

Identifying hedge fund elements susceptible to economic crime

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PREFACE

I dedicate this study to every individual that supported me during this research journey. Thank you for every suggestion, cup of coffee, word of encouragement and sacrifice that brought me to this point.

I would like to extend special and heartfelt thank you to the following persons:

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This has been a part of the great unknown, where my feet failed but to the King of all Kings be the glory and praise for everything that I have and am, is sewn together with His Grace.

May the Lord's favour be on the NWU and on our beloved country and its people.

O re tshegofatse, Morena

Seën ons, Heer

Bless us, oh Lord

ABSTRACT

Hedge funds have provided an alternative approach to investing and is said to have revolutionised the way people invest and manage their wealth (Frush, 2007:7). Yet, despite all its popularity and notoriety, few people understand what hedge funds are, how they work and how they are regulated, and this leaves many people with feelings of admiration and fascination, but also envy and fear (Desmet, 2008:1).

The global hedge fund industry has historically been known for its lack of transparency and Pierre-Louis (2009:23) emphasises that the elusiveness of hedge funds and their investment strategies is a cause of concern for the investing public, as well as the financial securities market.

After the Global Financial Crisis of 2008, the financial services market came under scrutiny and the global hedge fund industry began to reconsider its regulatory environment. Various countries have since implemented more rigorous regulations on hedge funds which indicates that more oversight was needed in the industry.

The objective of this study is to determine what elements of hedge funds are susceptible to economic crime through the conceptualisation and clarification of:

- i. The term “hedge fund fraud”;
- ii. The unique elements of hedge funds;
- iii. The analysis of identified case studies of hedge fund fraud in the United Kingdom (UK) and South Africa; and
- iv. The identified elements of hedge funds susceptible to economic crime through the analysis of the identified case studies.

Key terms: hedge fund/s, economic crime, fraud, United Kingdom, South Africa, susceptibility.

OPSOMMING

Verskansingsfondse bied 'n alternatiewe benadering tot finansiële beleggings en het gelei na 'n verandering in die manier waarop mense hul welvaart belê en bestuur (Frush, 2007:7). Ten spyte van al die gewildheid en berugtheid van verskansingsfondse, is daar min mense wat verstaan wat verskansingsfondse is, hoe dit werk en hoe dit gereguleer word. Hierdie misterieuse aard van verskansingsfondse laat mense verwonderd, gefassineerd, maar moontlik ook angstig (Desmet, 2008:1).

Die internasionale verskansingsfonds-bedryf is histories bekend vir sy gebrek aan deursigtigheid, en Pierre-Louis (2009:23) benadruk dat die ontwijkende aard van verskansingsfondse en hul belegging strategieë 'n bron van kommer is vir die beleggingspubliek en die finansiële- en sekuriteitsmarkte.

Na die Wêreldwye Finansiële Krisis van 2008, was die finansiële dienste-mark onder 'n vergrootglas geplaas en het die internasionale verskansingsfonds-bedryf begin om sy regulatoriese omgewing te heroorweeg. Sedertien het verskeie lande strenger maatstawwe oor verskansingsfondse geïmplementeer. Hierdie verskyning kan daarop dui dat oorsig in die bedryf nodig was.

Hierdie studie is daarop gemik om te bepaal watter elemente van verskansingsfondse vatbaar is vir ekonomiese misdaad deur die konseptualisering en verklaring van:

- i. Die term “verskansingsfondsbedrog”;
- ii. Die unieke elemente van verskansingsfondse;
- iii. Die ontleding van geïdentifiseerde gevallestudies van verskansingsfondsbedrog in die Verenigde Koninkryk (VK) en Suid-Afrika; en
- iv. Die geïdentifiseerde elemente van verskansingsfondse wat vatbaar is vir ekonomiese misdaad deur die ontleding van die geïdentifiseerde gevallestudies.

Sleutelterm: verskansingsfonds/e, ekonomiese misdaad, bedrog, Verenigde Koninkryk, Suid-Afrika, vatbaarheid.

LIST OF ABBREVIATIONS

ACFE	-	Association of Certified Fraud Examiners
AIF	-	Alternative Investment Funds
AIFMD	-	Alternative Investment Fund Managers Directive
CEO	-	Chief Executive Officer
DDCM	-	Dynamic Decisions Capital Management
EU	-	European Union
FCA	-	Financial Conduct Authority
FRA	-	Forward Rate Agreement
FSA	-	Financial Services Authority
FSB	-	Financial Services Board
FSCA	-	Financial Services Conduct Authority
IAS	-	International Audit Standard
IRS	-	Interest Rate Swap
ISA	-	International Standards on Auditing
MWL	-	Mat Worldwide Limited
NAV	-	Net Asset Value
OTC	-	Over the Counter
RVAF	-	Relative Value Arbitrage Fund
SEC	-	U.S. Securities and Exchange Commission
UK	-	United Kingdom
USA	-	United States of America
WCF	-	Weaverling Capital Fund
WCM	-	Weaverling Capital Limited
WCUK	-	Weaverling Capital (UK) Limited

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CHAPTER 1

PURPOSE AND SCOPE OF STUDY

1.1 Introduction and background

Hedge funds have provided an alternative approach to investing and is said to have revolutionised the way people invest and manage their wealth (Frush, 2007:7). Yet, despite all its popularity and notoriety, few people understand what hedge funds are, how they work and how they are regulated. The uncertainty which surrounds hedge funds and its reputation, leaves many people with feelings of admiration and fascination, but also feelings of envy and fear (Desmet, 2008:1).

Hedge funds are investment instruments consisting of privately pooled investments, administered by a professional investment manager, with a limitation on the amount of investors, to make a positive return by using different investment strategies in an environment with little regulation (Brav *et al.*, 2008:1735).

Almost ten years later, Nabilou (2017:27) formed the following working definition of hedge funds after considering various definitions provided by in the United States of America (USA) and European Union (EU): “a privately organized investment vehicle with a specific fee structure, that is not widely available to the public, is aimed at generating absolute returns irrespective of market movements (alpha) through active trading, and makes use of a variety of trading strategies.” Based on the above statements, the definition of a hedge fund has not changed much over the past decade.

Hedge funds have been around since the 1940's, when commodity producers and merchants began to lock in prices by using forward contracts (Frush, 2007:11). In 1949, Alfred Winslow Jones, a journalist for Fortune magazine at the time, established the first ever-recorded hedge fund (Frush, 2007:31). Since the establishment of hedge funds, the amount of hedge funds around the world has increased at a tremendous rate and in 2013, it was estimated that there were 14,700 hedge funds being managed by 6,500 fund managers worldwide (Department of National Treasury, 2015:3). In 2017 South Africa's hedge fund industry was estimated to be worth R67,4 billion (Association for Savings and Investment South Africa, 2018) and though it is relatively small in comparison to the global hedge fund industry, which has an estimated worth of US\$3,5 trillion (Kenny & Mallaburn, 2017:1), it is not an insignificant sum.

The first hedge fund fraud case was reported in the USA in 1968 and since then reports of hedge fund fraud have become more and more frequent (Johnson, 2010:249). According to the

U.S. Securities and Exchange Commission (2012:1), or SEC, there have been more than 100 cases filed involving hedge fund fraud between 2010 to 2012. These instances of hedge fund fraud include aspects such as the misuse of investor assets, false presentation of investment strategies or investment performance, as well as money laundering.

According to Fevurly (2013:165), the global hedge fund industry has historically been known for its lack of transparency, and Pierre-Louis (2009:23) emphasises that the elusiveness of hedge funds and their investment strategies is of concern for the investing public as well as the financial and securities market. This concern is what caused the private pension fund industry in South Africa to abstain from increasing their level of investments into hedge funds from 2,5 per cent to 10 per cent in 2011, as the market perceived hedge funds as too risky because of their complex nature and lack of regulation (Financial Services Board 2015:18).

The above-mentioned statements emphasise the risk of economic crime associated within hedge funds. Crimes which are a constant possibility, and without proper prevention, detection and regulation, it may escalate with catastrophic consequences.

Investments in new and growing markets are an obvious solution in answer to the pressure for new revenue, even though this also puts pressures on the growing markets to deliver growth and may lead to these new and growing markets being susceptible to economic crimes and, as a result, giving in to the pressure of creating new revenue (Ernst & Young, 2015). According to Foster (2016), the newly regulated South African hedge fund industry grew its assets under management in the 12 months leading up to 31 December 2015 by R5,1 billion, ending the year with assets under management of R62,1 billion. By the end of 2016, assets under management grew a further R5,3 billion ending at R67,4 billion under management (Association for Savings and Investment South Africa, 2017).

Due to the pressure of growing markets, including the hedge fund market, industries feel the need to report performance results that mirror the direction of the market at the very least (Kamarudin *et al.*, 2012:642). This type of pressure contributes to the presence of economic crime within these markets (Kamarudin *et al.*, 2012:642). The hedge fund industry is not immune to economic crime and over the past few years, there have been several financial scandals involving hedge funds.

According to Sarna (2010:138) one of the largest and prominent international hedge fund fraud cases was that of the Bayou Hedge Fund Group registered in the USA. The Bayou Hedge Fund Group raised US\$450 million since its foundation by Samuel Israel, Daniel Marino and James Marquez. The company directors, and investors were promised that it would continue to grow to US\$7,1 billion within 10 years.

However, trading losses occurred, which forced the company to hide its true financial position and provide misleading audited financial statements (Sarna, 2010:138). The Bayou investors lost over US\$350 million and Samuel Israel was sentenced to 30 years in prison and Daniel Marino was consequently sentenced to 50 years (Muhtaseb & Yang, 2008:186).

However, the most infamous case of hedge fund fraud is that of Bernie Madoff. According to Sarna (2010:151), this appears to be the largest Ponzi scheme in the history of financial scandals, which proceeded for years without detection until the financial market crash in 2008, when investors requested withdrawals from his fund, which consisted mostly out of alleged hedge funds. This led to a liquidity crisis and the discovery of the Ponzi scheme. Sarna (2010:147-148) also states that the value of the Ponzi scheme was US\$170 billion and that Madoff was convicted of 11 felonies and sentenced to 150 years in prison.

Similarly, to the Bernie Madoff case, a South African hedge fund, the Relative Value Arbitrage Fund (RVAF), collapsed in 2012 after it was operated as a Ponzi scheme by its principal Herman Pretorius (Pretorius), (Craig Stewart Inc v Impact Financial Consultants CC and Michal Johannes Calitz, 2014). The exact losses have not been calculated yet, but according to an article in Die Burger of 16 April 2015 the RVAF group accumulated approximately R2,5 billion between 2004 and 2012 from investors. Payments made by Pretorius unrelated to investors, amounted to R753 million and other unspecified payments amounted to R164 million, which leaves a remaining amount of approximately R1,58 billion unaccounted for.

The Department of National Treasury (2014:5) reported that the Global Financial Crisis of 2008, which was caused by the failure of the subprime mortgage market in the USA, caused major global disruptions in financial markets and economies and the crisis resulted in a major shift in how financial institutions are regulated and supervised. South Africa's Department of National Treasury issued a declaration in February 2015 that all hedge funds will be classified as collective investment schemes, under Section 63 of the Collective Investment Schemes Control Act (45 of 2002), effectively from 1 April 2015 (Financial Services Board, 2015:18). The consequence of this declaration is that the existing Collective Investment Schemes Control Act will affect the regulation of hedge funds in South Africa (Department of National Treasury, 2014:5).

The change in regulation was the first of its kind internationally, which made South Africa the first country with comprehensive hedge fund regulation (Association for Savings and Investment South Africa, 2018). The change in regulation was motivated by a lack of investor protection, monitoring and management of systemic risk, as well as integrity and transparency of the hedge fund industry (Novare, 2018). These factors have contributed to the presence of economic crime within the hedge fund industry and its maverick reputation (Muhtaseb & Yang, 2008:180-181).

By addressing these key issues regulators are attempting to control the industry, as effectively as possible and so doing, inherently limit opportunities for economic crime in an ever-changing financial market environment.

To conclude the motivation for this research the following aspects are prominent: Economic crime is present in every country and in every industry, and the hedge fund industry is no exception. Internationally investors have suffered prejudice due to many reported hedge fund fraud cases, with many of the cases having devastating losses and little chance of remedy. By identifying what elements of hedge funds make them susceptible to economic crime, the trust in the management of society's savings can hopefully be improved.

Furthermore, hedge funds are specialised investment vehicles that are not understood by many. Therefore, this study could provide information on how the nature of hedge funds contributes to the susceptibility thereof for economic crime. This study will identify the elements of hedge funds that are susceptible to economic crime, such as the investment strategies of hedge funds and other elements that will be discussed in chapter 4.

Therefore, the contribution of this study will be of interest to hedge fund managers, hedge fund regulators, hedge fund investors and investigators of economic crime, including forensic accountants. This study could also contribute to the regulation of hedge funds area of research, as there has been a recent inclination of hedge fund regulation changes globally and limited research has been done on the matter.

1.2 Problem statement

Historically, hedge funds globally have operated under little or no regulation and have only recently been subjected to stricter regulations, such as was implemented in South Africa (Association for Savings and Investment South Africa, 2016). The adaptation of hedge fund managers to the new regulations are yet to be observed, but the risk of economic crime in hedge funds will still be present due to income pressure, and possible remaining loopholes in the regulation of hedge funds, which leads to the following problem statement:

What elements of hedge funds make them susceptible to economic crime?

This study will address the problem statement by doing an analysis of three case studies regarding hedge funds that were subject to economic crime, in order to identify elements of hedge funds that are susceptible to economic crime.

1.3 Research aim and objectives

To address the problem statement, the following general and specific research objectives will be addressed through theoretical and conceptual studies of literature.

1.3.1 Research aim

The purpose of this study will be to identify elements of hedge funds that make them susceptible for economic crime within the context of three case studies.

1.3.2 Research objectives

The problem statement will be addressed in the primary objectives of this research, which will be to:

- i. Understand the term “economic crime”, “hedge fund” and “hedge fund fraud”.*

This objective will be addressed through the review of literature as contained in chapters two and the sub-categories of the objective will be, to define the term “hedge fund” “fraud” and “economic crime” in order to formulate a working definition for “hedge fund fraud”.

- ii. Understand how hedge funds are used as vehicles for economic crime.*

This objective will be addressed through the review of selected reported case law as primary literature source, for selected hedge fund cases and the sub-categories of the objective will be to provide an overview of the hedge fund fraud cases identified for this study and to identify the economic crimes and related business irregularities committed within this context.

- iii. Identify elements of hedge funds which make them susceptible for economic crime.*

This objective will be addressed through the review of literature. Furthermore, the selected hedge fund cases and the sub-categories of the objective will be to identify which elements of hedge funds make them susceptible for economic crime.

1.4 Research design and research methodology

This section lays out the research approaches that will be considered to achieve the goal of this study. The plans and procedures of research will span the steps from broad assumptions to detailed methods of data collection, analysis and interpretation (Creswell, 2014:3).

1.4.1 Research design

Mouton (2001:49) explains that the term “research design” addresses the type of study which will be used to answer the problem statement. Mouton (2001:56) further explains that a research design’s point of departure is the research problem, and which focuses on the product and logic of the research.

To clarify the research design, the type of study needs to be identified. There are two main types of studies: empirical studies and non-empirical studies. In order to determine the type of study that needs to be conducted, one has to identify the object of research. Objects of research can either be in so-called World 1, the world of all physical bodies, in World 2, conceptual problems or in World 3, products of the human mind (Mouton, 2001:52).

As the research question of this study is a meta-analytical question, this study entails the analysis of a body of scientific knowledge on economic crime and related business related irregularities within hedge funds. According to Mouton’s definition (2001:52-54) this is a World 3 object of research as it is the result of human conceptualisation and generalisation based on observations from World 1, and experiences gained from World 2.

1.4.2 Research methodology

As research methodology indicates how the research will be conducted (Mouton, 2001:49) the ontology and epistemology of the research needs to be considered. Ontology is the nature of reality in which the research will be conducted (Creswell, 2014:23). The world can be viewed as either an objective reality, known as the realist view, or as a reality that depends on variables, known as the relativist view. Epistemology, on the other hand, encompasses the meaning of knowledge or what any individual considers as knowledge (Creswell, 2014:23). As the ontology and epistemology determines the paradigm in which the research will be conducted, it is important to state which view of reality will be adopted.

This study will be adopting the relativist view of reality, on the basis that the elements of hedge funds that may be susceptible for economic crime depend on many variables and circumstances. In other words, the elements that may influence hedge funds and their exposure to economic crimes and other business related irregularities may vary from one case to the next, and therefore are situation-specific, or situation relativist. The epistemology of a relativist view, which is applicable for this study, is that knowledge is viewed as a complex issue with multiple layers (Creswell, 2014:24).

