, and finally, when their leader(s) was/were convicted and incarcerated. This depiction provides a clear illustration of how red flags were present well before the fraud or blow-up was discovered.

Consider the case of WexTrust Capital LLC, a private equity fund co-founded by Steven Byers and Joseph Shereshevsky, which perpetrated a $255 million fraud by operating a Ponzi scheme. In 2011, Byers was sentenced to over 13 years in prison while Shereshevsky received a 21-year sentence. Background investigations on the two men revealed numerous red flags well before the blowup in 2008. Byers had several criminal misdemeanour charges, including a DUI and driving with a suspended license.

Shereshevsky pleaded guilty to felony bank fraud in 1994 and was named as early as 1993 in federal suits, in which he was charged with conspiracy to defraud a financial institution. Shereshevsky also had a myriad of criminal charges (including improper and reckless driving), a number of civil suits (most notably a $69,000 lien), an uncontested matrimonial abandonment case, and additional civil cases stemming from his failure to make child support payments. These red flags, some more than 15 years prior to his arrest, indicated serious character flaws that contributed to his massive fraud. Another example from the graph is that of James Nicholson, who ran the Ponzi scheme called Westgate Capital Management. Nicholson pleaded guilty in December 2009 to securities fraud, investment advisor fraud, and mail fraud.

A Check Fund Manager investigation revealed that in 2001, Nicholson had provided false and misleading documents to the NASD to such an extent that he was permanently barred from association with any NASD member in any capacity. In spite of this severe sanction, Nicholson created 11 hedge funds and lured in 400 unsuspecting investors before the FBI finally intervened.

Whether or not investments proceed, red flags need to be uncovered through the due diligence process so proper evaluation can occur prior to investment.

Interpreting red flags

Every investor is different and each type of investor will have a diverse threshold for what red flags may be tolerated. To illustrate, a report on the flamboyant lifestyle of a successful fund manager may be intolerable to a public pension fund, lest word get out and tarnish their reputation. However, the same report given to a single family office may be met with indifference so long as the returns continue to impress. Proper operational due diligence is performed as a logical process; facts or red flags uncovered by an investigative report will drive that process. A court case where the fund was named as a defendant may fuel a discussion involving corporate governance over the fund's legal structure. A contract dispute case found in the federal courts for the fund may at first glance appear to impugn the character of the manager, but upon further analysis may be found to be the result of the fund's participation in a structured debt obligation, (a very common investment leading up to the financial collapse in 2008 and 2009). Further discussion with the manager and examination of the fund's obligations might reveal that the fund's worst-case exposure was a few minor basis points and that their legal team's involvement was minimal.

On the individual side, a red flag indicating a serious criminal charge against a manager (even perhaps of assault or robbery) may have a plausible explanation. In one recent report where a robbery charge was uncovered, the manager provided authenticated documentation that cleared him of any wrongdoing to the satisfaction of the operational diligence manager.

Divorce on the other hand, while common, can present a quandary for the operational manager, especially if the dispute is ongoing. Things to consider in divorce cases are whether the spouse has an ownership interest in the management company and if the action can result in the dissolution of the company's structure and its assets. Even without these conditions, the financial and emotional drain may affect the professional performance of the manager in question.

Consideration should be taken as to whether the red flags uncovered in a report are a true representation of a character flaw or are merely indicative of the fund's strategy. The inclination may be to red flag a fund whose report contains dozens of class action and stockholder lawsuits against not only the fund, but also specific individuals on the management team. However, the same report may be viewed in a different light if the fund's strategy is to invest in distressed debt, and as a matter of course, replace the company's board of directors with their own, which typically invokes the ire of the minority shareholders. In fact, given this scenario, the lack of such cases would be cause for concern.

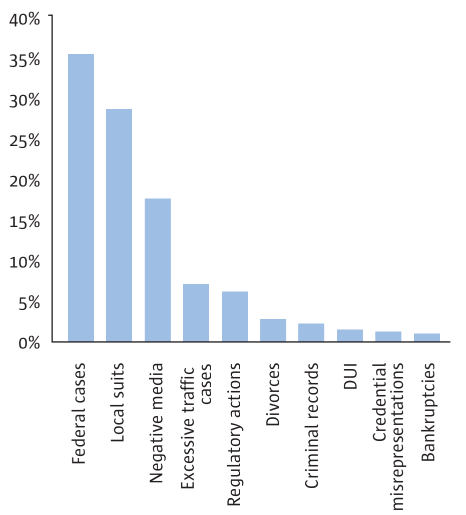
The challenge of performing proper due diligence does not end with the initial manager selection process; indeed it is just the beginning. The prudent investor throughout the term of their investment continues to perform due diligence research.

Examination of red flags in existing funds

Now that we have asserted the importance of red flags and how they should factor into the due diligence process, it is valuable to review a sampling of investigations on existing funds to see how often red flags similar to those found in the baseline blow-ups are present and what the implications are for the investment. This examination started with 5,978 Check Fund Manager investigative reports on alternative funds and their individual managers dated between 1 January, 2010 and 31 May, 2012. Reports that were produced on entities outside of the U A were removed from consideration. Also eliminated from consideration were duplicate reports where more recent reports were available from our sample on the same individual or company. What remained was a sample size of 3,902 reports.

*Source: CheckFund*Manager.net/articles

Fig.2 Breakdown of red flags



Of these 3,902 reports, 3,245 presented with no red flags or presented with minor exception indicators (classified as yellow flags). Examples of these minor yellow flags include being a plaintiff in a civil suit, being a creditor in a bankruptcy case, and small or insignificant liens or judgments. Reports were also eliminated that contained minor traffic violations, tax liens imposed by state or federal authorities which were satisfied, and half of the reports with only local civil suits, as those suits were considered to be minor or insignificant in nature. The remaining 657 reports represent 17% (or 16.8%) of funds that contain red flags similar to the example blow-ups (see Fig.1).

Of course it is not a foregone conclusion that the 17% of examined funds will terminate with a blow-up. Indeed few will reach that unfortunate demise. However, by eliminating from consideration these 17% of funds under evaluation, investors can protect their assets from a risk factor with a very clear historical correlation to failure.

Conclusion

Whether or not due diligence is conducted internally or by a contracted provider, the telling question to ask is, "How many of your funds under consideration have been rejected because they failed your due diligence process?" Also, "How many of your funds under consideration have been rejected because they presented unexplained red flags within the background investigation?" Based upon our analysis presented here, the answer to question #2 over time should be 17%.

Red flags can be indications of character flaws that speak to the true nature of an individual's judgment, ethics, and trustworthiness. This type of insight is critical in determining the best home for an investment. With further research, some red flags may prove to be of little consequence to an investor, or they may be found to indicate an even larger concern. Our findings have shown that background checks that expose these red flags are an imperative step in the due diligence process, as an investor cannot be expected to make an informed decision without all the evidence. **THFJ**

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ABOUT THE AUTHOR

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Guy Simonian is Founder and CEO of Check Fund Manager LLC. He is a member the Association of Certified Fraud Examiners, the American College of Forensic Examiners, the US Association of Professional Investigators, and the World Association of Detectives. He holds degrees from Tufts University and Rensselaer.