

# Private Equity and Hedge Funds: Methods of Choice for Money Laundering Threat Actors

Private investment funds under management have grown over the past 25 years into a several trillion-dollar industry in the United States. In a leaked Federal Bureau of Investigation (FBI) unclassified but sensitive bulletin, the FBI concludes, with high confidence,<sup>1</sup> that threat actors (both financially motivated criminals and foreign adversaries) are using the private placement of funds, including investments offered by private equity (PE) firms and hedge funds, to circumvent the anti-money laundering (AML) programs of other financial institutions and launder money. In making this assertion, the FBI advocates for greater regulatory scrutiny of private investment funds.

While not unique to private equity and hedge funds, certain characteristics of these funds may expose them to higher money laundering risk. These include the customer base, often composed of wealthy individuals, including politically exposed persons (PEPs); close relationship between wealth managers and investors, akin to relationships seen in private banking; the use of shell companies and trusts for investment purposes; and investment structures which may include multiple accounts in different jurisdictions, including

secrecy and tax havens, with funds moving through a concentration account.

Despite a couple of false starts and concerns expressed by other regulatory bodies across the globe and the media for years, the U.S. Department of the Treasury has never exercised its full authority under the USA PATRIOT Act to impose AML program requirements on these investment vehicles. In its 2018 Mutual Evaluation Report of the U.S., the Financial Action Task Force (FATF) characterized the lack of anti-money laundering requirements for investment advisers, such as those that manage hedge

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<sup>1</sup> High confidence generally indicates the FBI's judgments are based on high-quality information from multiple sources. High confidence in a judgment does not imply the assessment is a fact or a certainty; such judgments might be wrong. While additional reporting and information sources may change analytical judgments, such changes are most likely to be refinements and not substantial in nature.

funds and private equity funds, as one of the most significant gaps in the U.S.'s AML regime.

The FBI bulletin specifically highlights the fact that hedge funds and private equity firms may receive funds from entities registered in nations that make it easy to mask the true, underlying beneficial owners and cites as examples a number of cases where hedge funds and private equity firms have been used to facilitate transactions in support of fraud, transnational organized crime and sanctions evasion, including the following:

- A representative of a New York- and London-based hedge fund proposed investing in private placement funds and planned to use a series of shell corporations to purchase and sell prohibited items from sanctioned countries to the United States. The proposed hedge fund was to have operated entities registered in Luxembourg and Guernsey to evade regulatory requirements when transacting with sanctioned companies, according to those in the know.
- An unidentified Mexican cartel operating in the Los Angeles and Orange County, California areas recruited and paid individuals to open hedge fund accounts at private banking institutions. The cartel reportedly laundered approximately \$1 million through the accounts each week and then withdrew the money to purchase gold.
- A New York-based private equity firm received more than \$100 million in wire transfers from an identified Russia-based company allegedly associated with Russian organized crime.

Private investment funds that are exempt from Securities and Exchange Commission (SEC) registration, including hedge funds and private equity firms, are not subject to many of the public reporting requirements to which investment advisers managing other funds, such as mutual funds, must comply. For example, fund advisers may be required to disclose the total amount invested by beneficial owners who are non-U.S. persons, but do not have to provide any detail beyond that. Other information is provided by private funds on a self-reporting basis and is only available through subscription services, meaning that it is not readily accessible to law enforcement.

Absent any action to bring AML requirements for private investment funds in line with those of other financial institutions, the FBI expects money laundering using these vehicles to proliferate.

In the meantime, the bad news for those looking to exploit the weak AML regulatory environment for private investment funds in the United States is that many funds – some no doubt encouraged by the banks with which they do business and by organizations such as the Securities Industry and Financial Markets Association (SIFMA) – have adopted AML compliance programs as a best practice and in order to protect their reputations from being associated with money laundering and other criminal elements. These compliance programs are risk-based and customized to the fund's business and include, at a minimum:

- Evidence of management commitment and oversight
- Clearly defined risk appetite for customer acceptance and maintenance
- Policies and procedures which delineate roles and responsibilities (including the appointment and empowerment of an AML Compliance Officer) and include Know Your Investor due diligence standards and measures for identifying potentially suspicious activity
- Training on the specific risks and red flags of doing business with hedge fund and private equity investors
- Periodic independent testing

This new attention to the risks may prompt the Treasury Department to revisit and ultimately promulgate enhanced AML requirements for these private investment funds – but that remains to be seen.

Meanwhile, the risks are clear and law enforcement has signaled it is paying attention.

## About Our AML Services

Protiviti has a dedicated AML team within its risk and compliance practice. The core members of this team are former regulators, former compliance officers, fraud and forensic specialists, and AML and sanctions technology experts who have hands-on experience working in and with financial institutions of all types. We draw on our experience to help compliance professionals, senior management and boards of directors, and internal audit departments address the challenges they face in meeting their AML responsibilities in a sustainable, efficient manner.

Protiviti provides a wide variety of consultative services designed to assist private equity firms and other organizations in all aspects of AML/CFT (combatting financial terrorism) compliance.

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