The paradigm suitable for this study also supports the choice of a relativist view. If a realist view would have been chosen a positivist paradigm would have been adopted, which consists of

experiments to reach the objective and single truth. Unlike a positivist paradigm, the research conducted in an interpretivist paradigm will not attempt to establish a single truth, but rather gain a more subjective understanding of a phenomenon (Wang, 2015:334). Research conducted within the interpretivist paradigm requires the use of inductive reasoning from the stance of qualitative inquiry (Wang, 2015:310). According to Mouton (2001:118) inductive reasoning is when reasoning is inferred from a specific observation, or sample and inferred to a wider population. As this study will be examining a selection of cases that involve economic crime and business related irregularities within hedge funds to assist in answering the research question that is applicable to hedge funds in general, inductive reasoning is a suitable approach for this research.

A vast range of research methodologies reside under the interpretivist paradigm, but the methodology is most suitable for this study is a critical analysis. A critical analysis is when a researcher analyses available facts or information to make a critical evaluation of the material (Kothari, 2004:3). This study will review available literature, while deconstructing hedge funds to their respective elements, where each element will be critically evaluated to determine whether it contributes to the susceptibility of hedge funds to economic crime and related irregularities. The deconstruction of a phenomenon combined with the review of literature are methods that are often used in as part of a critical analysis and therefore supports the chosen methodology and research paradigm applied to this study.

1.5 Literature review

According to Ganchev (2014:20) hedge funds are some of the most popular investment vehicles in the large family of collective investment schemes. Hedge funds are predominantly ill-reputed within the financial and economic community. Their investment activity is often associated with creating crises on individual national financial markets or with infusing tension into the entire global financial market (Ganchev, 2014:20).

The review of available research indicated that one of the first journal articles on hedging as an investment strategy was done by Telser (1955) and titled "Safety first and hedging". Literature, around the time of the new millennium, such as Ackermann (1999) and De Brouwer (2001) discussed the performance, risk management, regulation and incentives of hedge funds. More recent literature, prior to the Global Financial Crisis of 2008, such as Botha (2005), Capco (2005), McCrary (2005), Stefanini (2006), Frush (2007), Tiffith (2007) and Brav *et al.* (2008) continued to address the same topics, as the literature that preceded it.

According to Sarna (2010:151), one of the largest Ponzi schemes in the history of financial scandals, the investment fund of Bernie Madoff (Madoff), continued for years without detection

until the financial market crash in 2008, when investors requested withdrawals from his fund, which consisted mostly out of alleged hedge funds. This led to a liquidity crisis and the discovery of the Ponzi scheme. Sarna (2010:147-148) also states that the value of this Ponzi scheme was US\$170 billion, and that Madoff was convicted of 11 felonies and sentenced to 150 years in prison.

Under the pressure of the financial crisis, several well-known and apparently reputable financial investment institutions were exposed as sophisticated frauds (Fenwick, *et al.*, 2015:103). The exposure of Madoff's Ponzi scheme, as well as other fraud schemes put hedge funds under the spotlight and led to several countries to review the regulatory environment of hedge funds in the aftermath of the Global Financial Crisis of 2008. Various authors such as Athanassiou (2012), Cassar and Garakos (2010), Ganchev (2015), Kim (2014), Lhabitant (2011), researched subjects that addressed the nature, internal controls, fees and regulation of hedge funds.

More research on these topics was necessary because according to Frush (2007:5), the hedge fund industry is dynamic in many ways and every hedge fund varies from the other. Nabilou (2017:5) ascribes this to the variable nature of hedge funds, in that a statutory definition of hedge funds which is adequately inclusive has been difficult to formulate.

Even though authors such as Ben-David *et al.* (2013), Cumming *et al.* (2010), and Pierre-Louise (2009) have done research on misreported hedge fund performance and stock price manipulation, only Johnson (2010) and Muhtaseb *et al.* (2008) have done research which reports on hedge fund fraud cases specifically and these research pieces focussed on hedge fund fraud cases within the USA only. Consequently, a large gap remains to reflect on the extent of economic crimes and other related business irregularities within hedge funds internationally.

Prior to the early 1990s, hedge fund fraud was not a worthy subject to study, as there rarely were cases to report, but with the increase of fraud to unseen levels in the 1990s, that all changed (Johnson, 2010:252). According to Sarna (2010:137), the SEC had brought 52 actions, totalling losses of approximately US\$1 billion, against hedge funds alleging fraud of all sorts by 2008. Although most managers do not set out to defraud investors from day one, many clearly have done so by capitalising on the lack of regulation and diverse nature of hedge funds, in order to escape the pressure from investors and the financial markets. According to Johnson (2010:261) among the 100 hedge fund fraud cases that he studied, 52 per cent of the fraudulent acts were preceded by substantial financial investment losses.

According to Kim (2014), the UK, the USA and Korea has begun with a regulatory transformation of their hedge fund industry, and South Africa implemented more rigorous hedge fund regulation in 2015 (Association for Savings and Investment South Africa, 2016).

The literature review, which forms part of the critical analysis, included, peer reviewed academic journals, case law, other academic research on the topic, extracts from relevant legislation, academic text books, websites of governing bodies that contributed to the academic field of hedge funds, economic crime, as well as a combination thereof, and web-based articles, newspapers and relevant surveys.

This literature review identified that hedge funds have been studied internationally for several years but that there is very limited research available on the susceptibility of hedge funds to economic crime. For the purpose of this study international sources were considered when researching this topic with literature from the United Kingdom (UK), South Africa and the USA as preferable sources, as the USA has the largest hedge fund industry globally. Specific focus was given to UK and South African case law pertaining to economic crime within hedge funds, as both these countries have similar legislative frameworks regarding economic crime.

Considering the recent change in hedge fund regulation in South Africa, understanding their susceptibility to economic crime is considered imperative to an attempt improve the management thereof and to identify further areas of research.

1.6 Selection of cases

As mentioned in the section above, as well as the problem statement this study will not cover the entire hedge fund industry, but rather identify the elements of hedge funds that are susceptible for economic crime through the analysis of the three case studies.

Stake (2005:443) explains that case studies are a common way of doing qualitative research and that it is not a methodological choice, but rather a choice of what is to be studied. Gray (2009:247) explains further that the use of case studies is especially useful when the researcher is trying to establish a relationship between a phenomenon and the context in which it is occurring. Case studies therefore serve to illustrate the relativity of data within a particular context.

For this research, the type of case study design will be multiple holistic. This entails the study of multiple cases but only a single unit of analysis can be identified and the aim is not to increase the sample but to replicate the findings of one case across several cases (Gray, 2009:257). The process of a multiple case study method is to develop a theory, select cases, write

individual case study reports for each case study and lastly analyse and conclude (Gray, 2009:251).

During this study, the above-mentioned method will be followed and an individual case study report will be written for each of the three cases of economic crime and business related irregularities. These case study reports form the foundation of Chapter 3 and the analysis thereof which follows in Chapter 4.

The selection of cases to be analysed, are examples of hedge funds affected by economic crime and business related irregularities in the UK and South Africa that were adjudicated or where significant investment losses were recorded. As the South African criminal law, banking law and financial law to a large extent stems from English law (Schreiner, 1967) the similarities in the legal systems of these countries will make it easier to identify the elements of hedge funds that are susceptible for economic crime and business related irregularities, because the industry functions within a comparable legal environment.

1.7 Chapter outline

Chapter 1: Purpose and scope of study

An introduction and background to economic crime and related business irregularities committed involving hedge funds are given, as well as a motivation for conducting the research due to the state of economic crime in hedge funds globally and in South Africa. The significance of the study, problem statement, research aim and objectives, research design, method for research, literature review and proposed outline of chapters are clarified.

Chapter 2: Understanding the term hedge fund fraud

The terms for fraud and economic crime are often used interchangeably and will be explained to create a working definition for hedge fund fraud. The definition of and key elements of hedge funds will also be discussed.

Chapter 3: Hedge funds as a vehicle for economic crime

Prominent case law in the United Kingdom and South Africa within the last ten years regarding hedge funds are discussed. The various hedge fund fraud schemes are identified and explained, as well as the discovery of hedge funds fraud.

Chapter 4: Identifying elements that make hedge funds susceptible to economic crime

Distinctive elements of hedge funds that make them susceptible for hedge fund fraud are identified and discussed critically.

Chapter 5: Conclusion and recommendations

Based on the objectives set out in chapter one, conclusions are made which illuminates recommendations regarding areas for further research based on the conclusions that were reached.

CHAPTER 2

UNDERSTANDING THE TERM HEDGE FUND FRAUD

The main objective of this chapter will be to explain the term hedge fund fraud. This will be done by forming an understanding of the term 'hedge fund', that will be explained by referring to various regulatory definitions of the term "hedge fund" as used in the United States of America (USA), United Kingdom (UK) and South Africa, as well as the terms 'economic crime' and 'fraud' as the term fraud can be used as a collective noun to refer to different forms of economic crime and other business irregularities, but can also be used to denote a specific type of crime in a strict legal context within the USA, UK and South Africa.

2.1 Understanding the term fraud as a specific crime and as a collective noun

The modern definition of fraud in the USA has been formed through case and statute law, but the roots can be traced back to the Latin word '*fraus*', which has a collective meaning of harm, deceit and wrongdoing (Silverstone *et al.*, 2012:17).

As stated in the introduction above the term fraud can, and is, generally used as a collective noun for economic crime and business irregularities which will be elaborated on in the sections to follow. However, the term fraud also refers to a specific crime in criminal law and term fraud will be further explained by referring to definitions from the UK Fraud Act (2006), South African common law and US legislation:

2.1.1 UK Fraud Act 2006

The UK Fraud Act (2006) received Royal assent on 8 November 2006 (UK Ministry of Justice, 2012:3). It was based on the recommendations in the UK's Law Commission's Report on Fraud in 2002 and a UK Home Office Fraud Law Reform consultation in May 2004, that proposed fraud law reform on the basis that the deception-based offences in the Theft Acts of 1968 and 1978 were too specific, overlapped and were outdated (UK Ministry of Justice, 2012:3). The UK Fraud Act (2006) was then enacted to make provision for the criminal accountability for fraud and the dishonest obtaining of services (UK Ministry of Justice, 2012:3).

Section 1 of the UK Fraud Act (2006) states that a person is guilty of fraud, if such a person is in breach of the offences listed in Sections 2, 3 and 4 of the Act. In terms of Section 2, 3 and 4 of the UK Fraud Act (2006) there are three punishable ways that an act of fraud may be conducted, which are: fraud by false representation (Section 2), fraud by failing to disclose information (Section 3) and fraud by abuse of position (Section 4).

Fraud by false representation, as set out in Section 2 of the UK Fraud Act (2006) is the making of a false representation by a person, with the intention to gain something for himself or someone else or to affect loss to someone else or to expose another to a risk of such a loss. According to Section 3 of the UK Fraud Act (2006), fraud by failing to disclose information is when a person fails to disclose information to another, even though there is a lawful obligation to do so, with the intention to gain something for himself or someone else or to affect loss to someone else or to expose another to a risk of such a loss. Section 4 of the UK Fraud Act (2006) defines fraud by abuse of position as the following: when a person occupies a position where it is their duty to protect, and not act against, the financial interests of another, but abuses their position and with the said abuse intends to gain something for himself or someone else or to affect loss to someone else or to expose another to a risk of such a loss.

The above Sections are relevant to instances of alleged hedge fund fraud in the UK, as they involve misrepresentations, insufficient disclosure and the abuse of position, which, according to Mohamed and Handley-Schachelor (2014:322) misleads the investors and regulators, as they rely on the presentations and disclosures and the fiduciary duty of the people in a position of power.

2.1.2 South African common law

Snyman (2014:32) defines crime as “conduct which accords with the definitional elements of the crime in question, which is unlawful and culpable”. According to Van Graan (2018:2) these definitional elements referred to by Snyman (2014:32) will depend on the specific crime in question. For the purpose of this study the definitional elements of economic crime and fraud will be considered.

As mentioned in the introduction of this section fraud can be a collective noun to refer to different forms of economic crime and other business related irregularities but can also denote a specific crime in a strict legal context. Within the South African legal context fraud is defined in terms of the South African common law as any unlawful act or omission by which a misrepresentation is made with the intention to defraud, which causes actual prejudice, or which is potentially prejudicial to another, whether there is personal benefit to the perpetrator or not (Snyman, 2008:531). Consequently then, the four elements of fraud in South Africa, according to Snyman, (2005:520) is: misrepresentation, prejudice or potential prejudice, unlawfulness and intention.

In addition to the strict legal context of fraud, as a collective noun fraud may also refer to economic crimes and other related irregularities. These generic references made to fraud and economic crime refer to wrongful or criminal activities to or in an organisation, intended to result

in the gain of money or benefits for the perpetrator (Van Romburgh, 2008:15). The following is a list of economic crimes that is included under the umbrella term of fraud (Snyman, 2014):

- i. Fraud;
- ii. Theft;
- iii. Removal of property for use;
- iv. Receiving of stolen property;
- v. Inability to give account of possession of goods suspected of being stolen;
- vi. Receiving of stolen property;
- vii. Embezzlement;
- viii. Forgery and uttering;
- ix. Theft by false pretences;
- x. Corruption;
- xi. Extortion;
- xii. Defeating or obstructing the course of justice;
- xiii. Perjury; and
- xiv. Organised crime.

2.1.3 US wire fraud and securities fraud

As hedge funds registered in the USA encompass the majority of hedge funds of the global industry (Citco Fund Services, 2017), it is important to note what framework is used in the USA to determine whether fraud has been committed within the hedge fund industry. The statutes of the USA do not define fraud in general but it does contain definitions for specific types of fraud such as wire fraud and securities fraud. However, in *Maturo v Gerard* (1985) the elements of fraud are stated as the following: “(1) that a false representation was made as a statement of fact; (2) that it was untrue and known to be untrue by the party making it; that it was made to induce the other party to act on it; and (4) that the latter did so act on it to his injury.”.

According to Zornow *et al.* (2018) the following are main regulatory provisions and legislation relevant to fraud in the USA:

- i. Section 32(a) of the Securities Exchange Act of 1934;
- ii. Section 24 of the Securities Act of 1933;
- iii. Sarbanes–Oxley Act of 2002;
- iv. Mail and wire fraud statutes (18 United States Code, Sections 1341 and 1343);
- v. Misapplication and embezzlement statute (18 United States Code, Section 656);
- vi. Fraudulent and fictitious claims statute (also known as the Criminal False Claims Act) (18 United States Code, Section 287);

- vii. Internal Revenue Code (26 United States Code, Section 7201 and 7206);
- viii. Computer Fraud and Abuse Act of 1986 (18 United States Code, Section 1030(a)(4));
- ix. False Statements Statute (18 United States Code, Section 1001); and
- x. Major Fraud Act of 1988 (18 United States Code, Section 1031).

Civil liability fraud action provisions, that may serve as predicates for criminal violations in certain circumstances, include (Zornow *et al.*, 2018):

- i. False Claims Act (also known as the Lincoln Law) (31 United States Code, Sections 3729 to 3733);
- ii. Sections 11, 12(a), and 17(a) of the Securities Act (15 United States Code, Sections 77k, 77l(a), 77q(a));
- iii. Sections 9, 10(b), 14, 16(b), and 18 of the Exchange Act (15 United States Code, Sections 78i, 78j(b), 78n, 78p(b), 78r);
- iv. Securities and Exchange Commission (SEC) Rules 10b-5 and 14a-9;
- v. Sections 4b, 6(c), and 6c of the Commodity Exchange Act;
- vi. Commodity Futures Trading Commission (CFTC) Rule 180.1; and
- vii. Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

Zornow *et al.* (2018) continues and states that the following are specific fraud offences under USA law:

- i. Securities fraud - Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 prohibit the use of deception, the making of a false statement, or engaging in an act that operates as a fraud or deceit in connection with the purchase or sale of any security. Sections 24 of the Securities Act of 1933 and 32(a) of the Securities Exchange Act of 1934 provide for criminal liability for securities fraud and require that the government prove that the violation was wilful;
- ii. Mail or wire fraud - The mail and wire fraud statutes, included in the United States Code number 18 Sections 1341 and 1343, prohibit devising or participating in a scheme to defraud that involves a material misrepresentation or omission and the use of the US mails or wires to further the scheme;
- iii. Bank fraud - The bank fraud statute prohibits the execution of, and any knowing attempt to execute, a scheme to defraud a financial institution to obtain property controlled by that institution by means of false pretences; and
- iv. Tax evasion - Tax fraud statutes prohibit wilful evasion or attempt to evade the payment of federal tax.

Hedge fund fraud as an economic crime may be prosecuted in accordance with the applicable specific fraud statutes mentioned above as there is no general crime of fraud within the legal framework of the USA (Zornow *et al.*, 2018) .

2.1.4 Using the term fraud as a collective noun for economic crime and other related business irregularities

Various organisations refer to the term “fraud” in a non-legalistic form, but rather uses it to refer to economic crime and other business related irregularities, as it is discussed in the paragraphs below.

