TEN CASE STUDIES OF HEDGE FUND FRAUD AND THE REPUTATIONAL DAMAGE THEY CAUSE TO PENSION FUND MANAGERS
INTRODUCTION

Investing in hedge funds has become more common for pension funds as they seek higher returns in the current low interest rate environment. But while hedge funds promise higher overall returns, their opacity creates concerns for pension fund managers who need to fulfill their fiduciary duty to investors and who fear reputational damage.

The reason pension funds are reluctant to invest in hedge funds – especially funds with less than $10B AUM – often has little to do with the financial risk. The SIPC, FBI, and other government agencies estimate the annual cost of securities fraud in the U.S. to be between $10–40 billion. Of the $23 trillion invested in U.S. mutual funds, hedge funds and private equity funds account for between 4–17 basis points. The risk therefore turns out to be around 10% of the management fee that investors would pay fund managers to look after their assets.
Because the reputational damages of fraud are difficult to quantify, they are often underestimated or ignored. Even if the pension fund manager suffers no financial damage, simply being associated with mismanaged or fraudulent hedge funds can result in profound reputational damage. Reputational damage can have severe consequences, including regulatory backlash against the fund manager and the loss of investor trust. In the most serious cases, investment professional’s careers have been ruined. Until ComplianceGuard entered the market, there were no financial tools to protect pension fund managers from reputational damage.

To understand the problem more deeply, consider the following ten case studies of fraud. Each of these resulted in serious reputational damage to pension fund managers and other institutional investors who invested in the fund – even when the actual financial losses were relatively small. In many of these cases, the reputational damage to the institution and the individual manager can only be conjectured. Still, the damage will be crystal clear for anyone who has held a role that carried executive and fiduciary responsibilities.
The Illinois Metropolitan Investment Fund invests public money on behalf of municipalities, pension funds, and local government boards. They lost more than $50 million after investing in allegedly fraudulent loans that are now at the center of a federal criminal investigation.

The Chicago Tribune identified 238 public entities throughout the Chicago area that participated in the fund. Of those, 207 lost money, ranging from less than $1 to $2.2 million. The list of investors burned by the alleged fraud includes more than 100 municipalities, 27 police and fire pension funds, 18 school districts, 15 libraries, 15 park districts, three community colleges and one airport. “This has completely shaken our trust,” said Todd Hileman, Glenview’s village manager. “I’ve seen other governments taken advantage of by some of these schemes, but I never thought I would be part of a scheme.” IMET’s loss represented less than 3 percent of its total assets. But the revelation rocked municipal managers because they are not used to dealing with distressed investments. “This was the first time we’ve ever lost money from an investment,” Savage said. “It was like a punch in the gut.”

---

Patriarch Partners “Zohar” Funds

Financial Damage

On March 30, 2015, the SEC filed a complaint against Lynn Tilton, claiming that she overcharged investors on fees collected on $2.5 billion worth of collateralized loan obligations, or CLOs. The SEC said that Tilton reported that the value of the underlying loans was unchanged—even though many of the companies had made partial or no interest payments for years. The SEC’s head of enforcement, Andrew Ceresney, said, “Tilton violated her fiduciary duty to her clients when she exercised subjective discretion over valuation levels, creating a major conflict of interest that was never disclosed to them.”

Reputational Consequences for Institutional Investors

In a case brought by two institutional investors, the investors allege that there was a direct financial loss of $44 million of their $135 million investment into Tilton’s fund. Since filing its action relating to the $200 million in overcharged fees, the SEC has continued to contact Tilton’s investors. This includes large institutions such as Goldman Sachs, Lloyds Bank, and Wells Fargo, as well as a handful of hedge funds including Värde Partners, Panning Capital Management, and Guggenheim Partners, who the SEC believes were overcharged fees based on Tilton’s fraudulent representation of CLO loan values.

http://www.garp.org/#!/risk-intelligence/detail/a1Z400000002vstJEAQ
FINANCIAL DAMAGE

