

RAPID RESPONSE BRIEF

THE POTENTIAL VULNERABILITY OF ALTERNATIVE INVESTMENTS IN HIDING ASSETS: HEDGE FUNDS

Hedge funds and other alternative investments provide an entirely legitimate form of investment. This paper sets out a number of potential risks which compliance professionals should take account of.

How does this relate to the Ukraine Crisis?

- The onset of the Ukraine crisis has seen 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. Finance has been identified as both an offensive and defensive weapon to be deployed by both sides.
- Much of the focus has been on financial institutions implementing trade and financial sanctions, and cutting Russia off from the financial sector. 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.

Context

1. Recent reporting has shone a light on an often little understood part of the global financial system – the role of alternative investments (including hedge funds, private equity, and family offices) in managing the funds of some of the world’s wealthiest investors. Revelations relating to the securitization of superyachts and other assets highlight some investment institutions’ customer base of politically exposed persons (PEPs), high net wealth individuals (HNWI), and the ensuing risk of legitimate and illegitimate funds intermingling.

2. By their very nature, hedge funds have a high barrier to entry and, depending on their jurisdiction, are sometimes lightly regulated. In short, they appeal to those seeking to put their money in medium to long-term investments outside of markets subject to more public and private scrutiny.
3. On February 26, 2022, the United States, European Commission, United Kingdom, France, Germany, Italy and Canada issued a joint statement issuing their support for Ukrainian sovereignty and outlining a series of strategic measures to be taken against Russia. One of these commitments was to establish a transatlantic task force charged with identifying and seizing the assets of sanctioned individuals and legal entities, and their networks.
4. On March 2, 2022, German authorities seized Alisher Usmanov's US\$600 million mega yacht in Hamburg as part of their sanctions enforcement against the commodities billionaire. As of the same date, the British Government is reportedly considering options for seizing property owned by oligarchs in the UK without providing compensation.

Definition¹

5. Hedge funds pool money from investors and invest in securities or other investments to get positive returns. Generally, they have more leeway than mutual funds to pursue investments and strategies that may increase the risk of investment losses. Hedge funds are limited to wealthier investors who can afford the higher fees and risks of hedge fund investing and institutional investors, including pension funds. Hedge funds typically limit opportunities to redeem or cash in your shares to four times a year or less and often impose a "lock-up" period of one year or more during which you cannot cash in your shares.

What is known about the sector?

6. International regulation of hedge funds is inconsistent and generally more light touch than other financial institutions. This lighter touch environment is almost certainly exploited by individuals seeking to avoid the burden of money laundering provisions that are applied to other financial institutions. For example, some small firms do not have to disclose the identities of their prominent investors or information about their investment portfolios. About US\$11 trillion in assets are subject to lighter touch AML regulation².
7. In the United States, hedge funds are not currently subject to the Bank Secrecy Act (BSA) although, in 2015, the Financial Crimes Enforcement Network (FinCEN) drew up, still to be implemented, draft rules that will bring investment advisors into the scope of the BSA, and include KYC and CDD duties within AML requirements. In the UK (the second biggest market for hedge funds), funds are subject to the Money Laundering Regulations, although this focuses on the fund manager rather than the fund itself.
8. Limited evidence of dirty money passing through hedge funds currently exists, but the opaque nature of these funds (and some of the assets they invest in) heightens the theoretical risk of dirty money entering the financial system, particularly in comparison with traditional asset managers. It is unlikely that "lock-up" periods deter HNWI's from placing investments into management.
9. Hedge funds could potentially feature in both the placement and layering stages of the laundering process. For example, criminals could use them as a place to invest illicit funds from their bank accounts (placement). What the hedge fund then does with this investment, e.g. trading in the capital markets, presents further opportunities to disguise the source of funds (layering).

1. Hedge Funds | Investor.gov

2. Massive and Opaque U.S. Private Investment Industry Presents Major National Security and Corruption Threats « Global Financial Integrity (gfindegrity.org)



10. Whilst a large proportion of hedge funds have strong compliance arrangements, there are scenarios where such operations may make them vulnerable to involvement in forms of market abuse, including insider trading/dealing and market manipulation. At least some of the funds linked to this activity have been laundered through a blend of conventional and non-conventional typologies.
11. A small number of international case studies³ have highlighted the separate risk that some hedge funds (or at least key individuals within the firms which manage them) may be wholly complicit in laundering activity, while others may be established by criminals expressly for that purpose. For example, a Mexican drug cartel is suspected of having invested its profits in a hedge fund, and another fund in the UK proposed investing in private placement funds, and using shell corporations to purchase and sell prohibited items from sanctioned jurisdictions.
12. Various high-profile Russian politically exposed persons (PEPs) are known to have invested billions of dollars in Western hedge funds. Much of this wealth will be funnelled through hedge funds based in major financial centers (but often registered in tax havens), although some of them may prefer to target funds in jurisdictions with lower levels of regulation. Moreover, some of them can likely circumvent an unwitting firm's compliance framework by hiding the origins of their funds and/or disguising ultimate beneficial ownership.
13. Hedge funds typically use outside service providers, including investment banks, wealth managers, administrators and depository institutions, for a range of services that facilitate the fund's activities, such as trade execution and transferring funds. This can lead counterparties to funds exposed to money laundering risk in some cases.

Practical Steps for Compliance

- Perform (or refresh) enhanced due diligence on PEPs with accounts in your own institution, and where possible, seek records from fund managers about the underlying investor and what vetting was performed.
- When taking custody of assets ensure that 'know your customer' (KYC) procedures and client risk ratings are tuned to identify the underlying source of funds.
- Some funds cater to HNWI from high-risk jurisdictions - take steps to manage this risk including setting a risk appetite around dealing with shell corporations.
- Be aware of counterparty risk, including money laundering risks relating to ultimate beneficial ownership and source of wealth.
- Ensure transaction monitoring systems are set to pick up client identity and transaction data.

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March 4, 2022

³. BlueLeaks: FBI Aware Large Investment Funds Enable Money Laundering (occrp.org)

About ACAMS

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