2.1.5 International Audit Standard 240

The International Standards on Auditing (ISA), are accepted audit standards, by several countries, for the performance of a financial audit of financial information. ISA 240 addresses the auditor’s responsibilities relating to fraud in an audit of financial statements and paragraph 11(a) defines fraud as: “An intentional act by one or more individuals among management, those charged with governance, employees or third parties involving the use of deception to obtain an unjust or illegal advantage” with deception and intention as key words (International Auditing and Assurance Standards Board, 2016:170).

Within the international audit environment, this definition serves a particular purpose and is used to determine an auditor’s responsibilities relating to fraud in an audit of financial statements but cannot be used to prosecute or prove that this offence has been committed as a crime, as it was specifically written for the ISA’s (International Auditing and Assurance Standards Board, 2016:168-170).

2.1.6 PricewaterhouseCoopers

According to PwC, Economic Crime survey economic crime is a collective noun for the following: asset misappropriation, procurement fraud, bribery and corruption, human resources fraud, financial-statement fraud, cybercrime, money-laundering, accounting fraud, tax fraud, illegal insider trading, etc. (PwC, 2018:8).

This definition of economic crime includes offences such as fraud, corruption, insider trading and money laundering, but excludes theft and related offences such as forgery and uttering false documents. PwC includes asset misappropriation in their definition which is not a recognised criminal offence (PwC, 2018:8).

2.1.7 Association of Certified Fraud Examiners

The Association of Certified Fraud Examiners (ACFE) has developed a so-called occupational fraud classification system and defines occupational fraud as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the company's resources or assets. This classification system divides occupational fraud into three main categories namely: fraudulent financial statements schemes, asset misappropriation and corruption (Giles, 2012).

Fraudulent financial statement schemes are the overstatement and/or understatement (manipulation) of financial statement line items to manipulate the performance of a company to a desired result (Giles, 2012) and the ACFE (Association of Certified Fraud Examiners, 2018:11) has identified the following areas that are repeatedly targeted within financial statements namely: timing differences, improper revenue recognition, concealed liabilities and expenses, inadequate disclosure and improper asset valuation.

According to the Association of Certified Fraud Examiners asset misappropriation is the misuse or theft of an organisation's assets (Association of Certified Fraud Examiners, 2018:78). The category of asset misappropriation includes schemes involving billing, non-cash, skimming, expense reimbursement, check tampering, payroll, cash on hand, cash larceny and register reimbursement (Association of Certified Fraud Examiners, 2018:11). The ACFE divides asset misappropriation schemes in two sub-categories: cash schemes and schemes involving inventory and other assets (Association of Certified Fraud Examiners, 2018:11).

It is important to note that the misuse of assets is not a crime, but that the theft of assets is a criminal offence. This distinction is important as the weight and burden of proof of these transgressions in a court of law is not the same. The misuse or theft of assets can thus not be seen as the same type of transgression but should be distinguished from each other.

The distinction of different types of economic crimes is important in order to create an understanding of the framework of economic crime within hedge funds. This framework will be used when examining the case studies in chapter three and chapter four.

2.1.8 Conclusion

From the above it can be seen that the term fraud is used to indicate a specific offence in the various countries identified but can also be used as a collective noun to refer to economic crime and other business related irregularities.

The basic elements of the term “fraud” from a legalistic perspective can be summarised as a false representation, made with intent to the potential or actual prejudice of someone else.

However, the term fraud used as a collective noun for different economic crimes, includes *inter alia* fraud, theft, corruption, forgery, uttering of false documents, embezzlement, money laundering, cybercrime, insider trading, tax fraud, procurement fraud, financial statement manipulation, etc. as well as related business irregularities that includes conflict of interest, asset misappropriation, business misconduct and abuse of company assets as explained above. The term fraud in this instance is therefore used not only to refer to economic crimes but also includes other business irregularities that does not constitute crimes, like asset misappropriation.

For purposes of this research document the broader interpretation of the term fraud will therefore be used. In other words, the term fraud will be used interchangeably with economic crime to indicate reference to the collection of economic crimes and business related irregularities, unless it is clear from the context that the term fraud is used to indicate the specific crime of fraud.

2.2 Hedge funds

Hedge funds create a formidable platform for investors to create wealth (Frush, 2007:3), but what exactly is a hedge fund?

There is no statutory definition for the term “hedge fund” in the USA, the global hedge fund hub (Muhtaseb & Yang, 2008:179). This chapter will attempt to define the term “hedge fund” by using relevant definitions formulated by different security bodies in the USA, UK and South Africa.

Furthermore, when defining hedge funds, elements that distinguish hedge funds from mutual funds will be discussed. Once hedge funds are defined, it will be examined in order to determine how they may be used or exposed to economic crime, which will be elaborated on in chapter 4.

2.2.1 Defining the term “hedge fund”

According to Frush (2007:5), the hedge fund industry is dynamic in many ways; moreover, every hedge fund manager and hedge fund varies from the other. Therefore, a statutory definition of hedge funds that is adequately inclusive has been difficult to formulate (Nabilou, 2017:5) but various descriptions of hedge funds have been provided by relevant security bodies and companies.

Stefanini (2006:1) is of the opinion that to rely on the literal meaning of hedge funds as a definition, namely that these funds engage in hedging techniques, is deceptive because it relates to only one of the many traits and investment strategies of hedge funds. Frush (2007:4) supports this assertion as he states that many hedge funds do not hedge risk at all, but on the contrary that some hedge funds create even more risk.

2.2.2 USA definitions

In 2003 the SEC had a roundtable discussion regarding hedge funds and considered 14 different definitions. The most comprehensive definitions were the following (U.S. Securities and Exchange Commission, 2003b):

2.2.2.1 Definition 1

The first selected definition is contained in an SEC paper titled “Invest wisely: an introduction to mutual funds” (cited by U.S. Securities and Exchange Commission, 2003b):

“‘Hedge fund’ is a general, non-statutory term used to describe private, unregistered investment pools that traditionally have been limited to sophisticated, wealthy investors. Hedge funds are not mutual funds and, as such, are not subject to the numerous regulations that apply to mutual funds for the protection of investors - including regulations requiring a certain degree of liquidity, regulations requiring that mutual fund shares be redeemable at any time, regulations protecting against conflicts of interest, regulations to assure fairness in the pricing of fund shares, disclosure regulations, regulations limiting the use of leverage, and more” (cited by U.S. Securities and Exchange Commission, 2003b).

According to the definition above hedge funds are privately managed, have relaxed regulation when it comes to fund liquidity, disclosure, conflict of interest protection and the use of leverage. Hedge funds are also limited to qualifying investors and registration of the fund with a regulatory body is not required.

2.2.2.2 Definition 2

The second definition is extracted from a discussion paper of the Financial Services Authority (FSA) of the UK, titled “Hedge funds and the FSA” (cited by U.S. Securities and Exchange Commission, 2003b):

“There is no universally accepted meaning of the expression ‘hedge fund’; indeed, many competing (and sometimes partially contradicting) definitions exist. A summary definition frequently used in official sector reports is ‘any pooled investment vehicle that is privately organised, administered by professional investment managers, and not widely available to the

public'. The term can also be defined by considering the characteristics most commonly associated with hedge funds. Usually, hedge funds: are organised as private investment partnerships or offshore investment corporations; use a wide variety of trading strategies involving position-taking in a range of markets; employ an assortment of trading techniques and instruments, often including short-selling, derivatives and leverage; pay performance fees to their managers; and have an investor base comprising wealthy individuals and institutions and a relatively high minimum investment limit (set at US\$100,000 or higher for most funds)" (cited by U.S. Securities and Exchange Commission, 2003b).

The above definition thus describes a hedge fund as an exclusive private investment vehicle, managed by professional investment managers that apply diverse investment strategies, require a high minimum investment and pay performance fees to hedge fund managers.

2.2.2.3 Definition 3

The third definition was taken from an SEC document titled "Hedging your bets: A heads up on hedge funds and funds of hedge funds" (cited by U.S. Securities and Exchange Commission, 2003b):

"Like mutual funds, hedge funds pool investors' money and invest those funds in financial instruments in an effort to make a positive return. However, unlike mutual funds, hedge funds are not registered with the SEC. This means that hedge funds are subject to very few regulatory controls. In addition, many hedge fund managers are not required to register with the SEC and therefore are not subject to regular SEC oversight. This lack of regulatory oversight has enabled the availability of hedge funds to accredited investors and large institutions and have limited their investors through high investment minimums (e.g., \$1 million). Many hedge funds seek to profit in all kinds of markets by pursuing leveraging and other speculative investment practices that may increase the risk of investment loss" (cited by U.S. Securities and Exchange Commission, 2003b).

The above definition states that hedge funds are mostly unregistered investment vehicles for qualifying investors, with a high minimum investment, and apply speculative investment strategies to make positive returns.

2.2.3 Definition 4

Finally, this definition was quoted from a document titled "All about hedge funds" by Robert Jaeger (cited by U.S. Securities and Exchange Commission, 2003b):

“A hedge fund is an actively managed investment fund that seeks attractive absolute return. In pursuit of their absolute return objective, hedge funds use a wide variety of investment strategies and tools. Hedge funds are designed for a small number of large investors, and the manager of the fund receives a percentage of the profits earned by the fund. Hedge fund managers are active managers seeking absolute return” (cited by U.S. Securities and Exchange Commission, 2003b).

This definition of a hedge fund highlights the diverse investment strategies of hedge funds to achieve absolute returns for qualifying investors as hedge fund managers receive a performance fee based on the returns earned by the hedge fund.

2.2.3.1 Conclusion

When considering the four SEC hedge fund definitions highlighted above, the following characteristics of hedge funds have been identified as commonalities and is echoed by Brav *et al.* (2008:1735) when they identified these characteristics of hedge funds from all 14 definitions discussed by the SEC during their round table discussion, namely:

- The first is that hedge funds are privately organised pooled investments;
- The second characteristic is that hedge funds are managed by professionals and receive performance-based compensation;
- Thirdly, hedge funds limit their investors to qualifying investors due to a high minimum investment; and
- Lastly, they operate with little regulation and registration requirements.

2.2.4 UK definition

In the UK, hedge funds are classified as Alternative Investment Funds (AIF's) contained within the Alternative Investment Fund Managers Directive (AIFMD), a European Union-wide framework for monitoring, supervising and strengthening the market in alternative funds (Financial Conduct Authority, 2016). The AIFMD was implemented in the UK on 22 July 2013 (Financial Conduct Authority, 2016).

Consequently, hedge funds have been grouped under the following definition of an AIF according to article 4 paragraph 1(a) of Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011, on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010: 1

(Financial Conduct Authority, 2016). For the purpose of this Directive, the following definitions shall apply:

“‘AIFs’ means collective investment undertakings, including investment compartments thereof, which:

- (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and
- (ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC.”

When the definition of an AIF is applied to hedge funds, hedge funds are pooled investment vehicles with specified investment strategies, for the benefit of the qualifying investors and do not require authorisation in accordance with the 2009 AIFMD. When the above definition is considered no reference is made to the minimum investment, hedge fund managers or performance fees, which are some of the characteristics that distinguish hedge funds from other investment funds.

2.2.5 South African definition

Similarly, to the UK, South Africa adopted new regulations for hedge funds which redefined hedge funds within South Africa. On 25 February 2015, the South African Minister of Finance made a declaration published in the Government Gazette (Vol. 596, No. 38503), hereinafter referred to as ‘the Declaration’, in terms of Section 63(1) of the Collective Investment Schemes Control Act, 2002 (Act 45 of 2002) that the business of a hedge fund is henceforth classified as a collective investment scheme.

Paragraph two of the declaration defines the business activity of a hedge fund as:

“an arrangement in pursuance of which members of the public are invited or permitted to invest money or other assets and which uses any strategy or takes any position which could result in the arrangement incurring losses greater than its aggregate market value at any point in time, and which strategies or positions include but are not limited to - (a) leverage; or (b) net short positions”.

Hedge funds in South Africa are thus defined as investment schemes that implements leverage, short positions, or derivative positions, for the purposes of improving returns or to protect the assets against market exposures, as investment strategies (Department of National Treasury, 2012:4). Derivatives are financial instruments whose value are derived from the value of several other things such as a physical commodity, a security, price index, etc. (Martin, 2012:98).

South African hedge funds are further classified as a Qualified Investor Hedge Fund or a Retail Hedge Fund according to the declaration published in the Government Gazette (Vol. 597, No. 38540) in terms of Sections 42, 90(2) and (4), and 114(4)(b) of the Collective Investment Schemes Control Act (45 of 2002).

Paragraph one of the aforementioned Government Gazette (Vol. 597, No. 38540) defines a Qualified Investor Hedge Fund, as a hedge fund in which only qualified investors may invest. Qualified investors, as defined in Section 1 of said Government Gazette (Vol. 597, No. 38540), invest a minimum of R1 million per hedge fund and has evident financial and business experience and knowledge about the various advantages and risks of investing in a hedge fund or they have acquired the services of a financial service provider that possesses this experience and knowledge. A Retail Hedge Fund is also defined in the Government Gazette (Vol. 597, No. 38540), but unlike Qualified Investor Hedge Funds there is no qualification on the type of investor therefor any investor is free to invest in this type of hedge fund.

According to a media release of the Association for Savings and Investment South Africa dated 11 October 2019, this classification, between a Retail- and a Qualified Investors hedge fund, is the first tier to hedge fund classification (Association for Savings and Investment South Africa, 2019). Three additional tiers have been added to distinguish between identical or substantially similar objective and investment policy and will be applied from 1 January 2020 (Association for Savings and Investment South Africa, 2019).

The second tier considers the geographical exposure of the hedge fund and is either classified as (Association for Savings and Investment South Africa, 2019):

- i. South African – where a minimum of 60 per cent of the investment portfolio is in the South African market;
- ii. Worldwide – where the investment portfolio invests in foreign markets and in South Africa with no limits on local and foreign investments;
- iii. Global – where a minimum of 80 per cent of the investment portfolio is invested outside of South Africa, with no specific geographical limitation; and
- iv. Regional – where a minimum of 80 per cent is of the investment portfolio is invested in a specific geographical foreign market.

The third tier will classify hedge funds according to their managers' investment strategies namely: Long Short Equity, Fixed Income, Multi-strategy and Other (Association for Savings and Investment South Africa, 2019). Long Short Equity Hedge Funds are investment portfolios that generate the majority of their returns from positions in the equity market in relation to the movement of the equity market (Association for Savings and Investment South Africa, 2019).

Fixed Income Hedge Funds are investment portfolios that invest in financial instruments and derivative instruments that are sensitive to movements in the interest rate market (Association for Savings and Investment South Africa, 2019). Multi-Strategy Hedge Funds are investment portfolios that over time do not rely on a dominating single asset class to generate investment opportunities but rather apply variable strategies and invest in different asset classes (Association for Savings and Investment South Africa, 2019). Other Hedge Funds are investment portfolios that apply strategies that does not fit into any of the above mentioned classification groupings (Association for Savings and Investment South Africa, 2019).

Lastly, the fourth tier will only be applied to Long Short Equity hedge funds and classify these hedge funds according to market exposure (Association for Savings and Investment South Africa, 2019). Hedge funds with a net equity market exposure in excess of 25 per cent will be classified as Long Bias Equity hedge funds (Association for Savings and Investment South Africa, 2019). Market Neutral hedge funds will be assigned to hedge funds that have very little direct exposure to the equity market (Association for Savings and Investment South Africa, 2019). Investment portfolios of hedge funds that follow a very specific strategy within the equity market will be classified as Other Equity hedge funds (Association for Savings and Investment South Africa, 2019).

2.2.6 Conclusion on hedge fund definition

For purposes of this study a hedge fund is defined as an investment instrument consisting of selected privately pooled investments for qualifying investors not commonly available to the general public, administered by a professional investment manager, who are also invested in the hedge fund and aims to make a positive return by using different investment strategies in return for performance fees and operates under less regulation than other investments.

2.3 Key characteristics of hedge funds

In order to discuss the key characteristics of hedge funds, it will be compared to a mutual fund's characteristics to demonstrate the key characteristics of a hedge fund.

2.3.1 Introduction

Investing in a hedge fund is rather different from investing in a mutual fund (Frush, 2007:15). This section will identify the most commonly identifiable characteristics of hedge funds to understand what makes hedge funds different from mutual funds and how these characteristics contribute to the susceptibility of hedge funds to economic crime.

2.3.2 Hedge fund investors and initial investments

In South Africa mutual funds are defined as open ended investment companies according to Section 1 of the Collective Investment Schemes Control Act (2002). Open ended investment companies have approved share capital and is structured to issue shares of different classes to investors, where each class represents a different portfolio with a specific investment policy (Collective Investment Schemes Control Act, 2002).