The Municipal Employees’ Retirement System and the New Orleans Firefighters’ Pension and Relief Fund invested a combined $100 million in one of Mr. Alphonse Fletcher’s funds, FIA Leveraged. Their understanding was that the fund would invest in liquid securities that could be sold in a matter of weeks. The details sounded “too good to be true,” as one board member put it. In fact, they were. A court-appointed bankruptcy trustee has since described Mr. Fletcher’s hedge fund as having elements of a Ponzi scheme. Four retirement systems are currently fighting to recover their money. The Firefighters’ Retirement System tried to withdraw $17 million of its investment. Another pension fund made a similar request. According to a joint announcement, three of the pension funds that invested in FIA Leveraged made withdrawal requests in July 2011 after a report in the Wall Street Journal raised questions about the investment. The requested withdrawals were denied. Over the next few months, more reports began to surface that questioned the soundness of Mr. Fletcher’s investments. The Louisiana pension systems hired auditors to look over the books. Finally the SEC, the FBI and the Louisiana inspector general’s office opened investigations that are continuing to this day.

REPUTATIONAL CONSEQUENCES FOR INSTITUTIONAL INVESTORS

The $100 million dollars in losses certainly hit firefighters and city employees hard. Perhaps the greater damage was in loss of confidence in the city’s pension managers, the mayor of the city and the supposed safeguards in place after Madoff. The explanation of how it happened and who is responsible is still emerging, but the cast, in addition to Mr. Fletcher, includes “those we normally think of as creating a line of protection against such fraud,” as Trustee Richard Davis put it in his 2013 report. Named in various lawsuits is the consultant, Mr. Meals; the administrator of the hedge fund, Citco; and its auditor, Grant Thornton, who resigned as auditor after overstating a related fund’s value by $80 million, according to court documents.

3 http://dealbook.nytimes.com/2014/02/24/pension-funds-sue-on-a-deal-gone-cold/?_r=0
FINANCIAL DAMAGE

Stanley J. Kowalewski was arrested in South Carolina in 2013 after being indicted by a federal grand jury in Atlanta for defrauding investors of hedge funds of up to $8 million and for obstructing the SEC’s subsequent investigation of his activities. “Kowalewski is charged with stealing from the investors who trusted him and then repeatedly lying to them and the SEC about his self-dealing,” said the United States Attorney Sally Quillian Yates. “The victims of his greed include pension funds, schools, hospitals, and other non-profits who lost over $8 million in hard-earned money, which Kowalewski diverted to his own personal use.”

REPUTATIONAL CONSEQUENCES FOR INSTITUTIONAL INVESTORS

Kowalewski’s victims were primarily institutional investors, including pension funds, schools, hospitals and other non-profits. One could only imagine the individual and institutional reputational costs resulting from this fraud case.

The SEC alleges that New Jersey-based Yorkville Advisors LLC, founder and president Mark Angelo, and chief financial officer Edward Schinik enticed pension funds and other investors to invest in their hedge funds by falsely portraying Yorkville as a firm that managed a highly-collateralized investment portfolio and employed a robust valuation procedure. They misrepresented the safety and liquidity of the investments made by the hedge funds, and charged excessive fees to the funds based on the fraudulently inflated values of the investments.

The SEC alleges that by fraudulently making Yorkville’s funds more attractive to potential investors, Angelo and Schinik enticed more than $280 million in investments from pension funds. This enabled Yorkville to charge the funds at least $10 million in excess fees based on the inflated values of Yorkville’s assets under management. The “enticed” heads of pension funds obviously ended up looking naïve and unprofessional for not performing due diligence on Yorkville to verify the claims about their portfolio’s robustness.
The former manager of a New York investment fund, Lawrence Penn, holding $24 million for Kentucky Retirement Systems has pleaded guilty to charges that he looted $9.3 million from the fund and falsified its financial records. According to the New York District Attorney’s office, Penn transferred fund money to a shell company and laundered it through several entities and accounts that he controlled with another defendant who has pleaded guilty. Penn then spent the money on credit card bills, cash withdrawals, a car, jewelry and rent, while duping investors and auditors with bogus statements.

