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Hedge Funds: A Primer on Money Laundering Vulnerabilities

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Executive Summary

The regulatory climate for U.S.-based investment advisers is poised to undergo significant change in the coming years. The Financial Crimes Enforcement Network (FinCEN) in August 2015 proposed to define investment advisers as "financial institutions" and require them to establish anti-money laundering (AML) programs. In addition, regulators have begun to turn their attention to securities firms with respect to AML efforts.

Despite money launderers utilizing more sophisticated schemes involving securities, they seem to go largely unidentified. Hedge fund launches since 2001 have more than tripled, and investments from risky high-net-worth individuals have surpassed those of institutional investors. Yet, since 2012, only 156 suspicious activity reports on hedge funds have been filed and the number of criminal cases remains low.

The fund's business model, service providers, and clients present vulnerabilities. The surging hedge fund market and evolution of investors emphasize the importance of understanding these vulnerabilities to money laundering (ML) and being vigilant in monitoring for suspicious activity.

The alignment of the investment objectives of the fund manager and money launderer—to preserve wealth—makes hedge funds particularly attractive. Hedge funds typically are offered through private placements, adding a layer of opacity that could increase ML risk. A common vulnerability across funds and service providers is that of complicity—funds or service provider personnel can allow and/or facilitate ML through their respective entities.

Service providers may mitigate risk to the fund if they identify suspicious clients and/or activity and increase risk if they fail to do so. Broker-dealers' reliance on other institutions to identify and vet clients, and close relationships between wealth managers and their clients create vulnerabilities for possible illegal activity.

Investment advisers will need to understand business-specific ML risks and be able to identify red flags signaling possible suspicious activity. Fund managers should conduct thorough AML risk assessments, develop robust know your customer programs, and employ a two-pronged approach to investigations—targeted and holistic. Targeted investigations can identify anomalies at the client- or account-level, highlighting red flags, while holistic investigations allow for the identification of systemic issues and key ML risks across clients and products.

Scope Note

Broadly, alternative investments are defined as assets that do not fall within traditional asset classes—stocks, bonds and cash. For this report, alternative investments are those that use fund structures and are only accessible to high-net-worth individuals and institutional investors. Specifically, the analysis and assessments contained in this report involve only hedge funds—those funds at all levels of assets under management that display the following characteristics:

- Absolute return investment objective
- Ability to take long and/or short positions
- Access to the widest possible range of financial instruments
- Performance-based fees

Shifting Regulatory Climate…

The regulatory climate for U.S.-based investment advisers is poised to undergo significant change in the coming years. The U.S. Financial Crimes Enforcement Network (FinCEN) in August 2015 proposed a rule that, if finalized, would require certain investment advisers, including advisers to certain hedge funds, to establish anti-money laundering (AML) programs and report suspicious activity pursuant to the Bank Secrecy Act (BSA). Furthermore, FinCEN also proposed to include investment advisers in the general definition of "financial institution," which would require additional reporting, record keeping and information sharing.

The proposed rule would apply to large advisers—those with more than $100 million in assets under management (AUM). Mid-sized ($25 million to $100 million in AUM) and small advisers (< $25 million in AUM) also would be subject to the rule if they are located in states that do not regulate or examine mid-sized or small advisers.

…Has Hefty Implications for Hedge Fund Managers

According to Jennifer Shasky-Calvery, former FinCEN director, "Investment advisers are on the front lines of a multitrillion dollar sector of our financial system. If a client is trying to move or stash dirty money, we need investment advisors to be vigilant in protecting the integrity of their sector."[1]

Shasky Calvery's statement suggests that FinCEN considers investment advisers to be a key segment of the U.S. financial system with respect to AML efforts, and, as such, well-positioned to monitor and report suspicious activity. FinCEN, keen to bring investment advisers under AML regulations for some time, proposed AML rules in 2002 for unregistered investment companies and in 2003 for certain investment advisers, although they were later withdrawn. At a time when suspicious activity report (SAR) filings on hedge funds are low but increasing and regulators are turning their attention to securities firms, many in the industry expect FinCEN will finalize the current proposed rule.