The UK defines an open-ended investment company, in Section 236 of the applicable act, as a collective investment scheme which satisfies both the property condition, as well as the investment condition (Financial Services and Markets Act, 2000). The property condition is that the property belongs beneficially to and is managed by, or on behalf of, a body corporate with the purpose of spreading investment risk and giving its members the benefits resulting from the management of those funds (Financial Services and Markets Act, 2000). The investment condition is that a reasonable investor would expect that he would be able to realise, within a reasonable period, his investment and be satisfied that his investment would be realised according to the value of property in respect of which the scheme makes arrangements (Financial Services and Markets Act, 2000).

According to Lhabitant (2011:52) hedge funds target high net worth investors in order to generate positive returns and protect the fund capital. These targeted investors are more likely to understand the complexities of hedge fund strategies, as they are sophisticated investors and due to this fact, the hedge funds comply with investor requirements (Lhabitant, 2011:53).

According to De Bouwer hedge fund investors are limited, which implies a high initial investment. Initial hedge funds investment differs from mutual funds. The minimum initial investment of a mutual fund is usually US\$1,000 and investors may withdraw their investments at any time at the relevant market price (De Bouwer, 2001:12). According to De Bouwer (2001:12), hedge funds contrast with mutual funds in that they have high initial investment requisites that range between US\$100,000 and US\$5 million. However, De Bouwer (2001:12) and Frush (2007:16) state that the most common range for a minimum investment is between US\$600,000 and US\$1 million.

2.3.3 Hedging and hedge funds

Historically, hedging made its first appearance in the agricultural sector where there were two basic forms of hedges, short hedges and long hedges (Telser, 1955:3). If a merchant purchased stock of a certain commodity at a given spot price, the merchant would like to protect himself against the risk of the spot price falling before selling his stock and therefor sold the same amount of futures of the same commodity (Telser, 1955:3). In this instance it is said that the

hedger is short in the futures, which makes this a short hedge. A long hedge refers to the instance where a merchant sells a forward contract and buys futures, because the merchant does not have stocks on hand (Telser, 1955:4). Such a merchant is long in futures and is short in the spot commodity. The long hedger does not hold stock, whereas the short hedger does.

In the modern era, the basic principle of hedging has remained the same, investors hedge one investment by making another one, but the methods of hedging have increasingly become more complicated. Today the use of derivative instruments, such as options and futures, are the most common way of hedging (Döhring, 2008:5). In section 2.2.8, this study elaborates on How these instruments as they are used in investment strategies.

The first significant difference between mutual funds and hedge funds regarding hedging is that mutual funds cannot protect their portfolios against descending markets, unless they stay liquid or sell. Also, mutual funds are not allowed to short sell their stock, as they do not have the mandate to take such high leverage positions. However, hedge funds can be protected by hedging strategies (Stefanini, 2006:1).

It is important to note that even though they are called “hedge” funds, they do not always adopt hedging strategies but other high-risk investment strategies as well and that some hedged mutual funds are making its appearance in the market recently as a hybrid type of fund (Stefanini, 2006:1).

2.3.4 Organisational structure

The organisational structure of mutual funds aligns perfectly with their scope of activity (Ganchev, 2015:33). It consists of many separate divisions that all service the management of the portfolio, such as accounting, marketing, investment analyses, etc. (Ganchev, 2015:33). The internal structure of a mutual fund is very specialised and developed (Ganchev, 2015:33). Mutual funds are currently viewed as dependent economic entities where they, after being established, appoint an expert management company to assist in the execution of proper and diligent management (Ganchev, 2015:29). Mutual funds are managed by a board where the inclusion of independent directors is compulsory for a specified percentage of the board. In the UK, the FCA suggests that 25 per cent of fund management boards should be independent (Romeo, 2017) and in South Africa the King IV Report on Corporate Governance was adopted stating that the majority of the board members should be non-executive directors and independent (Deloitte, 2017). This helps to ensure that the mutual fund is managed objectively.

Compared to the organisational structure of mutual funds, hedge funds' management structure is considerably simplified (Ganchev, 2015:32). A smaller and flatter structure means that the management of hedge funds are executed by two or three key persons (Frush, 2007:14). This

small group of managers ensures that decision making within hedge funds is even more robust (Frush, 2007:14).

There are four main participants within the hedge fund structure, with the first being the founder, also referred to as sponsors or managers. The establishment of the hedge fund and its investment portfolio and policy are the founders' primary responsibility (Ganchev, 2015:34). The second participant is the managing company or investment manager, and it is their responsibility to execute the investment policy and operational management of the hedge fund (Ganchev, 2015:35). Thirdly, the administrator acts as the last functional unit of the hedge fund and is responsible for various specialised features such as: calculating the net asset value, adjusting the net worth according to the incremented management fees, preparation of financial statements and finalising all issues regarding taxes (Ganchev, 2015:35). Lastly, most hedge funds have a legal advisor which assists the managers of the fund with all legal matters, such as the establishment of the fund, any disputes, communication with authorities, etc. (Ganchev, 2015:34).

Ganchev (2015:26) points out that the ability of hedge fund managers to choose the right investment vehicle and strategy combination is essential for a hedge fund to reach its primary goal. A lot of trust is consequently placed on the skills of the hedge fund manager and the choices they make to adapt and respond to changes in the market (Frush, 2007:14).

According to the 2015 PwC Global Hedge Fund Distribution Survey (2015:18) the experience or longevity of the portfolio manager is the second ranked key factor that investors consider when selecting hedge fund investments. Another factor, ranked fourth, is the reputation of the investment manager. Thus, trust is placed in the ability, experience and reputation of the hedge fund manager to a higher extent than with mutual funds, as the hedge fund manager has a broader mandate when executing its investments and this trust can easily be abused (PwC: 2015).

2.3.5 Fee structure

The most important difference between hedge funds and mutual funds is the fund manager's fee structure. Mutual fund managers' fees are regulated since mutual fund managers are employees and not co-owners of the fund (De Bouwer, 2001:12). Ganchev (2015:31) reiterates that mutual fund managers' funds are subject to legal provisions, which highlights the importance of investor protection within mutual funds.

Mutual funds charge an investment management fee that normally varies between 1 and 1.75 per cent of the net value of assets under management (Frush, 2007:25). This type of fee is calculated daily and the price of the fund is adjusted accordingly. As the mutual fund absorbs

the cost of this fee, investors will rarely see that these fees are deducted from their accounts (Frush, 2007:24). Hedge funds also charge investment management fees, which are generally around one per cent (Frush, 2007:26). This fee is smaller in comparison to mutual fund fees and is not charged in order to make a profit but is generally used to cover operating costs of the hedge fund (Ganchev, 2015:31).

In contrast with mutual funds, hedge fund managers also own capital in their fund and are co-owners of the hedge fund, which gives them a personal incentive to chase absolute positive returns at all costs (Ganchev, 2015:31-32). This is a factor to take into consideration with regards to the performance incentive fee that hedge fund managers' charge in addition to the investment management fee. Since the establishment of the first modern hedge fund the performance incentive fee was set at 20 per cent and has remained in this range (Ganchev, 2015:31). This was confirmed by Tiffith (2007:500) when he stated that hedge funds charge a high-performance fee of 20 per cent. Mutual funds typically charge no incentive fees, but when they do, it is to a limited extent and not as high of a percentage as hedge funds (McCrary, 2005:3-4).

2.3.6 Flexible investment strategies

According to Ganchev (2015:23) mutual funds follow the contemporary portfolio theory when it comes to portfolio management. This entails that mutual funds operate on the assumption that capital markets are efficient and employ long term conventional investment strategies, which can reduce or eliminate systematic risk (Ganchev, 2015:23). Lhabitant (2011:54) elaborates further by stating that mutual funds have limited charters regarding investment strategies that are driven by regulators and industries, whereas hedge funds have a broader spectrum of investment styles.

On the other hand, hedge fund strategies are flexible investment strategies that entail active, short term and dynamic management strategies for hedge fund portfolios (Ganchev, 2015:24). These strategies may range from being non-directional and less volatile than traditional markets, to being completely directional with a high level of volatility (Lhabitant, 2009:6). Lhabitant (2011:55) later states that these diverse investment strategies are the reason that the hedge fund managers can adapt to market conditions so well and is at the centre of the level of positive returns achieved. Investment strategies applied within hedge funds is an important characteristic, as it is the third-ranked key-factor that investors consider when selecting hedge fund investments (PwC, 2015).

2.3.7 Hedge fund categories

Hedge funds are sorted in different categories based on, firstly, their management strategies and, secondly, in terms of the market or sector (Stefanini, 2010:13). Fevurly (2013:167) states that each of these categories has one or more subcategories to describe the hedge fund in more detail and the term “strategy” is used in a broad sense to classify a hedge fund’s investment orientation. The nature of hedge fund management styles is so vast and complex, therefor the aim of this section is to give an overview of the most prevalent strategies.

According to Fevurly (2013:167), there are many types of hedge funds, but they are usually classified into four main categories namely: equity hedge funds, relative value funds, event-driven funds and global macro funds. Stefanini (2010:14) states that hedge funds can be classified as one of the following management strategy genres: relative value, event driven, directional, long/short equity and other. Frush (2007:19-22) categorises hedge funds into four styles: tactical or directional, relative value, event-driven and hybrid. Lhabitant (2009:7) classifies hedge funds as either tactical, equity long/short, event-driven, relative value arbitrage or other.

From the above, one notices that researchers partially differ in the manner in which main categories for hedge funds are classified. The reason for this is that the investment strategies applied in hedge funds are so vast, that it is difficult to reach a global consensus. As it is critical to have a basic understanding of the underlying hedge fund strategies and their differences in order to develop an understanding of how hedge funds operate, the main investment strategies will be laid out below by using Fevurly’s classification framework as the foundation.

2.3.7.1 Relative value

Strategies that are classified in this genre are arbitrage transactions that generate absolute returns from the price discrepancies of two related shares rather than from the direction of the market (Stefanini, 2010:14). Fevurly (2013:167) goes on by stating that, theoretically, these price discrepancies of shares shouldn’t be possible in an efficient market, nevertheless mispricing does exist which makes arbitrage possible. These strategies include convertible bond arbitrage, mortgage arbitrage, fixed income arbitrage, market neutral and yield alternatives.

2.3.7.2 Event driven

Returns are generated in an event-driven strategy by taking advantage of a special circumstance that occurs due to significant events that take place in the lifecycle of a company (Ackermann *et al.*, 1999:843). The main significant events that hedge funds invest in are financial distress of a company or companies that have filed for bankruptcy, mergers, spin-offs,

business acquisitions, liquidations and restructuring (Stefanini, 2010:207). The biggest risk related to this strategy is the non-realisation of the event, as the profit of the hedge fund is dependent on the event taking place (Fevurly, 2013:167). Examples of event driven strategies are merger arbitrage, credit arbitrage, private issues, special circumstances, distressed securities and activist investors.

2.3.7.3 Equity

Equity hedge funds, also known as directional hedge funds, take advantage of market trends rather than the analysis of single shares and are a macro type of strategy (Stefanini, 2010:14). Fevurly (2013:167) elaborates further and describes equity hedge funds as funds that goes long on shares that the manager believes will increase in value, while simultaneously shorting shares that the hedge fund manager believes will depreciate. Equity fund management strategies include short-sellers, market neutral, long or short equity and emerging market strategies (Fevurly, 2013:167).

2.3.7.4 Global Macro

In general, the global macro strategy has the highest risk and return profile of all the hedge fund strategies and is therefore also highly leveraged (Fevurly, 2013:168). Global macro funds invest in the price movements of equity, currency, commodities, interest rates, bonds, options, futures and other forms of derivative securities (Fevurly, 2013:168). The hedge fund managers, according to Fevurly (2013:168), apply macro-economic principles to identify disruptions in asset prices and these disruptions are pursued anywhere in the world, hence the name global macro. Fevurly (2013:168) further states that these funds can become quite large, as they have the widest mandate and managers may invest in any market or instrument, which makes these funds quite diverse.

2.3.7.5 Other

The multiple strategy is not part of Fevurly's four main strategy classes, but it is a strategy that is becoming more popular and is therefore worth mentioning. According to Brand (2014:46) the multiple strategy is when one hedge fund invests in another hedge fund and this is then called funds of hedge funds. There are two types of funds of hedge funds, namely a diversified fund that allocates capital to a variety of fund types, which is called the multiple strategy approach, and a niche fund that allocates capital to a specific type of fund and further diversifies across different hedge fund managers – the multiple manager approach (Brand, 2014:46). This strategy enables the hedge fund managers to have access to higher minimum investments than individual investors could afford and creates an additional fee to compensate the fund of funds manager (Botha, 2005:22).

Other emerging strategies in the market are long or short credits, energy trading, structured finance, real estate, natural events, index arbitrage, statistical arbitrage and volatility trading - just to name a few (Stefanini, 2010:14).

2.3.8 Performance

Stefanini (2006:2) states that the performance of a mutual fund is measured according to a benchmark, which makes the performance of the mutual fund a relative performance, and managers of mutual funds measure risk in correlation with the benchmark. Simply put, relative performance is the attempt to surpass your peers in performance (Frush, 2007:8). Frush (2007:8) continues to explain that relative performance gives no regard to whether a return is positive or negative, if it surpasses the benchmark, as set by the benchmark index, it reflects a positive relative performance. For example, if a manager earns five per cent when the index return is three per cent, then the manager is producing good relative performance. A manager also produces good relative performance, if he earns a negative three per cent return when the index return is negative five per cent.

According to Stefanini (2006:1), hedge funds' primary objective on the other hand is to guarantee absolute returns under any circumstances. Absolute returns are returns that are positive, regardless of the degree of positive returns delivered. For example, if a hedge fund manager earns one per cent it achieved its primary objective in reflecting an increase and if a manager earned a 25 per cent return, it achieved its secondary objective of attaining an attractive positive return. Absolute returns are achieved by the employment of different investment strategies, but by striving for absolute returns there are no benchmarks for measurement in hedge funds (Stefanini, 2006:1).

The performance of hedge funds also results from active management decisions and skill-based strategies and the use of non-traditional investment paradigms, for example, the efficient market hypothesis (Lhabitant, 2011:54). The direction of the markets in which mutual funds invest, influences the future return of mutual funds, whereas the future return of hedge funds has a low correlation with the direction of financial markets. Frush (2007:9) supports this statement when he affirms that hedge fund managers aim to manage the funds in such a manner that the state of the overall market, its ups and downs, will not be significant.

According to the 2015 PwC Global Hedge Fund Distribution Survey (PwC, 2015), performance is ranked as the most significant key factor for investors when selecting hedge fund investments. Investors have gravitated towards the larger hedge funds with strong performance, deep resources, recognised brands and longevity. Thus, the immense pressure that is placed on the hedge fund managers to deliver levels of performance that delivers their desired incentive fees,

attracts new investors and satisfies the current investors can be a dangerous element of hedge funds (PwC, 2015).

2.3.9 Liquidity considerations

Liquidity is an important issue for all investors and with mutual funds there is a maximum level of liquidity. However, the nature of hedge funds offers a minimal level of liquidity to investors (Ganchev, 2015:26). This results from the fact that mutual funds are legally required to publish daily issue and redemption prices of their shares, as investors of mutual funds may withdraw their investment at any moment, but as the scope of hedge funds are much smaller and the investors of hedge funds are sophisticated investors, daily liquidity is not a requirement as it is with mutual funds (Ganchev, 2015:27-29). When hedge fund investors of hedge funds wish to withdraw their investment, they are only permitted to do so at specific intervals (Frush, 2007:17). De Bouwer (2001:11) affirms this by stating that investments in hedge funds are usually fixed for a certain period, normally one calendar year.

The most common stipulation for hedge funds is that investments and withdrawals are allowed annually, but some hedge funds are more flexible allowing investments and withdrawals monthly or quarterly (Frush, 2007:17). The term “lock-up” is often used in the hedge fund industry to refer to these liquidity restrictions.

A lock-up period can also be the period that new investors must wait before they are eligible for the liquidity stipulations of the hedge fund, which makes it easier for hedge fund managers to apply investment strategies that would otherwise not been possible (Frush, 2007:17). For example, if a hedge fund stipulates it has a lock-up period of one year and a monthly liquidity provision, a new investor that invests on 1 January 2017, will be eligible for the liquidity provision on 31 January 2018.

The longer the lock-up period, the longer the hedge fund managers must employ and adapt their investment strategies and deal with the losses incurred, as money can be invested that would otherwise have been assigned to serve as a buffer for investment redemptions (Ganchev, 2015:29).

2.3.10 Risk profile

Mutual funds can be classified according to their risk profiles, namely low-, moderate- and high-risk (Ganchev, 2015:25). Hedge funds are not classified by their risk profiles, but according to the investment strategies that are employed (Fevurly, 2013:167). Hedge funds' primary objective is to achieve absolute returns, and therefore hedge funds are allocated a high-risk profile.

