



Due Diligence

In Conducting Background Checks of Hedge Fund Managers, What Specific Categories of Information Should Investors Check, and How Frequently Should Checks be Performed?

Sep. 9, 2009

By *Jack McCann* and *Daniel Weiss, McCann Global*

Background checks or investigations of managers of hedge funds, private equity funds and venture capital funds are in the spotlight with the recent frauds involving Bernard Madoff in New York and Stanford Financial in Houston. For defrauded investors, the focus in the Madoff and Stanford contexts has shifted to litigation and asset recovery. For those who still are invested in third-party managed funds or are considering investing in such vehicles, the Madoff, Stanford and other scandals have emphasized the importance of investigating the background of the individuals responsible for managing the funds.

It has also become clear that past levels of background investigation and due diligence have been limited. Frauds like those perpetrated by Madoff and Stanford are affinity frauds, meaning they are made possible in large part by new investors being impressed with existing investors, and the perception that being an investor confers status and membership in an exclusive club. Those who conduct such frauds count on limited scrutiny and sell the exclusivity of the investment vehicle.

No background investigation can prevent all fraud. However, background investigations can indicate signs of a checkered past, which in turn can increase the risk profile of a potential investment. Many institutional investors pore over past financial performance data and perform extensive due diligence on financial data. However, they often do not perform even basic background searches on criminal or civil matters. The reason often given is that “we know the person” or that “I know someone who has worked with that manager in the past.” These connections and gut level checks are important and necessary, but are not sufficient when managing other peoples’ or institutions’ money. They are also setups for an affinity related fraud. Experienced, state-licensed investigators can discover “surprises” in background checks.

Annual Background Checks

It is also important to have the background checks run on an annual basis so that an investor can monitor changes in the credit, civil litigation and any criminal activity of principals of the

manager. Oftentimes, the worst hits come after the investment has occurred. Fraudsters do not always become fraudsters until a material event “pushes” them into once unthinkable acts. Major life stressors, such as the death of a spouse or child, a divorce, debt, gambling and other addictions can initiate a new pattern of behavior not demonstrated prior to the stressor. Being up-to-date on an individual’s major life changes can be a significant way to reduce risk. A semi-annual call or office visit is often not a sufficient check since managers and their personnel often will seek to put their best foot forward for someone who is an important source of capital. It is possible that if a manager knows that a review will be conducted annually, but not on a set schedule, the manager may think twice before damaging its reputation.

Many investors have told us: “we do our own backgrounds using Internet-based background services.” The main reason: they are cheap. In an attempt to save a few hundred dollars on significant investments, these firms continue to utilize Internet-based background check services until they run into trouble. They unknowingly expose their firms, and their investments, to levels of risk that could be called into question at a later time.

Internet-Based Background Check Services – Limitations

What are the limits to most Internet-based background check services? A few that can result in material risk include the following:

1. Limited or No Civil Litigation Checks in County or District Courts

Problem: The person being “checked” could have scores of civil cases pending or show a track record of material litigation. This research must be done manually, one case at a time, and can result in a “miss” in an online background check. The civil litigation search may show cases which have criminal overtones, but were simply not large enough for the local or federal attorneys to pursue. Examples of material issues include factoring fraud, banking fraud and consumer fraud.

2. Undisclosed Status as Officer of One or More Corporations

Problem: The person being “checked” may be involved with other companies, some of which may be competitive to your interests as an investor. Involvement in other entities can pose a significant drain of the person’s time. Even if you know some of the other companies the person is involved with, it is good practice to disclose such affiliations. Internet-based background checks do not usually check Secretary of State and SEC databases because these checks are manual.

3. No Analysis of “Net Data Grab”

Problem: The Internet background services can grab a lot of information, much of it not relevant to the person being checked.

Utilizing popular Internet-based background check services provides little more than pages of often unrelated information. Such services regularly include information about individuals that are not the subject of your inquiry. At worst, the Internet-based background services can lead to investment decisions based on incomplete or incorrect information. A background check performed by a qualified background firm utilizes multiple sources, both from limited access and open sources, and compares the data to an individual’s self presentation.

More than ever, financial professionals need to be able to show capital sources that they have conducted proper background checks and due diligence on the people to whom they are

entrusting their own and other peoples' money. A thorough background check helps to provide transparency and to bring out many often-overlooked pre-investment issues.

Categories to be Checked

At a minimum, the following information should be gathered on key individuals at a fund under consideration for investment:

- Name Verification
- Alternative Names or Aliases
- Social Security Verification
- Drivers License Verification
- Marital Status
- Current Residency Verification
- Past Residency
- Criminal:
 - City
 - County
 - State
 - Federal
- Sex Offender Index
- Patriot Act Watch Lists
- Civil: Litigation, Judgments, and Liens
 - Federal
 - Bankruptcy
 - District
 - Appellate
 - County
 - Justice of the Peace
- Officer in Corporation: Potential Conflicts or Undisclosed Interests
 - State Corporation Registrations
 - SEC Registrations
 - Open Source Search
- DBA Registrations Country Clerk
- FCRA-compliant Credit Checks
- Motor Vehicle Records
- Past Employment Verification
- Education Verification
- Professional License Verification
- Social Networking Research
- News Sources
- Reference Interviews
- Applicant Interviews

Jack McCann: Prior to founding McCann Global, Mr. McCann served over 27 years with the New York Police Department. His service at the NYPD included assignments as a Detective with 8th Homicide Squad, the Bronx District Attorney's Office, Hostage Negotiation (Founding Member), Major Case Squad and he was sworn in as a deputy U.S. Marshall. Prior to retiring from the NYPD in 1993, Mr. McCann operated his high profile personal protection firm. Mr. McCann has served the private sector actively for the past 20 years. Upon retiring he added investigative services for his private sector clients.

Daniel Weiss: Mr. Weiss began his career in the security industry while in graduate school at Northeastern University, by working at a maximum security prison in Massachusetts, Walpole State Prison. Mr. Weiss left the public sector and entered the private security sector. During the past 15 years, Mr. Weiss has worked for Wells Fargo, Chubb, Alarmex, and has started three successful private sector security firms: EPS Security, GCS and Infrastruct Security.

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.