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RAPID RESPONSE BRIEF

THE POTENTIAL VULNERABILITY OF ALTERNATIVE INVESTMENTS IN HIDING ASSETS: PRIVATE EQUITY

As with hedge funds, private equity firms offer a legitimate means of investment in a range of markets. Overall, the nature of private equity will often entail the implementation of robust and stringent controls. However, in certain instances, potential loopholes in anti-money laundering (AML)/counter-terrorist financing (CTF) requirements mean that certain alternative investment firms do not always know the origin of the money they take in. This paper sets out some potential risks that compliance professionals should be aware of.

How does this relate to the Ukraine crisis?

- The onset of the Ukraine crisis has seen multiple national governments and multilateral institutions announce prohibitive and prescriptive measures taken against the Russian Government and its arms of state. These measures have focused on sanctions, illicit finance, and enablers.

- Much of the focus has been on financial institutions implementing a broad ranging set of trade and financial restrictions, plus sanctions placed on individual entities and individuals. One aspect of this effort is on the assets held by the group (popularly known as oligarchs) with close links to Vladimir Putin and the Kremlin. Oligarchs are known to have significant physical (property, transport, football clubs etc.) and non-physical assets (equities, bonds, private debt etc.) held in Western financial institutions.

- Several high profile and, in certain cases, sanctioned Russian actors are known to have invested significant capital in private equity funds, have a stake in private equity businesses, or are linked to investment vehicles with stakes in certain funds.

Definition

A private equity fund is a type of private fund that is managed by a private equity firm, which may be required to register with the SEC as an investment adviser. Private equity funds pursue a variety of investment strategies, for example buyout, growth equity, and venture capital.[1]

Context

1. Private equity funds tend only to be open to accredited investors – typically high net wealth individuals (HNWI) or institutions (such as pension funds, family offices, and foundations) with the ability to make a significant minimum investment. These investments are typically made in non-listed (i.e. private) companies. Equity capital in portfolio companies takes the form of capital appreciation generated during a holding period. Once all investments are exited, the fund closes.

2. As more countries impose punishing sanctions on Russia for the war in Ukraine, alternative investment vehicles and retail and wholesale institutions are examining their exposure to Russia. Many private equity funds are exposed to Russian money via their partners or limited partners (LPs) – the individuals and companies who provide the money for funds. However, it can often be difficult to determine the source of LP funds.

3. Exposure to Russian investors not included on sanctions lists is permissible, although firms should be aware of third-party, nominee, and reputational risk. Bank transfers could be difficult, with some Russian banks blocked from the SWIFT banking system. In most cases, Russian LPs were family offices investing the wealth of a family or individual and oversight of source of wealth is limited.

What is known about the sector?

4. Private equity funds present some of the same money laundering and asset dispersal risks presented by hedge funds, and some different ones. At least in part, this is because their activities are less likely to touch regulated/monitored markets than hedge funds, and are often through offshore jurisdictions and shell companies, making them consequently less transparent.

[1] SEC definition, https://www.sec.gov/education/glossary/jargon-z

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5. Like hedge funds, small private equity firms are relatively easy to establish and may pose a greater money laundering risk than larger firms because they are not always subject to the same reporting requirements in the United States and United Kingdom. Some firms are not obliged to disclose the identities of their main investors (or even undertake know your customer (KYC) checks) or information about their investment portfolios; theoretically making them an attractive proposition for those seeking to hide the money trail.

6. Investors, including oligarchs, could choose to make substantial investments in a business (or portfolio of businesses) via a private equity firm and then use the resulting dividends as a "legitimate" form of income. The long-term nature of these investments is unlikely to be a deterrent to HNWI investors.

7. In 2015, FinCEN drew up (still to be implemented) draft rules to bring investment advisors under the scope of the Bank Secrecy Act. In 2020, the House of Representatives introduced the "ENABLERS Act" bringing alternative investments under its scope, although it has yet to be driven forward.

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Practical Steps for Compliance

- Private equity and venture capital funds should maintain close attention to sanctions lists and broader sanctions activity such as access to interbank payment systems. Any hits on sanctioned entities or individuals must be acted on immediately.

- Compliance departments should ensure that full KYC checks are carried out on limited partners prior to accepting any investment. This should include, where possible, due diligence on source of funds and source of wealth. Given investors' links to high-risk jurisdictions, perpetual customer due diligence should be carried out on certain investment vehicles such as family offices and offshore shell companies.

- Source of capital analysis can be obscured by certain limited partnerships, including ultimate beneficial owners and where those investors reside. Given current sanctions, funds should take a holistic look at how they might connect with Russia including reviewing their LP investors and assessing portfolio companies' touch points with Russia.

- Given counterparty risk presented by the sanctioning of major Russian banks, funds should ensure that they are not exposed to unlawful assets from outside service providers such as investment banks or investment fund managers. Such outside service providers should also conduct research into the source of client funds.

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