Once again, it should be emphasised that the risk profiles of mutual funds and hedge funds have different origins. The risk profile of a mutual fund stems from systematic risk, risk that stem from the entire market, while the risk profile of hedge funds stems from unsystematic risk, risk that stem from a specific industry, segment or type of security (Ganchev, 2015:25).

2.3.11 Regulation

As mutual funds manage a substantial amount of public financial capital, they are regulated and monitored by regulatory bodies that enforce certain limitation and restrictions regarding the permitted investments for mutual funds (Stefanini, 2006:1 & Ganchev, 2015:32). These regulatory bodies also protect the investor by burdening the management company with certain requirements regarding capital adequacy, business processes, etc.

In contrast to mutual funds, hedge funds are subject to relatively weak institutional control and supervision (Ganchev, 2015:32). Internationally, hedge fund regulation in a broad sense has been absent of rigorous regulation and gives managers liberty to determine their own management style, what type of instruments they want to invest in, the organisational structure and legal form (Stefanini, 2006:2).

In recent years, regulatory bodies have tried to make the activities of hedge funds more transparent, but despite their efforts, hedge funds still actively seek obscurity within their new regulatory framework (Ganchev, 2015:32).

One might ask why hedge funds seek obscurity? Ganchev (2015:32) elaborates further on this matter by stating that hedge funds pursue obscurity to protect the secrets behind their investment policies, as it may influence the leverage mechanisms that hedge funds employ, which in turn may lead to the hedge funds going bankrupt.

2.3.12 Conclusion on characteristics of hedge funds

Based on the discussion above the table below summarises the differences between hedge funds and mutual funds:

Table 1 - Key characteristics of mutual funds and hedge funds

Key characteristic	Mutual fund	Hedge fund
Investors	Unlimited number of investors.	Limited number of usually high net worth investors.
Initial investment	Relatively low minimum investment, for example a	Relatively high minimum investment, for example a

Key characteristic	Mutual fund	Hedge fund
	minimum amount of US\$1,000 on average in the USA.	minimum amount of US\$1 million on average in the USA.
Hedging	Not allowed to short sell its position.	May apply hedging strategies to reduce investment risk.
Organisational structure	Developed, specialised internal structure and managed by a management company.	Streamlined structure with only two or three key personnel members.
Fee structure	Management fees between one and 1.75 per cent.	Management fees up to one per cent and performance fees up to 20 per cent.
Investment strategies	Limited charters regarding investment strategies that are driven by regulators and industries.	Broader spectrum of flexible investment strategies that entail active, short term and dynamic management strategies.
Performance	Measured according to a benchmark, which makes the performance of the mutual fund a relative performance.	Measured according to the hedge funds ability to achieve absolute returns that are positive.
Liquidity	The maximum level of liquidity due to daily liquidity as a requirement.	A minimum level of liquidity due to lock-up periods and no need for daily liquidity.
Risk profile	Stems from systematic risk and may be used to classify mutual funds.	Stems from unsystematic risk, but not used to classify hedge funds.
Regulation	Regulated and monitored by regulatory bodies that enforce certain limitations and restrictions regarding the	Subject to relatively weak institutional control which gives managers liberty to determine their own management style,

Key characteristic	Mutual fund	Hedge fund
	permitted investments for mutual funds.	what type of instruments they want to invest in, the organisational structure and legal form.

Hedge funds' intrinsic characteristics afford them the ability to create a return on investment that is higher than the average investment by implementing aggressive investment strategies with a very low correlation to traditional investments, have a driven manager and invest in a hedge fund of funds (Fevurly, 2013:172).

In addition to the combination of advantages and disadvantages that the characteristics of hedge fund create, they are also the reason that each hedge fund will differ from the other, some more greatly than others, with important differences such as size, composition, strategies employed and culture (Frush, 2007:5). These differences inevitably lead to enormous variances in the levels of risk, volatility and performance of the hedge funds.

The fee structure, regulation, investors, performance, investment strategy risk and return ratios and other contributing factors may have an influence on the type of fraud scheme that could be realised within the hedge fund (Fevurly, 2013:172).

An understanding of economic crime and business related irregularities and hedge funds is thus a critical part in the analysis of the susceptibility of hedge funds to fraud, because hedge fund fraud schemes can only be identified and explained properly, once there is an understanding of hedge funds and how they operate.

2.4 Conclusion on hedge fund fraud definition

According to a testimony by William H. Donaldson, the 2003 chairperson of the SEC, the following are examples of hedge fund fraud (U.S. Securities and Exchange Commission; 2003a), even though some of these examples are not technically considered to be fraud as a specific crime in the UK or South Africa:

- "Making false or misleading statements in offering documents";
- "Misappropriating assets";
- "Market manipulation in a variety of guises";
- "Reporting false or misleading performance, including with respect to valuation of securities"; and

- “Fraudulently allocating investment opportunities”.

Although the SEC a USA regulator lists all the aforementioned examples as fraud, all of the examples, given above, fall within the broad definition of economic crimes, which are recognised in the UK and South African, which can therefore be used as a guideline when identifying economic crime within hedge funds.

Therefore, for the purpose of this study the term hedge fund fraud, refers to fraud, used as a collective noun for different types of economic crime and/or business related irregularities, committed in relation to hedge funds.

CHAPTER 3

HEDGE FUNDS AS A VEHICLE FOR ECONOMIC CRIME

In this chapter two prominent judgements pertaining to hedge funds in the United Kingdom (UK) and South African judgements against investment managers within the past ten years are discussed. The various hedge fund fraud schemes are identified and explained, as well as how it was uncovered.

The first UK hedge fund that will be discussed is the hedge fund of Dynamic Decisions Capital Management (DDCM). This case led to one of the biggest fines issued by the Financial Conduct Authority (FCA), previously the Financial Services Authority (FSA), to a hedge fund manager in recent years, as will be discussed below. The second UK hedge fund that will be discussed is the hedge fund of Weavering Capital where its hedge fund manager received 13 years in prison for his actions. The last case that will be discussed is the South African hedge fund the Relative Value Arbitrage Fund (RVAF) that was used as a vehicle to run a Ponzi scheme, which led to several civil actions against investment managers.

Upon evaluation of these cases, elements of hedge funds that make them susceptible for economic crime will be identified and discussed in chapter four.

3.1 Dynamic Decisions Capital Management

DDCM was incorporated in the UK in 2004 and acted as investment manager to the Dynamic Decisions Growth Premium Master Fund (Growth Premium Master Fund). Two other funds namely the Dynamic Decisions Growth Premium X1 Ltd (X1 Fund) and Dynamic Decisions Growth Premium X2 Ltd (X2 Fund) were funds that invested in the Growth Premium Master Fund.

All of these funds had in some way contributed to the events that led to the actions that came against hedge fund manager Alberto Micalizzi (Micalizzi). The events discussed below will be set out according to various FCA notices that revoked DDCM's licence, as well as Micalizzi's permission to perform regulated activities. Furthermore, according to an Upper Tribunal hearing in *Alberto Micalizzi vs The Financial Conduct Authority* Micalizzi's actions were found to be dishonest and lacking integrity.

3.1.1 Background to DDCM

DDCM was founded in 2004 by Micalizzi (FCA, 2012). Micalizzi, an Italian professor in Finance, served as one of DDCM's directors and as the Chief Executive Officer (CEO) since 10

December 2004 (FSA, 2012). DDCM was an FCA authorised fund management company that managed a hedge fund called Growth Premium Master Fund, as well as two Feeder Funds namely X1 Fund and the X2 Fund (FSA, 2012).

Feeder Funds are funds that source investments and then reinvest in a master fund. In this case the X1 Fund and the X2 Fund would have reinvested their funds in the Growth Premium Master Fund. The X1 Fund was the unlevered feeder fund, which meant that debt did not form part of its capital structure, whereas the X2 Fund included debt in its capital structure and was therefore the levered fund that invested in the Growth Premium Master Fund (FSA, 2012).

PFPC International Limited, which later became PNC Global Investment Servicing (Europe) Limited (PNC), was the Growth Premium Master Fund's administrator (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13). PNC was mandated to provide financial statements, portfolio summaries and valuation services according to the Administration and Accounting Services Agreement dated 15 December 2004 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13-15).

At the end of 2008, Micalizzi invested in convertible bonds (Asseterra Bonds) and these bonds supposedly gave the holder rights to the proceeds of up to US\$10 billion of diesel oil from the autonomous Russian Republic of Bashkortostan in the Ural Mountains (Moulds, 2012). However soon afterwards, the Growth Premium Master Fund was unable to meet its redemption requests and it became clear that the Asseterra Bonds were not valid financial instruments (Moulds, 2012). Upon investigation, it was found that the counter-parties to the Asseterra Bonds were either fictitious or shell companies and subsequently formed part of an investigation of the Milan Finance Police (De Sa'Pinto & Fletcher, 2011). The Asseterra Bonds, because it was immensely illiquid and of suspicious nature, were impossible to sell which led to the liquidation of DDCM in 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:95).

3.1.2 The investment strategy of the Growth Premium Master Fund

The Growth Premium Master Fund had two classes of investor. The first class of investor were investors that voluntarily invested directly in one of the feeder funds, namely the X1 fund, and these investments were governed by the relevant Offering Memorandums of the feeder funds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:12).

The second class of investor were investors that were classified as lenders who provided leverage to one of the feeder funds, namely the X2 fund. These lenders were: IXIS Corporate and Investment Bank (Natixis), Bear Sterns International Limited (Bear Sterns) and Nomura (Alberto Micalizzi vs The Financial Conduct Authority, 2014:12). The lenders were entitled to interest payments, regardless of the Growth Premium Master Fund's performance, as these

parties did not invest in the master fund or the feeder funds but generated artificial exposure to the Growth Premium Master Fund by providing leverage (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13). As this class of investor was classified as a lender, these lenders had a preferred right above the first class of investor regarding the return of their capital (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13). In the sections to follow, reference will only be made to two of the three lenders, Natixis and Nomura, as they were the only lenders that gave evidence at the Upper Tribunal (Alberto Micalizzi vs The Financial Conduct Authority, 2014).

The Growth Premium Master Fund was advertised by DDCM as a low risk, market neutral and solvent fund that engaged in a pairs-strategy investing in equities and outperformance options (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13). This was the main investment strategy of the Growth Premium Master Fund and meant that the Growth Premium Master Fund would find two related shares that are differently valued to one another in different markets (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13). Long and short positions were then taken up in the undervalued and overvalued shares respectively (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13). The Growth Premium Master Fund summarised its investment strategy in accordance with their two main drivers, thus as having long volatility and short correlation positions (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13).

Volatility refers to the fluctuations of the relevant market and correlation refers to the correlation of share prices of shares on the same indexes (Rebonata, 2004:26). The long volatility position will increase in value if the volatility of the market increases (Rebonata, 2004:26). Therefore, the short correlation position means that if there is a high correlation and the share prices decrease, the Growth Premium Master Fund will short (sell) its correlation position to still try and make a profit.

The goal of the Growth Premium Master Fund was to manage a diversified portfolio and distribute risk evenly (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13). The investment restrictions for the Growth Premium Master Fund and its feeder funds were set out in their respective Offering Memorandums as follows (Alberto Micalizzi vs The Financial Conduct Authority, 2014:14):

- Neither funds will invest more than 20 per cent in securities;
- Neither funds will expose more than 20 per cent of the gross assets of the fund to the credit worthiness or solvency of another party and lastly; and
- Neither funds may invest in physical property of commodities.

The Offering Memorandums also granted the Growth Premium Master Fund an opportunity to trade a special category of over the counter transactions (Alberto Micalizzi vs The Financial Conduct Authority, 2014:14). This allowed the Growth Premium Master Fund to invest in a wide range of instruments, which included bond trades, if it was in line with the Growth Premium Master Fund's investment strategy (Alberto Micalizzi vs The Financial Conduct Authority, 2014:14).

3.1.3 Investment restrictions by the lenders

In addition to the restrictions and provisions of the Offering Memorandums, the lenders to the Growth Premium Master Fund also set out certain restrictions pertaining to investments. Firstly, Natixis provided leverage to the Growth Premium Master Fund through Total Return Swaps and annexure three of this leverage agreement contained certain investment restrictions (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15). These investment restrictions included debt securities in the list of permitted investments. These debt securities had to have two market-maker bid-offer prices published on the systems of Reuters, Bloomberg, IDC or Telerate on a daily basis (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15). Lastly, these debt securities also needed an outstanding issue size of at least US\$100 million (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15).

Natixis also specified further conditions pertaining to debt securities. These conditions stated that the debt securities may only be used for cash management, should be AA rated, may not exceed a period of 180 days and the gross exposure to the market value of the debt position should not surpass 100 per cent of the Net Asset Value (NAV) of the Growth Premium Master Fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15). Any other investment in debt securities that do not comply with the above-mentioned conditions may not exceed five per cent of the NAV of the Growth Premium Master Fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15). Natixis also specified Western Europe and the USA, as its geographical restrictions where the assets of the Growth Premium Master Fund should predominantly be invested (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15). Natixis clearly stated the illiquid debt securities were forbidden investments, which would later be ignored by the Growth Premium Master Fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15).

The second primary lender, Nomura, specified investment restrictions similar to Natixis (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15) in annexure three of the OTC Equity Option Transaction confirmation, which was used as a vehicle to provide leverage for the Growth Premium Master Fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15). Convertible bonds were listed as acceptable instruments only if they met with the conditions

stated by Nomura. These conditions included that the bonds must mature within 12 months, be issued by an entity listed on any of the Indices, have a fixed option to be converted into equity, should be able to meet a demand for payment before due date every quarter and the underlying asset of the bond must be liquid (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15). Nomura also stated that the exposure of the Growth Premium Master Fund to such bonds must not exceed three per cent of the NAV of the fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:15).

3.1.4 Reported investment performance in October 2008

As mentioned above, the main strategy of the Growth Premium Master Fund was to invest in equities and outperformance options and engage in a pairs-strategy (Alberto Micalizzi vs The Financial Conduct Authority, 2014:13). The NAV of the Growth Premium Master Fund increased with US\$85 million from January 2008 to September 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:16). From 17 to 19 October 2008 DDCM held its annual portfolio off-site meeting in Portofino, Italy (Alberto Micalizzi vs The Financial Conduct Authority, 2014:20). Investors of the Growth Premium Master Fund were invited to attend this meeting and Micalizzi presented consolidated information of DDCM (Alberto Micalizzi vs The Financial Conduct Authority, 2014:20).

In his presentation, Micalizzi reported on consolidated Assets Under Management as increasing from US\$330 million to US\$500 million in 2008 and also stated that it would be DDCM's goal to reach a target of US\$1 billion of Assets Under Management and unlevered growth of seven to eight per cent in 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:20). Micalizzi's presentation never referred to the losses of the main strategy of the Growth Premium Master Fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:20). This presentation gave investors the impression that the portfolio of DDCM was performing above expected levels when compared to market, as it was at the time of the collapse of the Lehman Brothers and the financial crisis of 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:20).

3.1.5 Investment in the Asseterra bonds in October 2008

The Growth Premium Master Fund was making losses with its main investment strategy and Micalizzi needed an investment that would guarantee profits. It was then that during the month of October 2008 that Micalizzi started to orchestrate the buy and sell programme pertaining to certain Asseterra Bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:21). The Growth Premium Master Fund acted as an agent to subscribe to a bond, which will then be sold to investors through secondary placement (Alberto Micalizzi vs The Financial Conduct Authority, 2014:21). The proposed acquisition was US\$500 million units of a bond through this buy and

sell programme designed by Micalizzi (Alberto Micalizzi vs The Financial Conduct Authority, 2014:21).

Micalizzi had communications with several individuals of different entities pertaining to this type of transaction but the final parties involved was the Growth Premium Master Fund and Pacific Global Oil Australia (Pty) Limited (PGO).

PGO was based in Canberra, Australia, and managed by an Alex Glenn (De Sa’Pinto & Fletcher, 2011). PGO was also represented by a commodities trader, Daniele Palla (De Sa’Pinto & Fletcher, 2011). During the course of Reuters’ investigation into this scandal, Reuters visited all three of PGO’s offices but found little evidence of the company (De Sa’Pinto & Fletcher, 2011). PGO, however did not issue the Asseterra Bonds. The Asseterra Bonds were issued by a company in a trailer-park suburb of Phoenix in the USA, whose head, David Spargo, was on the run from U.S. authorities (De Sa’Pinto & Fletcher, 2011). According to Reuters’ investigation a global network of shell companies that included a Spanish-based charity, the International Charitable Christian Fund, headed by Vladimir KobR backed the Asseterra Bonds (De Sa’Pinto & Fletcher, 2011).

