PRISM INSIGHTS

TRENDS IN OPERATIONAL DUE DILIGENCE

Financial frauds and Ponzi Schemes are on the rise in 2020.

From an ODD perspective, what are some underlying themes of a fund fraud....

Fraud can be a Ponzi Scheme, and/or a mis-representation of the value of investments in an effort to buy time and recoup trading/investment losses.

Fraud can be failing to execute an investment strategy altogether.

Having an independent and well designed ODD review, should help investors avoid fraud.

The importance of conducting investment manager due diligence is underlined every time we hear about a fraud case study. From Bernard Madoff to Martin Shkreli to Thomas Petters, the main theme exists: thorough professional grade operational due diligence should be performed every time. Most, if not all frauds and Ponzi schemes start out as real investment funds, but when a manager hits an unexpected drawdown, their desire to stay in the spotlight or maintain their financial cash flow and their position in society; psychology in many fraud instances has taken over their duty as a fiduciary mindset. Here are some other financial fraud operational risk themes:

Financial Frauds seem to often (if not always) involve the creation of fictitious client statements. With that said, the use of a qualified independent fund administrator for any type of fund is even more valuable today than one would have imagined 15 years ago. Conducting due diligence on the administrator is also key to ensuring that the administrator is issuing independent statements, and the qualifications of the administrator will give assurance to their ability to sufficiently oversee the fund's accounting. The existence of a reputable auditor (Big 4 or one of the nationally recognized firms) will also serve the investor well. If you are an institutional investor or another fiduciary in 2020, and you need to conduct due diligence on a fund auditor, this situation is unusual, and you may be increasing your operational risk.

Financial Frauds often involve conflicts of interest and/or investment managers who run multiple businesses under the same roof. This can provide an asset manager with an easy window to transfer funds from one entity to another entity in an effort to temporarily cover up losses. Conducting thorough financial due diligence on a fund's audited financial statements is also critical to seeing possible transactions that could signal a fraud (this is why many ODD professionals are CPAs and former Big 4 auditors). The use of unaudited SPVs, related party transactions, and entity name changes are also flags that should be considered.

Financial Frauds often involve esoteric investment strategies in the field of lending or receivables. These strategies often are run by people outside of mainstream financial markets that may not have well known references you can check (former employers, investment banks, well known fund managers), they do not have custodians, they are often run by a small team sometimes outside of larger financial centers making them harder to visit onsite, and they are more complex to due diligence. For these reasons, investors sometimes think they can and should take on more risk, because the strategy is rare and there are few options to obtain exposure to the investment strategy. The inherent risks however are larger but the bar for operational risk should be the same if you want to legally protect your assets and the assets of your clients.

Financial Frauds often involve people who provide limited, or unusual types transparency to investors during a due diligence review. Some examples would be a manager who declines to participate in due diligence meetings or calls, managers that delay a due diligence process, managers who provide brief and guarded responses to standard due diligence questions, and managers who attempt to intimidate their investor or their investor's advisors during due diligence meetings.

Overall, an independent ODD review should steer investors away from frauds if the work is done thoroughly and the work plan is well designed. Having the skillset to clearly understand complex investment strategies and organizations is key to the opinion of the ODD review.