To fulfill the AML program requirement, investment advisers would need to include, at a minimum, the following four pillars:

- Designation of an AML compliance officer

[1] FinCEN, *FinCEN Proposes AML Regulations for Investment Advisers,* 2015

- Development of internal policies, procedures, and controls
- Ongoing training program
- Independent audit program

In addition, if included in the definition of "financial institution," investment advisers will be required to:

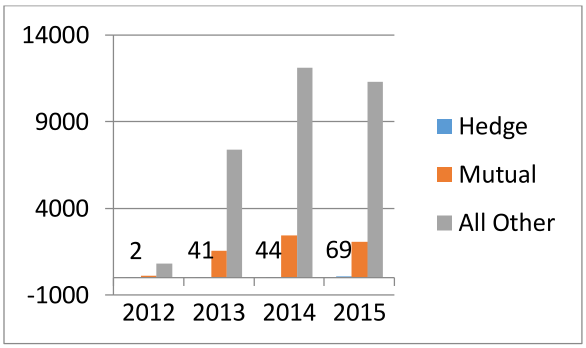
- File currency transaction reports
- Comply with record keeping and travel rules
- Participate in information sharing programs pursuant to Sections 314(a) and 314(b) of the USA PATRIOT Act

ITG's July 2015 survey of leading U.S. hedge fund chief financial officers (CFOs) indicates 47 percent of CFOs cite keeping up with regulatory and rule shifts as their most pressing issue. Likewise, alternative investment consultants also perceive regulation to be a key concern for 2015. According to alternative assets data provider Preqin, 68 percent of these consultants believe regulation is one of the most important issues in the hedge fund market for 2015—a jump from 49 percent for 2014. While much of their concern is likely due to the EU's Alternative Investment Fund Managers Directive, probable strengthening of AML regulations also is likely to be part of the equation.

Implementing and supporting an AML program will require investment advisers to understand business-specific money laundering risks and red flags indicating possible suspicious activity. This can be accomplished by conducting thorough AML risk assessments and increasing the number and scope of investigations, thereby developing empirical evidence of, and red flags associated with, possible money laundering through the use of securities and hedge funds. As far back as October 2001, the Government Accountability Office noted that while money launderers utilized more sophisticated schemes and looked for as many avenues as possible to launder money, law enforcement and securities officials acknowledged that cases involving money laundering through securities remained low. Officials specifically emphasized a primary factor limiting the number of cases was the absence of a requirement to file SARs. More recently, the Central Bank of Ireland in its 2015 review of funds' compliance with AML/counter-terrorist financing (CTF) regulations found risk assessments across funds to be inadequate. The Central Bank also determined that the risk assessments were not used to inform the fund's risk appetite or its updates to policies and procedures.

Current U.S. SAR statistics indicate this reporting problem persists, in particular with respect to hedge funds. Figure 1 demonstrates that since 2012, only 156 SARs on hedge funds have been filed across the U.S., with the highest number filed in any one year at just 69 in 2015, according to FinCEN's SAR stats. In contrast, since 2012, institutions filed 6,171 SARs on mutual funds and 31,645 SARs on all other types of securities.[2]

Figure 1: Number of SARs Filed - Securities



Source: FinCEN SAR Stats Online

Ireland's Central Bank also found inadequate practices with respect to SARs, citing a lack of internal policies and procedures for investigating and reporting suspicious activity and a reliance on the policies and procedures of service providers (SP).

[2] FinCEN defines "all other securities" as bonds/notes, commercial mortgages, commercial paper, futures/options on futures, options on securities, penny stocks/microcap securities, security futures products, stocks, and swap, hybrid, or other derivatives.

Hedge Funds: The Business Model

Broadly, a hedge fund is a pooled investment vehicle actively managed to achieve absolute returns. The term "hedge" refers to attempting to lower overall risk by taking asset positions to offset a specific source of risk. Hedge fund investors mainly include high-net-worth individuals and institutional investors. This primarily is as a result of the significant capital required to invest in a fund. Hedge fund managers usually invest their personal assets in their fund, which aligns their interests and management of the fund with those of the other investors.