Micalizzi denied having any involvement with PGO, but during the Upper Tribunal hearing it was found that Micalizzi drafted on PGO headed notepaper, provided Danielle Palla, a letter agreement between PGO and Fidor confirming that PGO would buy Fidor’s shares in the Growth Premium Master Fund in exchange for EUR35 million of face value of the Asseterra Bond (Alberto Micalizzi vs The Financial Conduct Authority, 2014:45). Micalizzi thus had the ability to dictate the content of communication distributed by PGO pertaining to the Asseterra Bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:45).

There were ten agreements between the Growth Premium Master Fund and PGO pertaining to the bond transactions and it will be grouped for discussion below according to the units of the Asseterra Bonds the agreements relate to. The details of the Asseterra Bonds were contained in the offering circular, but no signed version of the offering circular could be produced (Alberto Micalizzi vs The Financial Conduct Authority, 2014:36). The supposed offering circular pertaining to the Asseterra Bonds was entered into between Asseterra Incorporated and PGO on 28 January 2008 and had a maturity date of 1 February 2018 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:19). The annual interest rate was set at 4,25 per cent and the underlying commodity of the Asseterra Bonds was the proceeds from US\$10 billion of Russian diesel oil (Alberto Micalizzi vs The Financial Conduct Authority, 2014:43).

The first three agreements between the Growth Premium Master Fund and PGO relate to Bonds A1026 and A1027. An agreement (Purchase Agreement One) dated 30 October 2008

was entered into where the Growth Premium Master Fund would purchase bonds A1026 and A1027, with a nominal value of US\$100 million each, from PGO for US\$100 million (Alberto Micalizzi vs The Financial Conduct Authority, 2014:26). The settlement terms required an initial payment of US\$5 million on 10 November 2008 and the residual amount would be settled on 15 January 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:26). In a second agreement (Option Contract One) dated 3 November 2008, PGO granted the Growth Premium Master Fund the option to sell the bonds to PGO for US\$105 million on 15 January 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:26). The last agreement pertaining to these specific bonds (Repurchase Agreement One) dated 5 November 2008 finalised the repurchase of the bonds by PGO from the Growth Premium Master Fund for US\$105 million on 15 January 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:26).

The second batch of agreements relate to Bonds A1028, A1029 and A1030. An agreement (Purchase Agreement Two) dated 10 November 2008 was entered into where the Growth Premium Master Fund would purchase bonds A1028, A1029 and A1030, with a nominal value of US\$100 million each, from PGO for US\$150 million, which will be settled on 15 January 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:26). An agreement (Repurchase Agreement Two) dated 10 November 2008 finalised the repurchase of the bonds by PGO from the Growth Premium Master Fund for US\$157,5 million on 15 January 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:27). Lastly, an agreement (Option Contract Two) dated 10 November 2008, PGO granted the Growth Premium Master Fund the option to sell the bonds to PGO for US\$223,5 million on 15 January 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:27).

The third batch of agreement relate to Bonds A1031, A1032 and Bonds of Nexus Management (Pty) Limited (Nexus). A letter agreement (*in specie* Agreement) dated 2 December 2008 specifies a subscription of US\$75 million by Nexus in the Growth Premium Master Fund by which the Growth Premium Master Fund accepted an *in-specie* settlement of the whole amount through Bonds with a face value of US\$ 150 million (Alberto Micalizzi vs The Financial Conduct Authority, 2014:27). The second agreement (Purchase Agreement Three) dated 3 December 2008 stated that the Growth Premium Master Fund would purchase bonds A1031 and A1032, with a nominal value of US\$100 million each, from PGO for US\$60 million which will be settled on 15 January 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:27). An agreement (Repurchase Agreement Three) dated 29 December 2008 stated that PGO would purchase the units of bonds acquired from Nexus for the *in-specie* subscription, as well as bonds A1031 and A1032, that amounted to a total of US\$350 million, from the Growth Premium Master Fund for US\$336 million and settle the payment (Alberto Micalizzi vs The Financial Conduct Authority, 2014:27).

The Purchase- and Repurchase Contracts between the Growth Premium Master Fund and PGO can be summarised as follows (Alberto Micalizzi vs The Financial Conduct Authority, 2014:27):

Table 2 - Purchase and Repurchase Contracts between the Growth Premium Master Fund and PGO

	Contracts	Amount (US\$ million)
1	Purchase Contract One (settlement of US\$5 million made on 10 November 2008)	95
2	Purchase Contract Two	150
3	Purchase Contract Three	60
	Amount due by the Growth Premium Master Fund to PGO	305
4	Repurchase Agreement One	105
5	Repurchase Agreement Two	157,5
6	Repurchase Agreement Three	336
	Amount due by PGO to the Growth Premium Master Fund	598,5

From the above table, it can be noted that the purchase price of Purchase Contract One, Two and Three were all far less than the nominal values of the Asseterra Bonds. In all cases, the Asseterra Bonds were sold at a discounted rate, with the minimum discount being 50 per cent of the nominal values of the Asseterra Bonds.

Lastly a letter (Bond Settlement Agreement) incorrectly dated as 13 January 2008, (it should be 2009), served as an agreement whereby PGO relinquished the US\$305 million due on 15 January 2009 by the Growth Premium Master Fund in accordance with Purchase Agreement One, Purchase Agreement Two and Purchase Agreement Three (Alberto Micalizzi vs The Financial Conduct Authority, 2014:27) and the Growth Premium Master Fund agreed to waive the same amount due by PGO in accordance with Repurchase Agreement Three and that the residual amount of US\$31 million will be paid by PGO on 20 January 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:27). The residual amount was calculated by taking the value of Repurchase Agreement Three US\$336 million and subtracting the waived amount of US\$305 million. When the waivers are taken into account the amount by the Growth Premium

Master Fund to PGO is zero and the amount due by PGO to the Growth Premium Master Fund is US\$293,5 million.

Upon examination of the document properties of the contracts, it was determined that Purchase Contract One and Repurchase Contract One was back dated and that these documents were in fact created on 5 November 2008 and therefore cannot have been entered into on 30 October 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:27). The applicable date of Purchase Contract Two and Repurchase Contract Two was accepted by the FCA as 10 November 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:29). These contracts represented the proposed acquisition of US\$500 million units of bonds broken down in two acquisitions (Alberto Micalizzi vs The Financial Conduct Authority, 2014:29).

3.1.6 The attempt to sell the Asseterra Bonds to Lootah Farazad Investments

The need for the Option Contract One and Option Contract Two, mentioned in the above section, was also considered as the Growth Premium Master Fund already had an obligation to resell the Asseterra Bonds to PGO under the Repurchase Agreements (Alberto Micalizzi vs The Financial Conduct Authority, 2014:29). Upon examination of the document properties of the Option Contracts, it was determined that these documents were created on 19 December 2008 and were executed on or after this date (Alberto Micalizzi vs The Financial Conduct Authority, 2014:30).

The necessity for creating these contracts can be prescribed to two events. The first being that in December 2008 the Growth Premium Master Fund tried to enter into an agreement with Lootah Farazad Investments (LFI) to purchase the Asseterra Bonds specified in Purchase Agreement One and Purchase Agreement Two. This transaction could not have been possible if the Growth Premium Master Fund was still obliged to resell the Asseterra Bonds to PGO in accordance with the Repurchase Contracts (Alberto Micalizzi vs The Financial Conduct Authority, 2014:31). The second event would be requests from Nomura for further information about the Asseterra Bonds on 19 December 2008, as the input guidelines sent to them showed the value of the Asseterra Bonds as US\$328,5 million, but just three days prior the Asseterra Bonds were shown as US\$190 million (Alberto Micalizzi vs The Financial Conduct Authority, 2014:31). The sudden increase in the stated value of the Asseterra Bonds in the updated guidelines were attributable to the newly created Option Contracts (Alberto Micalizzi vs The Financial Conduct Authority, 2014:31).

The *in-specie* Agreement, Purchase Agreement Three and Repurchase Agreement Three were all found to be back dated. It was determined upon examination of the document properties that Purchase Agreement Three and Repurchase Agreement Three was created on

29 December 2008 and could not have been entered into prior to that date and that the *in-specie* Agreement was only signed on 30 December 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:32).

During October, November and December of 2008, Micalizzi actively sought a third-party buyer for the Asseterra Bonds, as PGO failed to introduce any buyers for the bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:84). LFI were identified as a potential buyer and Micalizzi began to orchestrate a deal between the Growth Premium Master Fund and LFI (Alberto Micalizzi vs The Financial Conduct Authority, 2014:84). The conditions of the sale were negotiated and the final version was that LFI would make a subscription of US\$80 million in the Growth Premium Master Fund and in return, LFI would receive the Asseterra Bonds that were collateralised and convertible into diesel oil (Alberto Micalizzi vs The Financial Conduct Authority, 2014:85).

Based on evidence provided by LFI and accepted by the Upper Tribunal, LFI informed the Growth Premium Master Fund that they did not have the funds for the US\$80 million subscription and would only be able to make the said subscription once profits of the sale of the Asseterra Bonds had been realized (Alberto Micalizzi vs The Financial Conduct Authority, 2014:84). LFI also needed funding to purchase the Asseterra Bonds and was under the impression that Mashreq Bank would be providing the financing, as they had an existing credit line at this bank (Alberto Micalizzi vs The Financial Conduct Authority, 2014:86). Mashreq Bank informed LFI that the funding would only be released if sufficient proof of product and a contract between LFI and the final buyer of the commodity was received (Alberto Micalizzi vs The Financial Conduct Authority, 2014:86).

Despite the fact that LFI had not secured the funding required, they entered into a Purchase Agreement with the Growth Premium Master Fund for two units of the Asseterra Bonds and a second Purchase Agreement with the Growth Premium Master Fund for three units of Asseterra Bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:87). LFI also entered into a Purchase Agreement with PGO for another eight units of Asseterra Bonds with a nominal value of US\$100 million each (Alberto Micalizzi vs The Financial Conduct Authority, 2014:87).

Unsurprisingly, the Asseterra Bonds could not be sold to LFI, as no sufficient proof of product was ever provided by Micalizzi to LFI and the funding could not be released, as there was no proof that the underlying commodity was real (Alberto Micalizzi vs The Financial Conduct Authority, 2014:87). On 2 February 2009, LFI officially withdrew from the purchase agreements with the Growth Premium Master Fund and PGO (Alberto Micalizzi vs The Financial Conduct Authority, 2014:88).

3.1.7 Actual performance of the Growth Premium Master Fund from October 2008 to December 2008

The performance of the Growth Premium Master Fund and the impact of the Asseterra Bond investments for the months of October, November and December of 2008 were analysed by the FCA for the purpose of the Alberto Micalizzi vs The Financial Conduct Authority, 2014, and the FCA concluded the following:

Table 3 - Summary of the performance of the Growth Premium Master Fund for October, November and December of 2008

	October 2008 (US\$ million)	November 2008 (US\$ million)	December 2008 (US\$ million)
Loss on equity instrument	-47,28	-1,01	-12,19
Loss on cash	-6,49	-0,14	-13,16
Loss on OTC options	-24,74	-166,18	-93,76
Loss on other instruments	-9,12	-2,1	3,7
Profits on Bonds excluding the Asseterra bonds	2,69	-2,69	-20,25
Subtotal	-84.94	-172.12	-135.66
Profits on Asseterra bonds	90,19	178,38	141.52
Total Profit	5,25	6,81	5.86

In October 2008 the Growth Premium Master Fund's main investment strategy made a loss of US\$84,94 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:16). Most of the losses were attributable to investments in equities. The losses attributed to the OTC options were suffered due to 67 OTC options of which 43 expired and led to a net loss of US\$103,5 million (Alberto Micalizzi vs The Financial Conduct Authority, 2014:16).

The main investment strategy of the Growth Premium Master Fund lead to a loss of US\$172.12 million in November 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:17). During this time most of the losses were attributable to investments in OTC options (Alberto Micalizzi vs The Financial Conduct Authority, 2014:17). Of the remaining OTC options, 19 of

these expired in November 2008 and had a net loss of US\$213,58 million that was caused by the unwinding of previously accounted unrealised profit and the wasted costs of the OTC options (Alberto Micalizzi vs The Financial Conduct Authority, 2014:17).

In December 2008 the main investment strategy made a loss of US\$135,66 million and most of the loss was once again attributable to the remaining OTC options that incurred losses of US\$93,76 million (Alberto Micalizzi vs The Financial Conduct Authority, 2014:18). Upon examination of the above table, it should be noted that the profits resulting from the Asseterra Bonds were more or less enough to neutralise the losses suffered by the Growth Premium Master Fund through its main investment strategy.

By the end of 2008, the Growth Premium Master Fund had invested 55 per cent of its assets in the Asseterra Bonds and were thus profoundly exposed to this investment and its underlying commodities (Jaitly, 2016:619). The investment in the Asseterra Bonds did not generate any returns for the Growth Premium Master Fund and the acquisition and consequent sale thereof was also not correctly accounted for (Alberto Micalizzi vs The Financial Conduct Authority, 2014:37). When redemption requests were submitted by investors, the Growth Premium Master Fund was unable to meet their requests and consequently liquidated in May 2009 (FSA, 2012).

3.1.8 Misrepresentation to investors

Investors received monthly performance estimates of the Growth Premium Master Fund from a Miss Pichlerove, but she only sent the figures and calculations that she received from Micalizzi (Alberto Micalizzi vs The Financial Conduct Authority, 2014:37). Micalizzi was thus solely responsible for the content of reports that were being sent to investors.

As seen in Table 3 above, the Asseterra Bonds made a profit of US\$90,19 million for the Growth Premium Master Fund in October 2008 that reversed the losses incurred and resulted in a profit of US\$5,25 million. (Alberto Micalizzi vs The Financial Conduct Authority, 2014:37). Investors received reports from Micalizzi that indicated a return of 0,36 and 0,75 per cent for the fund's five different share classes, but no reference was made to the losses that the fund incurred (Alberto Micalizzi vs The Financial Conduct Authority, 2014:37).

It should be noted that a profit of US\$90,19 million was recognised as income of the Growth Premium Master Fund, even though Purchase Agreement One was not entered into until 8 November 2008, at the earliest, and Option Contract One did not exist during October 2008. Therefore, no value should have been attributed to the Asseterra Bonds or included in the profit and loss calculation for October 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:37). In fact, the Upper Tribunal concluded that the Growth Premium Master Fund did not

follow a proper valuation method in determining the face value of the Asseterra Bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:37).

Micalizzi admitted, that despite having entered into Repurchase Agreement One, this agreement was never sent to the funds' administrators, thus the transaction was never recognised, which lead to the high level of profit recognised for the Asseterra Bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:37). The Upper Tribunal declared the omission by Micalizzi as deliberate with the intention to create and report a profit that did not exist to conceal the actual losses suffered (Alberto Micalizzi vs The Financial Conduct Authority, 2014:37).

Furthermore, by the end of November 2008 the valuation of the Asseterra Bonds increased from 95,06 per cent of face value to 103,42 per cent, which did not make sense as the underlying asset, namely diesel oil, experienced a drop in commodity price for the relevant period (Alberto Micalizzi vs The Financial Conduct Authority, 2014:38).

The profit recognised for December 2008, was due to the income that was generated through Repurchase Agreement Three, but as Purchase Agreement Three, Repurchase Agreement Three and the *in specie* Agreement all came about within two days of each other, the Upper Tribunal was of the opinion that no reliance could be placed on the agreements and that there was no chance for realization of the profit (Alberto Micalizzi vs The Financial Conduct Authority, 2014:38).

Investors that testified at the Upper Tribunal stated that they were never informed of the investments in the Asseterra Bonds, or any other fixed income position during the period October 2008 to December 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:44). Investors also testified that they had received no communication indicating the losses incurred by the Growth Premium Master Fund. Furthermore, if they had been aware of the fund diverting from its main investment strategy, they would have submitted redemption for 100 per cent of their investments (Alberto Micalizzi vs The Financial Conduct Authority, 2014:44).

Micalizzi's reaction to the testimony of the investors was that it only represented a small percentage of investors, but as there was no direct evidence from other investors that they had been informed of the losses and as Micalizzi failed to provide such witnesses, the Upper Tribunal was satisfied that said communication did not exist (Alberto Micalizzi vs The Financial Conduct Authority, 2014:45). Jaitly (2016:619) states that DDCM informed investors about its reduction in its options and futures positions and its investment in fixed income instruments only in February 2009, two months after the transactions had been entered into.

The only reference of the Asseterra Bond transactions made to an investor was to Fidor SpA (Fidor), a business management consulting company. Micalizzi provided Fidor with a certificate of bond A1027 and endorsed it as a transfer by PGO to the Growth Premium Master Fund before Fidor subscribed to the fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:46).

Other supporting documents were promised and provided by Micalizzi which led to the subscription by Fidor in the Growth Premium Master Fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:46). Even though Fidor had knowledge of one of the Asseterra Bonds, no attempt was made to explain the impact of the Asseterra Bonds on the NAV or to disclose the losses of the main strategy of the fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:46). PGO made an offer to Fidor on 28 November 2008 to buy all of Fidor's shares in the Growth Premium Master Fund in exchange for US\$35 million of the face value of the Asseterra Bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:45). This letter was written on PGO headed notepaper by Micalizzi (Alberto Micalizzi vs The Financial Conduct Authority, 2014:45).