In addition to the $9.3 million stolen, Kentucky Retirement Systems does not know what will become of the remainder of its stake in Camelot. It cannot withdraw its remaining money until the fund matures years from now, said KRS Chief Investment Officer David Peden. It could sell the stake on the secondary market, but terms would not be favorable, he said. The reputational damage to the heads of KRS would be significant and long-term as the processes to recover some of the lost value of their fund are expected to continue for a long time.

---

http://kycir.org/2015/03/19/former-manager-of-funds-tied-to-kentucky-pension-system-investments-pleads-guilty-to-theft/
FINANCIAL DAMAGE

Two private equity funds in which the Rhode Island state pension fund invested a combined $70 million admitted to securing discounts from attorneys and other vendors but failed to share those savings with their investors, leading to higher than necessary fees, according to disclosures filed with the SEC.

REPUTATIONAL CONSEQUENCES FOR INSTITUTIONAL INVESTORS

“Why are we paying an inflated fee when they’re getting a discount?” said Marcia Reback, a newly reappointed union representative on the State Investment Commission, which oversees billions in state retiree funds, “It seems to be fraudulent.” Ted Siedle, a Forbes.com contributor and outspoken skeptic of pension reform and the use of alternative investments, said, “This is one of the reasons that the fees are higher than they should be... There’s just a million ways this stuff happens and it’s all shrouded in secrecy.” The reputational damages are squarely at the doorstep of the state pension fund for insufficient operational oversight, not asking harder questions when faced with higher than usual fees.

THERE’S JUST A MILLION WAYS THIS STUFF HAPPS AND IT’S ALL SHROUDED IN SECRECY.

FINANCIAL DAMAGE
The SEC announced fraud charges against the investment advisory firm Atlantic Asset Management for allegedly investing institutional clients in $43 million of illiquid bonds without disclosing a conflict of interest with the broker-dealer connected to the firm. Atlantic is partially owned by BFG Socially Responsible Investing Ltd., a fact not disclosed in its public SEC filings. According to the SEC's complaint filed in federal court in Manhattan, BFG used its undisclosed ownership interest to dictate AAM’s investment in what SEC officials called “dubious, illiquid bonds” issued by a Native American tribal corporation. The sales generated a private placement fee for the affiliated broker-dealer. SEC officials, who are requesting a jury trial, said clients were not told about the conflict of interest, and their concerns over the bonds’ valuation and suitability were not addressed. AAM has not found buyers for the bonds and clients have not been able to liquidate their positions.

REPUTATIONAL CONSEQUENCES FOR INSTITUTIONAL INVESTORS
All of the $43 million of dubious illiquid bonds were purchased with institutional investor’s money. In this case, the heads of institutional investment fund were negligent in operational oversight, missing on the conflict of interest and not asking harder questions about bonds’ valuations.

FINANCIAL DAMAGE

The United Marine Division Local 333 Beneficial Fund Annuity Plan accused its third-party administrator, auditor, and attorney of failing to protect it from Carlo Chiaese, an investment manager who swindled $1.7 million – the entire fund – in a Ponzi scheme that unraveled in 2011. Prosecutors said that Chiaese drew investors in by touting his experience and promised them that their money would go to traditional securities like mutual funds and bonds. Using that pitch, he was able to amass about $2.9 million in investor money between 2008 and 2010, including $1.7 million from the Local 333, according to court documents. None of the money went to the promised investments, prosecutors alleged. Instead, they said, it went to leases on a Porsche, Audi and Land Rover; country club fees; stays at luxury hotels in New York and the Caribbean; and purchases at high-end retailers like Hermes, Bergdorf Goodman and Saks Fifth Avenue.

Reputational Consequences for Institutional Investors

The United Marine Division Local 333 Beneficial Fund Annuity Plan, a Staten Island, N.Y.-based union of tugboat drivers and longshoremen, lost all of its pension assets to the fraud.