The Alternative Investment Management Association defines the following categories of investment strategies hedge funds may employ:

- Relative Value: Profiting from a perceived mispricing between financial instruments
- Event-Driven: Capturing price movements associated with a corporate event (merger, bankruptcy, etc.)
- Opportunistic:
    - Long-Short Equity: Securities selection - offsetting long and short positions to decrease exposure to market risk

- Global Macro: Actively allocating capital over a variety of strategies and asset classes across different countries and markets

Hedge fund managers are paid “2 and 20” fees—management fees of about 2 percent of invested capital per annum and performance fees of about 20 percent of net profits generated during the fund’s lifecycle. Performance fees serve to incentivize managers to avoid losses and seek high returns. These fees can be contingent upon the “hurdle rate,” which is a preferred rate of return that typically is the risk-free rate. More often, performance fees are subject to a “high-water mark,” or a specific threshold defined to ensure a fund manager earns fees only on new profits, not profits that merely recover previous losses.

Absolute Returns a Primary Draw

A primary characteristic distinguishing hedge funds from other investment vehicles is the fund manager’s absolute return investment objective, or the attempt to avoid losses. The fund manager accomplishes his objective by managing overall risk, first by differentiating between rewarded risk (those assets that are likely to generate a return [upside risk]), and excess risk (those risks that will not generate a return [downside risk]). These downside risks include exogenous or endogenous market shocks, changes in liquidity, etc. The manager then invests in assets with “upside risk” and other assets to hedge against “downside risks.”

In contrast, the relative return investment objective employed by most mutual and index funds is to meet or beat a benchmark return. This approach manages only the risk of underperforming the benchmark, neglecting any “downside risk.”

The difference between these investment objectives has an important implication for the fund’s money laundering risk. It is widely understood that securities are primarily vulnerable to money laundering during the layering and integration stages of the money laundering cycle. Assuming a money launderer is rational, the absolute return investment objective provides him with a layer of asset protection during these stages, making funds more attractive for investment of illicit proceeds and increasing money laundering risk.

Primary Service Providers

Hedge funds typically use outside service providers (SPs)—broker-dealers, wealth managers, and depository institutions—for a suite of services that facilitate the fund’s investment activities, including trade execution and funds transfer.

SPs are particularly important because they can increase or decrease the money laundering risk to the fund. At times, they are best positioned to identify suspicious activity or unsatisfactory clients, thereby mitigating money laundering risk. However, they may also introduce additional money laundering risk if they do not successfully identify these issues, thereby attracting or executing possibly illegal business.

Legal, Tax Considerations Conflict with Money Laundering Risks

The needs of hedge funds and the needs of regulators are fundamentally conflicted primarily because hedge funds require secrecy to protect their investment strategies while regulators require robust disclosure. However, rather than a lack of regulation, hedge fund managers take advantage of exemptions to regulations when structuring funds.

Typically, hedge funds are structured as limited liability companies or limited partnerships specifically to limit taxation—only the fund's investors, not the fund itself, pay taxes on their investment returns. Often hedge funds are domiciled in offshore tax-shelter countries, some of which also are considered secrecy havens, to minimize taxes for non-U.S. investors. The top five non-U.S. countries for hedge funds are the Cayman Islands, Luxembourg, Ireland, the British Virgin Islands (BVI) and Bermuda. The Tax Justice Network considers Bermuda and BVI

Cayman Islands—Secrecy Haven a Leading Domicile for Hedge Funds

The Cayman Islands is the world's sixth largest banking center and accounts for about 5 percent of the global market for offshore financial services. While Cayman has improved from its 2013 ranking, it remains at number five on the 2015 Financial Secrecy Index. Despite entering into agreements primarily to share tax information, Cayman continues to lobby against the U.K. government on openly identifying beneficial ownership.