3.1.9 Misrepresentations to Natixis

Misrepresentations were also made to Natixis and Nomura, lenders of the Growth Premium Master Fund, (the second class of investor) (Alberto Micalizzi vs The Financial Conduct Authority, 2014:46). As stated earlier, the lenders had their own investment restrictions that the Growth Premium Master Fund needed to adhere to. During 2008, Natixis wanted to change the manner in which they provided leverage to DDCM to a method that had a more acceptable risk management level, but the discussions pertaining to this shift was unsuccessful and lead to Natixis submitting a redemption request of US\$110 million on 24 October 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:47). Natixis received lender's reports for the relevant period dated 7 November 2008, 21 November 2008 and 5 December 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:50).

In the lender's report dated 7 November 2008, the Asseterra Bonds were listed as Fixed Income Instruments, at its nominal value of US\$200 million and this amount was also used to state the mark-to-market value of the bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:50). In this report, the Asseterra Bonds were included in the list of cash holdings and the NAV was stated as US\$610 million (Alberto Micalizzi vs The Financial Conduct Authority, 2014:50). Similarly, to the report dated 7 November 2008, the report dated 21 November 2008 stated the Asseterra Bonds remained at US\$200 million and the NAV also remained at US\$610 million (Alberto Micalizzi vs The Financial Conduct Authority, 2014:50). The 21 November 2008 report post-dates the acquisition in accordance with Purchase Agreement Two, but no reference

is made to the acquisition in the lender's report (Alberto Micalizzi vs The Financial Conduct Authority, 2014:51). The report dated 5 December 2008 also omits the Purchase Agreement Two acquisition and it also omits the acquisitions made pertaining to the *in-specie* Agreement and Purchase Agreement Three (Alberto Micalizzi vs The Financial Conduct Authority, 2014:51).

The omissions of the *in-specie* Agreement and Purchase Agreement Three can be attributed to the fact that the agreement only came into existence on 29 December 2008 and could therefore not be included in the lender's reports for December 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:51). The NAV in the 5 December 2008 report, is stated as US\$470 million, but no steps were taken by Micalizzi to inform Natixis of the overstated NAV and profits or to disclose the factual position of the Growth Premium Master Fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:51).

After receiving the lenders report dated 5 December 2008, Natixis requested all Bloomberg identifiers for the items classified as cash, to address some concerns they were having (Alberto Micalizzi vs The Financial Conduct Authority, 2014:51). DDCM provided Natixis with the requested information, which included information pertaining to the Asseterra Bonds and this was the first time that Natixis became aware of the Asseterra Bonds and of their nature (Alberto Micalizzi vs The Financial Conduct Authority, 2014:53). Natixis discovered that the Asseterra Bonds had a maturity date of 2018, the Asseterra Bonds did not have a standard report from Reuters or Bloomberg, the bid-offer spread was very wide, and the Asseterra Bonds were not rated (Alberto Micalizzi vs The Financial Conduct Authority, 2014:53).

Natixis found this investment to be illiquid and that all of these elements of the Asseterra Bonds were in contradiction of their investment restrictions applicable to debt securities (Alberto Micalizzi vs The Financial Conduct Authority, 2014:53). Natixis also found that there was no due diligence performed before investing in the Asseterra Bonds and the level of the Growth Premium Master Fund's exposure to the Asseterra Bonds made Natixis uneasy (Alberto Micalizzi vs The Financial Conduct Authority, 2014:53). The transactions pertaining to the Asseterra Bonds also lacked commercial sense and the valuation method used to value the Asseterra Bonds was concerning (Alberto Micalizzi vs The Financial Conduct Authority, 2014:56). For all of these reasons mentioned above, Natixis therefore submitted a full redemption request on 17 December 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:56).

Thereafter, Natixis performed their own due diligence on the Asseterra Bonds and raised the following concerns derived from the due diligence exercise with Micalizzi and a member of

DDCM's board, on 13 February 2009, after DDCM failed to make contact with Natixis (Alberto Micalizzi vs The Financial Conduct Authority, 2014:59):

- i. A delivery contract for the commodities did exist, but there was no detail pertaining to volumes and values as no deliveries were planned;
- ii. The volumes of diesel oil that was produced did not reconcile with the delivery volumes stated by PGO;
- iii. The letterhead of the proof of product documentation was stated as ZAO Technokom, but it differed from the official stamp on the documentation that was stated as 000 Technokom;
- iv. There was no contract between ZAO Technokom and the other parties involved in the commodity transaction;
- v. A search for PGO lead to a company called Pacific Global Australia (Pty) Limited, but the business of this company was the production and sale of sea food products and no other company resembling this name was identified and linked to the production of diesel oil;
- vi. There was no office telephone number provided on the ZAO Technokom documentation, only one mobile number; and
- vii. Lastly, the Certificate of Conformity, a certificate granted to products that meets a minimum set of regulatory, technical and safety requirements before it may be sold in a particular country, did not contain the signature of the buyer.

ZAO Technokom was a service provider that was listed as the delivery company for the underlying commodity, diesel oil. A delivery contract existed but it had no fixed volumes of values and only served as a framework (Alberto Micalizzi vs The Financial Conduct Authority, 2014:56). Micalizzi continued with the narrative that the transactions pertaining to the Asseterra Bonds, were legitimate investments and tried to convince the board of DDCM of his narrative (Alberto Micalizzi vs The Financial Conduct Authority, 2014:56). After the above discoveries, Natixis reported DDCM to the FCA in a letter dated 12 February 2009 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:60).

3.1.10 Misrepresentations to Nomura

Another lender, Nomura, invested US\$41,8 million in the Growth Premium Master Fund through a shareholding hedged lending transaction on 8 December 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:60). This investment was made by relying on the Offering

Memorandum, investors' communications, marketing documents, investment guidelines and due diligence questionnaires published by the Growth Premium Master Fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:61). As mentioned in a previous section, Nomura also specified certain investment restrictions that the Growth Premium Master Fund needed to adhere to, specifically to debt securities or convertible bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:61). After the transaction between Nomura and the Growth Premium Master Fund had been completed, a weekly report dated 12 December 2008 was sent to Nomura where the Growth Premium Master Fund states that they have complied with all the investment provisions and restrictions of Nomura (Alberto Micalizzi vs The Financial Conduct Authority, 2014:67).

However, no reference is made to the losses suffered by the main strategy, cash holdings that had a zero value and the Asseterra Bonds is listed at a mark to market value of US\$190 million and as US\$5 million in another column, and convertible bonds are listed as US\$12,8 million, which is 2,7 per cent of the NAV (Alberto Micalizzi vs The Financial Conduct Authority, 2014:67). Micalizzi updated this report due to Purchase Agreement Three and Repurchase Agreement Three and the updated report showed cash holdings at US\$15,96 million and the Asseterra Bonds is listed at a mark to market value of US\$328,5 million and as US\$5 million in another column. Convertible bonds are still listed as US\$12,8 million, which increased the holding above the three per cent limit set by Nomura, as the NAV decreased to US\$400 million (Alberto Micalizzi vs The Financial Conduct Authority, 2014:67).

Nomura had several questions pertaining to the investment in the Asseterra Bonds, specifically to the cash flows of the Asseterra Bond transactions, but Micalizzi could not provide Nomura with satisfactory answers (Alberto Micalizzi vs The Financial Conduct Authority, 2014:69). This led to Nomura submitting a redemption request on 24 December 2008, for its entire investment in the Growth Premium Master Fund to be paid out on the redemption date of 31 December 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:70).

The Growth Premium Master Fund was placed in liquidation and the liquidators were appointed on 9 April 2009, but still, Micalizzi continued with his search for potential buyers for the Asseterra Bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:89). After months of communicating with the potential buyers and despite having entered into a purchase agreement no proceeds were received by the liquidators and the last attempt to sell the Asseterra Bonds failed (Alberto Micalizzi vs The Financial Conduct Authority, 2014:89).

3.1.11 Civil proceedings against Micalizzi and DDCM

The Serious Fraud Office of the UK opened an investigation into DDCM but closed the investigation during July 2010 because they felt that they would not be able to get a conviction in the criminal court (FSA, 2012). As a result, Micalizzi never stood trial, he was not convicted of being guilty of fraud, but the Upper Tribunal hearing did conclude that his actions were dishonest and lacked integrity. These actions of Micalizzi and the rulings of the Upper Tribunal pertaining to these actions will now follow.

The judgement of the Upper Tribunal determined that the Asseterra Bonds were never genuine, as the underlying commodity did not exist and therefore it could never be converted into diesel oil (Alberto Micalizzi vs The Financial Conduct Authority, 2014:93). Despite the various purchase and repurchase agreements pertaining to the Asseterra Bonds, there was no actual cash flows for these agreements and no interest payments pertaining to the Asseterra Bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:96).

During the Upper Tribunal hearing, the FCA was of the opinion that Micalizzi knew that the Asseterra Bonds did not exist from the beginning of this venture (Alberto Micalizzi vs The Financial Conduct Authority, 2014:99). The judge ruled against the FCA, as the Upper Tribunal was not convinced of the FCA's position on the balance of probabilities (Alberto Micalizzi vs The Financial Conduct Authority, 2014:99). The Upper Tribunal concluded that Micalizzi believed that the Asseterra Bonds were real at the onset of the transactions in November 2008 due to the following actions of Micalizzi (Alberto Micalizzi vs The Financial Conduct Authority, 2014:94):

- i. He attempted to make the Asseterra Bonds marketable;
- ii. He wanted to convert the Asseterra Bonds into its dematerialised form and contacted Euroclear and Morgan Stanley to assist in the process; and
- iii. He also consulted with two law firms to draw up the documentation for this conversion.

The Upper Tribunal was satisfied that initially, Micalizzi had the intention of creating a buy and sell arrangement pertaining to the Asseterra Bonds (Alberto Micalizzi vs The Financial Conduct Authority, 2014:95). However, the Upper Tribunal also concluded that Micalizzi was indifferent to whether the Asseterra Bonds were authentic investments (Alberto Micalizzi vs The Financial Conduct Authority, 2014:95). The Upper Tribunal came to this conclusion due to the fact that Micalizzi did not conduct proper due diligence before investing in the Asseterra Bonds and because he was unmoved by the concerns of Natixis, Nomura and one of its brokers Morgan Stanley (Alberto Micalizzi vs The Financial Conduct Authority, 2014:95).

The Upper Tribunal finally concluded that the fictitious nature of the Asseterra Bonds would have been known to Micalizzi when he became aware of the concerns of third parties, the lack of cash flow from PGO to the fund pertaining to the Bond Settlement Agreements and the failure to procure sufficient proof of product for the purchase by LFI (Alberto Micalizzi vs The Financial Conduct Authority, 2014:95). The Upper Tribunal ruled that Micalizzi's actions, after he became aware of the above, was found to be dishonest and lacking in integrity (Alberto Micalizzi vs The Financial Conduct Authority, 2014:95).

The Upper Tribunal also made conclusions pertaining to the actual contracts and valuations pertaining to the Asseterra Bonds transactions (Alberto Micalizzi vs The Financial Conduct Authority, 2014:96). It was found the Purchase Agreement One and Repurchase Agreement One was backdated and the Upper Tribunal concluded that the backdating was necessary in order to conceal the losses incurred due to the main strategy by recognising the profit of these two agreements in October 2008 (Alberto Micalizzi vs The Financial Conduct Authority, 2014:96). The Upper Tribunal found these actions to be dishonest, which was confirmed by an admission by Micalizzi, as he stated that he withheld Repurchase Agreement One from PNC, as it would have limited the unrealisable profit recognised for the Asseterra Bonds transactions (Alberto Micalizzi vs The Financial Conduct Authority, 2014:96).

The continuous losses of the main investment strategy caused Micalizzi to change the buy and sell arrangement to a scheme of concealment, but the Upper Tribunal was also of the opinion that Micalizzi did actively try to create a market for the Asseterra Bonds parallel to the concealment of the losses (Alberto Micalizzi vs The Financial Conduct Authority, 2014:96). Micalizzi needed to create a market for the Asseterra Bonds, as he realised that the main strategy would not be able to recover and reverse the losses suffered and that this would be the only way to recover from the losses incurred by the Growth Premium Master Fund (Alberto Micalizzi vs The Financial Conduct Authority, 2014:96).

Several misrepresentations were made to investors as the losses suffered due to the main strategy of the Growth Premium Master Fund were never disclosed and Micalizzi approved or wrote the monthly commentaries that gave the impression that the fund was performing well despite the challenging market circumstances (Alberto Micalizzi vs The Financial Conduct Authority, 2014:96). The Upper Tribunal concluded with the following pertaining to information provided to investors by Micalizzi:

"Mr Micalizzi deliberately misrepresented the position to the investors and failed to provide them with information as to the true position, even when it was clear that they had been misled by the original information".

The Upper Tribunal also concluded that Natixis and Nomura did not receive the necessary information about the Asseterra Bonds and that neither of these lenders had knowledge of the true position of the fund at the time (Alberto Micalizzi vs The Financial Conduct Authority, 2014:97). Statements made by Micalizzi to Nomura were scrutinized especially due to the significant investment of US\$41,8 million and it was determined that the false answers provided by Micalizzi lacked integrity and were dishonest (Alberto Micalizzi vs The Financial Conduct Authority, 2014:97).

Micalizzi had several questionable actions, but the ones highlighted above were the most significant with tangible consequences to investors and lenders.

3.1.12 FCA notices served against Micalizzi and DDCM

The FCA issued a Decision Notice to both Micalizzi and DDCM on March 2012 (FSA, 2012). The Decision Notice issued to DDCM informed them that the FCA had decided to revoke the permission granted to DDCM to perform regulated activities under part four of the Financial Services and Markets Act (2000) based on the actions of DDCM's Chief Executive Officer, Micalizzi (FSA, 2012). The FCA found that DDCM did not have a competent and sensible management and failed to exhibit sound and sensible business within the expected standards (FSA, 2012). DDCM was thus deemed an unfit and improper person and thus had their permission revoked (FSA, 2012).

Similarly, the FCA wished to revoke the permission granted to Micalizzi to perform controlled functions under Section 63 of the Financial Services and Markets Act (2000), by issuing him with a Decision Notice (FSA, 2012). In addition, the FSA also wished to impose a fine of £3 million for non-compliance of the FSA's Statements of Principle for Approved Persons and to bar him from executing any role pertaining to any regulated activity performed by any authorised person, exempt person or professional firm (FSA, 2012).

3.1.13 Conclusions on DDCM

The actions of Micalizzi lead to one of the biggest fines imposed by the FCA in 2015 (Holt, 2015:1). The pressure and magnitude of the losses suffered by the Growth Premium Master Fund on its main investment strategy forced Micalizzi to search for or create an opportunity to relieve the pressure.

Initially, the Asseterra Bonds investment may have seemed like a lucrative transaction, but it became evident after a few weeks that it would not be making the yields the Growth Premium Master Fund needed, as the whole transaction had no economic substance. As discussed above, several of the contractual parties could not be verified, the underlying commodity of the

Asseterra Bonds could also not be verified and the profits and returns stated in the monthly reports pertaining to the Asseterra Bonds, only existed on paper.

Investors were only informed about the deviation from the Growth Premium Master Fund's main investment strategy in February 2009, after the transactions were initiated in December 2008 and the agreements to these transactions backdated to October 2008. Investors were never informed about the sheer volume of losses that the fund's main investment strategy had sustained. In addition to deviating from its main investment strategy, the investment in the Asseterra Bonds contradicted the Offering Memorandum, as well as the investing limitations set out by its lenders. The flexible nature of hedge fund investment strategies is thus the first element that contributed to its susceptibility to economic crime.

Secondly, the small management structure of hedge funds was an element that made the Growth Premium Master Fund susceptible to economic crime. Micalizzi organised the investment in the Asseterra Bonds and acted in isolation because there was no other party to challenge his decisions. His actions proved to be dishonest and he failed to exhibit sound and sensible business judgment within the expected standards. There was a lack of governance, internal controls and third-party service providers and administrators involved in the management of the Growth Premium Master Fund that contributed to these investments not being detected.

The third element applicable in this case is the financial performance of hedge funds and investor reporting. The pressure to report consistent positive returns to investors was the trigger point in this case. Micalizzi had to find a way to turn around the position of his hedge fund due to the losses made on the main investment strategy and he tried to do that by investing in the Asseterra Bonds. Furthermore, Micalizzi was solely responsible for the content of financial reports that were sent to investors and no reference was made to the losses that the hedge fund incurred on the main investment strategy. Furthermore, performance fees due to Micalizzi is directly linked to the reported performance of the fund. This element of hedge funds serves as an incentive to misreport investment returns to ensure that the desired performance fees are receivable and serves as the fourth element that made this hedge fund susceptible to economic crime.

