

Private eyes for private placements

There is a whole sub-genre of detective focused on the hedge fund industry. After the fallout from scandals such as those at Bayou Management or Wood River Capital Management, investors are going beyond mere due diligence to ensure that the funds in which they invest – and the managers these funds hire – are above reproach.

Guy Simonian, CEO of CheckFundManager.com of West Hartford, Conn., says he has investigated more than 8,000 funds and managers in the past few years, serving institutional investors, capital lenders, larger private equity firms and funds of funds.

“One in six has some kind of exception,” the technical term for red flag, Simonian says. “Of those, one in three have something serious enough to [affect] a decision.”

In other words, according to Simonian, there’s a better than 5% chance that a fund or manager has something significant to hide. That’s the low estimate. Randy Shain, vice president of New York-based First Advantage Investigative Services, reports that “15 percent of the time we’re coming up with something we think is pretty significant.”

These closet skeletons can take the form of fabrications around employment or educational history, bankruptcies, a judgment or lien, a pending lawsuit, or even just a rash of bad press. Investigators also look into restrictions mandated by regulators, often as a result of a Securities & Exchange Act of 1934 violation. Sometimes a criminal record is uncovered, ranging from RICO Act entanglements to more commonplace crimes of passion or avarice.

Shain adds that the reasons for leaving a firm can sometimes fall off a resume: “Sometimes I’ll hear, ‘He’s a good trader, but can’t run a business to save his life.’”

Some exceptions are more frequently encountered than others, according to Simonian.

“There is some criminal activity – sexual abuse, theft, forgery,” he says, “but more [investigation subjects] lied on their resume about their education or a dispute with partners.” The public hears more about the unlawful acts because “crimes make better headlines than bankruptcy.”

Hedge fund investigators tend not to be Spillane-esque gumshoes, nor are they generally former law enforcement or regulatory officials. More than likely, the background checker is a recent college graduate aspiring to a career as an investigative journalist.

“This doesn’t require use of a handgun,” Simonian says. A good investigator mostly needs “to be articulate and computer-savvy.”

Being a former government official can actually get in an ethical investigator’s way, according to Shain. He cites the hypothetical case of an investigator who may have worked for the FBI and now claims to have access, “through friends at the Bureau,” to

the NCIC criminal database. Anyone who is no longer a member of the intelligence or law enforcement community ought to have access to that database's records, Shain asserts.

Simonian points out that the investigation is just "one piece of a big puzzle" when making a judgment about a prospective fund or manager, and that ultimately it's the call of his clients' compliance officers or due diligence managers.

Even so, some investigators express chagrin at what they perceive to be the legalistic, minimalist approach some firms take when considering who to trust their money to.

"'Due diligence' does not equal 'check the boxes,'" says Shain, whose division issues a hedge fund investigation product called the BackTrack Report. "The real question should be, 'Is this hedge fund manager worth the risk?'"

In an internet age, though, do investigators – who charge more than \$1,000 at the low end – really give a buy-sider anything she can't get from a \$75 lookup through an online service such as Intelius, or as part of a sunk Lexis-Nexis monthly fee?

Investigators say that the Web may be the first place to look, but they're quick to point out that not all courts have their records online yet. To get a full view of an individual's history of civil and criminal litigation, a trip to all the courthouses in all the jurisdictions the subject has ever lived or worked is still necessary. The telephone is still the best tool for verifying professional credentials.

And they can turn up something that's not to be found via modem. Shain points to little-known facts about the convicted lead conspirator at Bayou, which could have been turned up with a little old-school detective work.

"Sam Israel was arrested for drunk driving. Drugs were found in his car," Shain claims. "Also, there was a \$2.2 million judgment against him in California."

Even so, turnaround times for investigators' reports is usually a matter of days. Frankly, it's a small industry and it's the same people being investigated over and over, so firms like First Advantage or CheckFundManager.com probably already have a dossier on anyone an investor is likely to want to check out. It then becomes a matter of updating.

Another way of looking at such dossiers is that they are "off-the-shelf," as Michael Hennessy, managing director of Morgan Creek Capital Management, puts it.

The Chapel Hill, N.C., -based group does not use investigative services "as a matter of course," according to Hennessy, but has on occasion. Morgan Creek relies on investigators for firms that are focused on investments "with opaque pricing, or where liquidity is a bit more squirrelly," Hennessy says. "When there aren't as many independent eyeballs, [a manager] can wander off the reservation."

But if a fund or manager is focused on more traditional vehicles – large-cap stocks or investment-grade bonds, say – Hennessy sees “marginal benefit in more due diligence.” If an in-house background check or the free advice of trusted sources cast any doubt on a prospective business affiliate, there tend to be other candidates for the role.

“We’ll probably just walk away,” he says.

The University of Colorado Foundation, though, uses investigators not just with hedge funds but “anytime we’re making a significant commitment to an organization,” according to chief investment officer Chris Bittman.

He distinguishes between due diligence -- which focuses on investment processes and results, and which the Denver-based foundation performs in-house -- and a background check into a potential associate’s life history. Background checkers “pick through a different set of data,” Bittman says.

Even so, Bittman could not point to an example in which his group walked away from a candidate because of what investigators turned up, nor could he cite a case in which a candidate was cleared by background checkers only to have an embarrassing past surface later.

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