This lack of action on beneficial ownership for its more than 95,000 registered companies makes its poor secrecy index score no surprise. Cayman was rated noncompliant on eight out of the index's 15 key financial secrecy indicators (KFSI), the most important of which with respect to money laundering involve lack of information on company ownership and the availability of harmful legal vehicles.

- KFSIs 3, 4: Does not maintain company ownership in official records or call for public access
- KFSI 10: Allows cell companies, trusts with flee clauses

Other indicators show Cayman only partly complies with the Financial Action Task Force's Recommendations and partly cooperates with other states on money laundering issues.

to be tax havens, Luxembourg to be a secrecy haven, and Cayman is considered to be both. Simultaneously, several of these top locations also are rated medium risk for money laundering, specifically.

Hedge funds also typically seek exemption from the registration and disclosure requirements of the Securities Act of 1933. Exemption can be granted if the hedge fund agrees to private placement, which restricts public solicitation of investors and encourages the fund to limit offerings to only wealthy investors. Private placements add a layer of opacity that could increase money laundering risk.

The risks related to legal and tax considerations need not imply a significant restructuring of the business model, rather they suggest a need for vigilance with respect to clients and activities.

Staggering Growth of Funds…

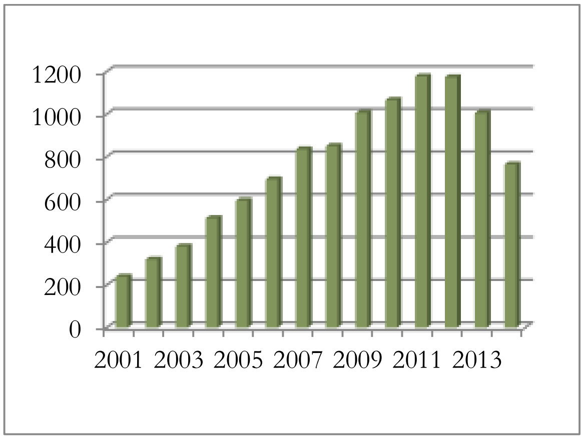
The USA PATRIOT Act of 2001 was the most recent major inflection point in U.S. AML legislation, tightening regulations and increasing reporting requirements for financial institutions. Preqin data indicates, since 2001, the number of hedge funds launched per year has increased at an astounding rate—Figure 2 shows the number of funds launched in 2014 (764) was more than triple the number launched in 2001 (239), even though 2014 saw a dip in launches from 2011/2012 levels. AUM by the end of 2014 totaled $3.019 trillion, $355 billion, or about 12 percent of which, was added in 2014 alone.

…And Capital from Private Wealth

As the market has grown over the past decade, sources of capital have also evolved. Inflows from institutional investors continued to increase in 2014, but inflows from private wealth sources, including high-net-worth individuals, surpassed that of institutional investors in 2014. According to Preqin, high-net-worth individuals, wealth managers, and family offices primarily account for this uptick in inflows. As shown in Figure 3, Preqin data shows that 59 percent of fund managers reported an increase in capital in 2014 from high-net-worth individuals and 58 percent reported an increase from wealth managers and family offices. In contrast, 44 percent of fund managers reported an increase in capital from institutional investors.

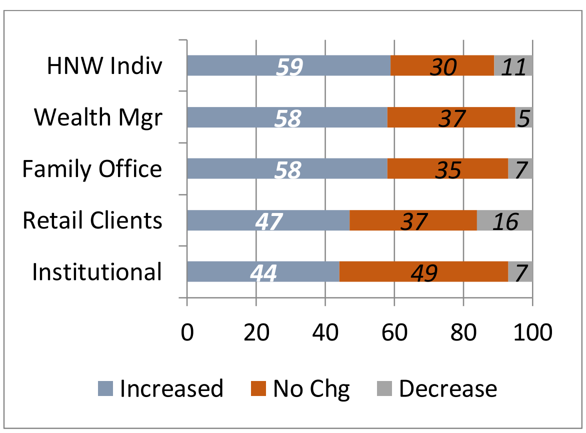
Given the money laundering risks associated with these private wealth sources, this evolution of inflows suggests an increase in the overall riskiness of those funds in which they invest. Therefore, efforts to know your customer (KYC) and monitor for suspicious activity will be key components for fund managers to mitigate money laundering risk and, more broadly, overall risk.