FINANCIAL DAMAGE

Two Detroit pension funds and Pontiac’s pension fund for general retirees collectively lost $23.8 million on their investments in Roy Dixon’s Onyx Capital Advisers private equity fund, according to the district attorney’s office. Dixon invested 80 percent of the invested money from the pension funds in a used car businesses owned by his friend Farr, according to the SEC complaint, which went belly up. Dixon is a co-defendant with former Detroit Treasurer Jeffrey Beasley, who is accused of “accepting bribes in return for approving investment requests to the Detroit pension funds,” U.S. Attorney Barbara McQuade’s office said in a statement after the indictment was unsealed.

REPUTATIONAL CONSEQUENCES FOR INSTITUTIONAL INVESTORS

“The situation and the things we’ve learned about the indictment ... while the indictment itself is certainly no evidence of anyone’s guilt, the business practices that are alleged in both the prosecution documents and the defense documents certainly raise concerns that would make any prudent pension board sort of want to look at their methodology and make sure there was nothing untoward happening with the retirees’ money,” said Pontiac Mayor Leon Jukowski, who serves on the pension board. The pension board also spent over $300,000 in legal fees trying to determine if there were any assets that could be attached, and were unsuccessful with the retirees’ money. The individuals involved can be tagged with lack of operational oversight, lacking prudence, and of course professionalism in executing their fiduciary responsibilities.

ACCEPTING BRIBES IN RETURN FOR APPROVING INVESTMENT REQUESTS.

http://www.theoaklandpress.com/article/OP/20130105/NEWS/301059953
THREE KEY TAKEAWAYS FROM THE CASE STUDIES

1. IN ADDITION TO SIGNIFICANT FINANCIAL DAMAGE, HEDGE FUND FRAUD CREATES SEVERE REPUTATIONAL DAMAGE TO INVESTORS

First of all, each case serves to prove the point that in addition to financial losses, fraud can result in severe reputational damage to institutional investors, with personal ramifications for its representatives and executives. Because of this, investors – and hedge funds – need to make the issue of fraud a top priority.
2. AT THE HEART OF FRAUD IS A FLAWED AUDITING PROCESS

The second key takeaway is that all of the examples point to a problem with the audit process. Either the audit came too late to be of help or the audit process itself was corrupted. A solution to the problem of fraud, then, will have to address the audit process.

3. BLOCKCHAIN TECHNOLOGY RESOLVES ALL AUDITING ISSUES

What if an instant audit were possible? With ComplianceGuard’s blockchain technology that is now possible. ComplianceGuard gives pension fund managers the assurance that hedge funds using the application are being audited 24/7.

What if every transaction was authenticated and audited as soon as it was entered? With ComplianceGuard’s blockchain technology the audit occurs at the time of the transaction entry, so there is no need for an auditor to later come in and confirm that the numbers are correct. From the moment the data is entered, it’s audited.

Furthermore, the parameters for the auditing tools can be customized to the specific hedge fund’s investment style and structure, while also enabling controls and notices about regulatory compliance, inside trading and conflict of interest. These capabilities eliminate the need for auditing the numbers, while the tests for various types of fraud is extremely rapid and accurate.

None of the above ten examples of fraud would have escaped ComplianceGuard’s blockchain technology-based system. This leads to a lower likelihood that hedge funds will attempt to commit fraud in the first place, a lower chance that they will succeed if they do attempt to commit fraud, and a lower level of damage if they successfully commit fraud.

First of all, each case serves to prove the point that fraud can result in severe reputational damage to institutional investors – even if the financial damage they experience from the fraud is minimal. Because of this, investors – and hedge funds – need to make the issue of fraud a top priority.
ABOUT CG BLOCKCHAIN INC.

CGBlockchain’s ComplianceGuard is for pension funds, endowments and other institutional investors in hedge funds who wish to be proactive in their approach to risk.

Our team works together to research, explore and implement new technologies and standards that increase transparency and reduce risks in hedge fund investing.

For more information visit cgblockchain.com

Copyright © 2017 CGBlockchain. All rights reserved.