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Using Background Checks To Prevent Fraud

by Beth Connolly on October 19, 2012



Poor finish to a long-winded explanation. If hindsight is twenty-twenty, then what insights can be gleaned from studying the results of background checks on individuals who subsequently committed fraud?

A lot, it turns out. At the Hedge Fund Operational Due Diligence Summit in New York, held on Oct 1-2, Guy Simonian, CEO of [Check Fund Manager](#), shared some of the results of two years of research into the background checks of criminals in his talk, **Background Checks, Frauds, and Blow-ups**. The full results of his research are now published in the [Hedge Fund Journal](#).

Here is a selection of lessons learned during examinations of background checks.



Samuel Israel III

- 1. Work ethic matters.** In the case of Samuel Israel III, founder of the Bayou Hedge Fund Group, a background check turned up a checkered history of short periods of employment at a variety of companies. Israel moved on from one firm after a “bad trade” and was permitted to resign from another for failing to adhere to company policy.
- 2. Investigate the management company as well as the individual in question.** John Whittier, the founder of Idaho hedge fund Wood River Capital Management, had a relatively clean background. But his former company had been sued for failing to pay rent payments and was on its third prime broker in seven months.
- 3. Investigate all of the principals at the company.** Steven Byers, co-founder of WexTrust Capital LLC, had very few marks on his record. But his chief operating officer and co-founder, Joseph Shereshevsky, had quite a tarnished past: seven or eight traffic violations, marital discord, child support battles, and bank fraud.



Florian Homm

- 4. Impressive credentials are not always indicative of good character.** Absolute Capital Management Holdings fund manager Florian Homm obtained his BA and MBA from Harvard University, graduating cum laude. One would think such an intelligent, accomplished person would have no need (and too much pride) to resort to fraud. Yet Homm was [accused by the SEC](#) of portfolio pumping to the tune of \$440 million.
- 5. Follow up on negative media.** Negative press can be a sign of more bad news to come. If these stories come up in a background check, they must be investigated.



Tom Petters

- 6. Pay attention to the number of red flags.** A background check must pass what Simonian calls “the scale test.” In the case of Tom Petters, founder of the Petters Group, a \$3.65 billion Ponzi scheme, a background check turned up so many documents and pages of complex lawsuits that it simply did not pass the scale test. Petters was convicted in 2009 and sentenced in 2010 to fifty years in federal prison.
- 7. Perform service provider authentications.** Bernie Madoff didn’t use any outside service providers. That was a red flag.
- 8. Do not rely on the SEC.** “The SEC is great at filing charges and enforcing penalties,” said Mr. Simonian, “but they’re not so great at

detecting fraud. Bernie Madoff passed his SEC exam.” Be proactive in doing your own investigations after a background check. Don’t be complacent. In the case of Madoff, that SEC exam was a false green flag.

9. Character matters. “They say character is what you do when no one is looking,” said Simonian. And that’s how fraud happens—someone with access is dishonest when no one is looking. Pay attention to past incidents involving personal relationships and family. Grant “Gad” Grieve of Finvest Asset Management LLC, who was [sued by the SEC](#) in February 2009 for inventing fake auditing firms and creating false financial statements.

10. Perform ongoing due diligence. Develop your own processes and do one investigation every month.

In conclusion, Mr. Simonian said, there are four things to keep in mind when you turn up red flags during a background check.

1. Who do you work for and what is your investors’ tolerance for negative news?
2. Is the litigation indicative of a character flaw or just related to an investment style?
3. What is the financial obligation of the manager or the worst case exposure to a suit?
4. Can a personal matter affect the operations of a company? For example, would a divorce dissolve the company?

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Beth Connolly is Editor-in-Chief of the [Wall Street Job Report](#) and the [Compliance Exchange](#). She [blogs creatively](#) at *When Nutmeg Met Basil*. Connect with her on [LinkedIn](#), [Twitter](#), and [About.Me](#).

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It boggles my mind how some city governments are making illegal to conduct background checks for employees and prospects when FRAUD is rampant and kicking every where.

by [Subash Murray](#) on October 21, 2012 at 10:56 pm. [Reply #](#)

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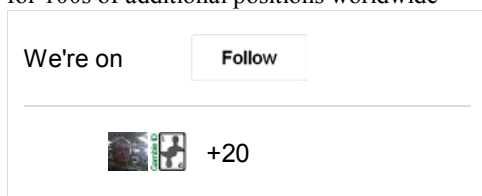
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