Figure 2. Hedge Fund Launches per Year



Source: Preqin

Figure 3: Percentage of Managers Noting a Change in Capital



Source: Preqin

Vulnerabilities to Money Laundering

In a report to Congress submitted in December 2002, U.S. financial authorities stated that hedge funds were the most susceptible of unregistered investment companies to money laundering because of their structure and the liquidity of investments. These vulnerabilities remain today; however, the evolution of the market and money laundering trends create additional concerns. One of the more explicit vulnerabilities commonly found across funds and SPs is that of complicity—complicit funds or SP personnel can turn a blind eye and/or directly facilitate money laundering through their respective entities.

Business, Regulatory Structure:

Table 1 details the vulnerabilities associated with the business and regulatory structure of funds. Arguably, the alignment of the investment objectives of the fund manager and the needs of the money launderer make funds particularly attractive.

Illicit actors, for example drug traffickers, spend and lose significant amounts of their illicit proceeds on the costs of doing business—production, transport, seizures, etc. Once these costs have been incurred, assuming the drug trafficker/money launderer is rational, he will seek those opportunities to “integrate” the proceeds that offer the lowest risk to the initial capital invested and, therefore, his wealth. The primary goal of hedge fund managers is to do exactly that, preserve wealth by avoiding losses. Therefore, the investment objectives of the fund manager and the money launderer—like any legitimate investor—are fundamentally the same. As an added benefit, the fund also provides the opportunity for the drug trafficker to earn a return on the “protected” wealth. In fact, Preqin data shows that 25 percent of hedge funds had net returns of 10 percent or more in 2014, with returns of top-performing funds at 50 percent to as high as 225 percent. When redeemed, the illicit proceeds initially invested in the fund appear to be from a legitimate source.

Service Providers:

Broker-dealers, wealth managers, and depository institutions introduce additional vulnerabilities and exposure to money laundering, increasing money laundering risk to a fund. The Central Bank of Ireland in its 2015 AML/CFT review, found a number of deficiencies with respect to SPs:

- Lack of review by funds of SPs’ AML/CFT policies and procedures
- Lack of regular monitoring by funds of SP’s functions through assurance testing
- Lack of information provided by SPs to funds
- No evidence of AML/CTF training for SPs’ staff

A broker-dealer’s reliance on another institution’s AML process to identify a client creates a key vulnerability. Broker-dealers are often best positioned to identify money laundering risks associated with a client, but they might assume a particular client’s relationship with another institution and its KYC process must mean that the client must have satisfied that institution’s AML requirements and, therefore, does not pose a risk. Any reliance by a broker-dealer or a fund itself upon a third party for AML purposes can amplify this vulnerability because it may be difficult to know that the third party’s program operates at an appropriate standard.

Wealth managers are primarily vulnerable because of their close personal relationships with clients. Table 2 lists other vulnerabilities associated with wealth managers that involve the types of products and services offered and the types of clients.

Some depository institutions provide services to high-net-worth individuals similar to that of a broker-dealer and/or wealth manager, thereby presenting many of the same

Table 1. Vulnerabilities Associated with Business/Regulatory Structure of Hedge Funds

Alignment of Investment Objectives	The hedge fund manager's primary investment objective, to preserve investors' capital, is fundamentally aligned with a primary objective of an illicit actor.
High Investment Requirements	The high initial investment required, historically $1 million, makes it easy to use a single vehicle to integrate large sums of illicit proceeds.
Relatively Short Lockup Period	The lock-up period—the period during which the investor is unable to redeem his funds—is shorter than other types of investments, increasing relative liquidity.
Role of Tax, Secrecy Havens	Tax and/or secrecy havens play an integral role is the hedge fund business. Limited or no record keeping requirements in these jurisdictions make it possible to obscure ultimate beneficial ownership and source of wealth.
Limited or No AML Regulation	While some hedge funds managers voluntarily have implemented AML programs, the market is largely unregulated for AML, limiting scrutiny of and regulatory reporting on suspicious actors and/or activity.

vulnerabilities. Depository institutions also present additional vulnerabilities associated with the placement of possible illicit proceeds into the financial system, which can then be transferred into or through funds.

Client Types

Certain clients of hedge funds, including trusts and shell companies, are particularly vulnerable to money laundering abuse. Many hedge funds are domiciled in jurisdictions that require limited to no beneficial ownership information for trusts and shell companies. Even if this type of information is collected, it may not be accessible. This means that ultimate beneficial owners may not be easily identified.

Spotting Suspicious Activity: Know Your Clients, Risks and Red Flags

A significant portion of money laundering risk to a fund is introduced when a risky or unacceptable client is allowed to invest. Therefore, the fund should have a thorough understanding of the client and his source of wealth and expected activity. The fund also should implement an ongoing process to update client information periodically throughout the duration of the relationship.

As stated earlier, the low number of SARs filed and few law enforcement cases suggest to regulators that a deep understanding of money laundering through securities—particularly hedge funds—is somewhat limited

Table 2. Vulnerabilities Associated with Wealth Managers

Wealthy Clients	Wealthy individuals and politically exposed persons (PEP) may be unwilling to provide information and/or documentation about themselves, their wealth, activities, etc.
Close Relationships	Wealth managers may maintain close relationships with clients and, thus, they may accept inadequate information and documentation to verify clients.
Complex, Concentration Accounts	Maintenance of many accounts in different jurisdictions for a single client and the movement of funds through concentration accounts make it difficult to trace activity.
Role of Secrecy Havens, Obscuring Entities	Access to a wide variety of products and services across jurisdictions, including secrecy havens, that may involve the use of trusts and shell companies make it difficult to identify ultimate beneficial owners.

industry-wide. In February 2015, Andrew Ceresney, director of the SEC's Enforcement Division, said, "the number of firms that filed zero SARs or one SAR per year was disturbingly large" and "I find it hard to believe the industry as a whole is fulfilling its obligations."[3]

The identification of suspicious activity and, therefore, SAR filings will be a function of identifying business-specific risks and red flags through performing risk assessments, implementing a robust KYC program, and taking a two-pronged approach to investigations—targeted and holistic. Targeted investigations can identify anomalies in the client's legal structure, subscription/ /distribution/redemption and trading patterns, KYC, etc., resulting in the identification of red flags.

Holistic investigations allow for the identification of systemic issues and key risks across funds and clients. They can be based on the following components of the fund's business model:

- Jurisdictions
- Intermediaries
- Clients

Concluding Remarks

Hedge funds are susceptible to money laundering primarily from two sources: vulnerabilities associated with the fund's business model and vulnerabilities associated with SPs and clients. Regulators are aware of

[3] SEC, *Remarks at SIFMA's 2015 Anti-Money Laundering & Financial Crimes Conference*, 2015

these vulnerabilities and have begun to turn their attention to securities firms.

Hefty civil money penalties imposed upon Oppenheimer & Co., Inc., by several U.S. financial authorities demonstrate this increased attention. U.S. authorities cited myriad deficiencies within Oppenheimer's AML program, including the failure to identify and report suspicious activity, failure to conduct adequate due diligence on a foreign correspondent account, and failure to maintain records of beneficial ownership. Shasky Calvery in FinCEN's press release on Oppenheimer stated, "broker-dealers face the same money laundering risks as other types of financial institutions," and "their compliance culture must change."[4] Her statement suggests a general regulatory appetite to more closely scrutinize the AML compliance efforts of securities firms and intermediaries.

In fund parlance, successfully hedging AML risk will require funds to be proactive in developing AML programs that are informed by their specific money laundering risks and adequately identify and report suspicious activity.

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[4] FinCEN, *FinCEN Fines Oppenheimer & Co. Inc. $20 Million for Continued Anti–Money Laundering Shortfalls*, 2015

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