The liquidity of the Asseterra bonds, as well as the valuation thereof, serves as a fourth and fifth element. With no real underlying commodity backing the Asseterra bonds, as the diesel oil commodity was fictitious, the Asseterra bonds were illiquid instruments. The valuation of the Asseterra bonds were performed by Micalizzi and distributed by DDCM were not objective as no third-party valuator had any input in the valuations of the Asseterra bonds.

Lastly, Micalizzi was trusted by his employees and by the investors, which also contributed to the susceptibility of this hedge fund to economic crime. He managed to orchestrate the Asseterra Bond transactions, manage the investments and the investor reports and what gets recorded in the financial records, all on his own. If the Lehman Brothers had not collapsed and the lenders had not conducted their own due diligence on the Asseterra Bond transactions, Micalizzi's actions would have never been exposed. Micalizzi managed to do all this due to his reputation and the trust entrusted to him by the investors.

3.2 Weaving Capital

Four companies were incorporated in the UK, the British Virgin Islands and the Cayman Islands bearing the Weaving name. These companies were Weaving Capital (UK) Limited (WCUK), Weaving Capital Fund (WCF), Weaving Capital Limited (WCM) and the Weaving Macro Fixed Income Fund Limited (Macro Fund). All of the above-named companies were involved in events that led to the perpetration of fraud, of which the details will be set out below according to Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012 and Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011.

In Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012 there was a charge of civil deceit against the first defendant, Magnus Peterson and against the tenth defendant, Eduard Platt. A criminal case was also brought against Magnus Peterson and he was sentenced to a total of 13 years in prison, having been found guilty of eight counts of fraud, forgery, false accounting and fraudulent trading (Serious Fraud Office, 2015).

3.2.1 Background

3.2.1.1 Weaving Capital UK

WCUK was founded by Swedish-born Ulf Magnus Michael Peterson (Magnus Peterson) in 1998 (Athanasios, 2012:85). Before founding WCUK, Magnus Peterson worked as an interest rate and foreign exchange trader at a Swedish bank in Gothenburg and in 1989 he transferred to the Swedish bank's London office (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:1). In 1995, he became the Swedish bank's Global Head of Proprietary Trading and in that same year, he and his wife moved to an independent US futures brokerage firm called R.J. O'Brien and Associates (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:1).

Magnus Peterson left R.J. O'Brien in 1998 to set up WCUK and act as a director, chief executive officer and principal investment manager (Weaving Capital (UK) Limited (in liquidation), *et al. vs Ulf Magnus Michael Peterson, et al.* 2012:1). In 1999, Magnus Peterson's wife joined as the Head of Trading Execution and in 2000 she became a director of WCUK and left R J O'Brien and Associates (Weaving Capital (UK) Limited (in liquidation), *et al. vs Ulf Magnus Michael Peterson, et al.* 2012:1).

The original mandate of WCUK was to function as a privately-owned investment manager and provide macro-economic research to proprietary traders at banks and hedge funds, but in March of 2000, WCUK migrated to asset management and started its own hedge fund (Athanassiou, 2012:85).

3.2.1.2 Weaving Capital Fund

The hedge fund was incorporated in the British Virgin Islands in 1999 and named the Weaving Capital Fund (WCF). Its directors were Magnus Peterson's stepfather, Hans Ekstrom, and, until 2006, his brother Stefan Peterson, where after he replaced his brother as director (Weaving Capital (UK) Limited (in liquidation), *et al. vs Ulf Magnus Michael Peterson, et al.* 2012:2). As well as being a director, Magnus Peterson was also a shareholder in WCF and from 2008 he and his wife were the majority shareholders (Weaving Capital (UK) Limited (in liquidation), *et al. vs Ulf Magnus Michael Peterson, et al.* 2012:2).

WCF carried on the business as a hedge fund from its incorporation until 2003, when it ceased to trade with third parties (Weaving Capital (UK) Limited (in liquidation), *et al. vs Ulf Magnus Michael Peterson, et al.* 2012:2). WCUK managed WCF from its incorporation until it completely ceased to trade in 2008 (Weaving Capital (UK) Limited (in liquidation), *et al. vs Ulf Magnus Michael Peterson, et al.* 2012:2). WCF achieved an outstanding performance of more than 140 per cent in the first 10 months since incorporation (Athanassiou, 2012:85), which pleased its principal investor Magnumhold Limited, a private investment vehicle owned by Magnus Peterson, his wife and a Swedish investor (Weaving Capital (UK) Limited (in liquidation), *et al. vs Ulf Magnus Michael Peterson, et al.* 2012:2).

However, in 2001 WCF incurred substantial losses (Athanassiou, 2012:85) and ceased any form of trading with third parties in 2003. During that same year the fund had no administrator, auditor or external investors (Weaving Capital (UK) Limited (in liquidation), *et al. vs Ulf Magnus Michael Peterson, et al.* 2012:2). Even though WCF became inactive as a hedge fund with no third-party trades from 2003, Hans Ekstrom remained a director of WCF and Stefan Peterson remained as a director of WCF until early 2006 (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:3).

Magnus Peterson used the WCF to enter into transactions with another hedge fund, the Weaving Macro Fixed Income Fund.

3.2.1.3 Weaving Macro Fixed Income Fund

During April 2003 WCUK incorporated another hedge fund in the Cayman Islands, as a corporate income tax exempted company called the Weaving Fixed Income Fund Limited, which was later renamed the Macro Fund (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:2). With the establishment of the Macro Fund the share capital of the company was US\$50,000, which was divided into 100 management shares at US\$1 and 4,990,000 participating shares at US\$0.01, where the latter was listed on the Irish Stock Exchange and therefore subject to its requirements (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:2).

The Macro Fund's intention to achieve low risk and steadier returns attracted investments worth millions of dollars from financial institutions, funds of funds, pension schemes, charities and high net worth individuals (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:2). The reported growth in its assets under management was immense, as it increased from US\$27 million in December 2004 to US\$583 million in December 2008 (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:2).

The appointed directors of the Macro Fund were Stefan Peterson and Hans Ekstrom and according to the advisory agreement, dated 31 July 2003, the Macro Fund appointed Magnus Peterson, as its principal investment advisor (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:3). The appointed auditors of the Macro Fund were Ernst & Young (Cayman office) (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:3).

3.2.1.4 Weaving Capital Management

This advisory structure of the Macro Fund was altered in 2007 when Weaving Capital Management Limited (WCM) was incorporated in the Cayman Islands around 7 July 2006. WCM was appointed as the investment manager of the Macro Fund on 30 January 2007 and WCUK, as the investment advisors on 30 January 2007 (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:3). Stefan Peterson and Hans Ekstrom were the directors of WCM. Although WCM was the investment manager of the Macro Fund, the Macro Fund paid management fees to WCUK and not to WCM. Therefore, the

introduction of WCM in the advisory structure had no meaningful consequences (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:3).

3.2.1.5 Investment advisor/manager/s of the Macro Fund

WCUK was appointed as the Macro Fund's investment managers on 31 July 2003 and WCM took over from WCUK on 31 January 2007 (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:10).

On 30 January 2007, the Macro Fund, WCM and WCUK entered into an Investment Advisor agreement, where the Macro Fund appointed WCUK, as its investment advisor and WCM delegated its responsibility of asset investment of the Macro Fund to WCUK (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:3). Therefore, despite the appointment of WCM, WCUK inadvertently continued to act as the investment manager of the Macro Fund (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:3).

3.2.1.6 PNC Global Investment Servicing

The Macro Fund appointed PNC Global Investment Servicing (Europe) Limited (PNC), as its administrator and PNC International Bank Limited, as its custodian (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:3). According to an Administration and Accounting Services Agreement of 30 July 2003, PNC were expected to keep records of trading accounts and transactions of the Macro Fund and to assist the external auditor of the Macro Fund with its requests and enquiries (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:11).

PNC were also responsible for preparing the balance sheet, calculating capital gains or losses, calculating the market value of the Macro Fund's investments and the NAV of the Macro Fund, preparing the monthly trade lists and providing statistical data of the Macro Fund when requested (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:12). According to the Offering Memorandum dated 24 September 2008, PNC could only be held accountable for the administration responsibilities, as set out by the Administration Agreement and nothing more (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:12).

3.2.2 Use of the hedge funds by Magnus Peterson

The Macro Fund incurred trading losses through its main investment strategy and in 2003 Magnus Peterson used the two hedge funds that he managed, WCF and the Macro Fund, to

enter into over the counter transactions with each other (Weaverling Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5). The over the counter agreements that were entered into related to Interest Rate Swap (IRS) transactions and Forward Rate Agreements (FRAs) (Weaverling Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5).

The proceeds of these IRS and FRA transactions reversed the incurred losses of the Macro Fund through its main investment strategy and increased the NAV of the Macro Fund significantly (Weaverling Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5). Despite the increased NAV of the Macro Fund, the redemption requests of its investors could not be met when the 2008 financial crisis occurred (Weaverling Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5).

The Macro Fund and WCF entered into 15 FRAs from 2003 until 2008 and 30 IRS transactions between 2005 until 2008 (Weaverling Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:7). These over the counter transactions between the Macro Fund and WCF became the subject of an investigation, which will be discussed in more detail in the sections to follow.

3.2.3 Over the counter transactions concluded between the Macro Fund and WCF

The Macro Fund started trading on 11 August 2003 with assets under management of US\$593,000 but by 28 August 2003, the Macro Fund had already incurred significant trading losses (Weaverling Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:19).

However, the Macro Fund entered into two over the counter (OTC) options with WCF on FRAs to convert the incurred trading losses of 19,3 per cent to a 3,2 per cent profit for August 2003 (Weaverling Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:3). These initial FRA agreements were later found to have no economic substance (Weaverling Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:27).

An FRA is when the two parties of the agreement agree on a forward interest rate on a certain notional amount for a certain period commencing on a specific future date (Fät & Pop, 2015:1158). These transactions were only entered into at the end of August 2003, but were used to calculate the NAV of the Macro Fund for the month of August 2003. (Weaverling Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5).

In this case, it is important to distinguish between over the counter (OTC) and exchange-traded transactions. The exchange on which exchange-traded derivatives are traded defines the terms of the transaction and the transaction is settled once the trade is made (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:3). In contrast with exchange-traded derivatives, the terms of over the counter (OTC's), including settlement thereof, are mutually agreed by the parties to the transaction (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:3).

In general, futures are always exchange-traded derivatives where options can be either exchange-traded or over the counter (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:3).

During the course of 2004, Magnus Peterson entered into 13 further OTC FRAs on behalf of the Macro Fund with WCF based on documents presented in the case of Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* These FRAs were concluded to reverse trading losses into profits at the end of the month, which lead to an increase in the Macro Fund's NAV and a misrepresentation of the Macro Fund's true position (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4).

Fenwick *et al.* (2015:104) states that these initial FRAs, referenced to the London Interbank Overnight Rate (LIBOR) concluded between the Macro Fund and WCF were soon followed with LIBOR referenced interest rate swaps (IRS) with WCF.

From 2005 the Macro Fund started trading in Interest Rate Swaps (IRS) contracts (referenced to LIBOR) with the WCF, a company that ceased third party trades since 2003, as mentioned earlier (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:4).

An IRS transaction is a derivative instrument and involves the exchange of interest rates between parties (Kuprianov, 1994:49). The terms of an IRS transaction usually set out that one party agrees to pay interest based on a fixed rate on a definite notional amount and the other party agrees to pay interest on the same notional amount based on a floating rate (Kuprianov, 1994:51). Movements in interest rates determine which party receives the benefit of an increase in the value of the IRS transaction (Kuprianov, 1994:51). If interest rates increase, the value of the IRS transaction increases for the fixed interest rate payer, but when interest rates decrease, the value of the IRS transaction increases for the floating interest rate payer (Kuprianov, 1994:51).

On 17 February 2005, the first of 30 interest rate swaps with WCF was initiated (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, 2012:4). These IRS contracts arranged that WCF paid interest, based upon a predetermined fixed rate on a specified notional amount, in exchange for the Macro Fund's interest payment on the same notional amount, based upon a floating rate, referenced to one-year sterling LIBOR (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:6).

Put more simply, WCF and the Macro Fund exchanged interest payments on the same notional amount, but WCF's interest rate was fixed and the Macro Fund's interest rate was not. For the period in question, 2003 till 2008, events occurred that led to a decrease in interest rates, especially in 2008, which made the Macro Fund's IRS contracts look very profitable on paper (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:6).

The initial IRS transaction in February 2005 increased the Macro Fund's financial position with £21 million (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4) and the value of the IRS transactions escalated from US\$2,6 million in 2005 to US\$637,1 million according to the draft NAV statement as at 28 February 2009 (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:4).

At the end of 2006, the cumulative value of the outstanding IRS contracts was US\$86,8 million, US\$70,9 million more than the previous year. In 2007 the aggregate value of the outstanding IRS contracts reached US\$195.6 million and by the end of 2008, the cumulative value reached US\$626,6 million (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:7). According to Athanassiou (2012:85), the Macro Fund stated that it achieved returns in the range of 10 to 12 per cent per annum for five consecutive years and had US\$639 million in assets at the end of 2008. The general trend in the fluctuation of the net asset value of the IRS contracts, from mid-2006 and on, was a growth of about 70 per cent (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:6).

The derivative instruments used between the Macro Fund and WCF, namely FRAs and IRS', were both over the counter transactions (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:3). These financial instruments were customised by the parties involved and did not trade on a public exchange or include a financial mediator (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:4).

Upon examination of the IRS contracts, it was observed that during the same period that the IRS contracts were entered into, the Macro Fund entered into 43 termination or “step-down” transactions that terminated an IRS transaction or decreased its speculative value (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:4).

In total 26 of the IRS transactions were terminated in its entirety and WCF therefor only received interest payments pertaining to the IRS transactions in the region of £8 million between July of 2006 and September 2007 (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:4). The reason that the termination agreements (43), exceeded the total number of IRS transactions (30), is that every step-down agreement is included in the count of 43 (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:4). This means that one IRS transaction may have a step-down transaction that reduced the value, as well as a termination transaction.

The Macro Fund made significant losses pertaining to its options trading that was its mandated investment strategy. With the incurred losses from the Macro Fund’s mandated trading strategy and the termination of 26 of its IRS transactions with WCF, the Macro Fund should have reported a decrease in NAV from 2005 till 2009 (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:5). However, the Macro Fund disregarded the termination transactions when valuing the IRS transactions with WCF and continued to increase the NAV of the Macro Fund (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:4).

3.2.4 Valuation of the Macro Fund

By March 2004, 40 per cent of the NAV of the Macro Fund was made up of these FRA holdings (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4). This position caused an employee of PNC, the Macro Fund’s valuation firm, to ask for an explanation, as these transactions were executed with a related party (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4). Magnus Peterson responded immediately by saying that he intended to reduce the Macro Fund’s exposure to related party transactions, but Magnus Peterson did not act on his promise and the Macro Fund kept the FRAs until December of 2004 (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4).

Up until the end of 2005 PNC thought that the valuation of the Macro Fund was calculated by MAN Valuation Services Limited, where in fact the valuation was done by an employee of the Macro Fund, Eduard Platt (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus

Michael Peterson, *et al.* 2012:4). For the following two years PNC took Eduard Platt's valuations at face value, until a valuation of the Macro Fund was obtained from Markit, a specialist in company valuations (Weaver Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4). In October 2007 Markit valued the Macro Fund's swap positions at £79 million, whereas Eduard Platt's valuation was nearer to £94 million on 28 September 2007.

The valuation of the IRS transactions for the Macro Fund kept on increasing and was very profitable on paper, as they were the floating interest rate payer to these transactions and WCF paid a fixed rate that was higher than the floating rate. So, when interest rates decreased, which it did in general for the period in question, especially 2008, the value of the IRS transactions increases for the floating interest rate payer, which was the Macro Fund (Weaver Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:5).

The increase in value of the IRS transactions for the Macro Fund, as prepared by PNC, is shown as US\$15.9 million at the end of 2005, US\$86,8 million by the end of 2006, US\$195,6 million by the end of 2007 and US\$626,6 million by the end of 2008 (Weaver Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:6).

The value of the IRS transactions increased with US\$610,7 million in just four years.

3.2.5 Unravelling of the Macro Fund

With a strong financial position, due to the interest rate swaps, the Macro Fund looked very attractive for new investors and very successful for the current investors right until the collapse of the Lehman Brothers in September 2008 (Weaver Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4). The collapse of the Lehman Brothers in 2008 and the subsequent financial crisis led to a very high number of redemption requests for the Macro Fund, which it was unable to meet, as the Macro Fund overstated its NAV and most of the Macro Fund's reported returns were fictitious (Weaver Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:19).

Redemption payments had to be made to investors within 30 calendar days after the redemption day, which was the first business day of every month (Weaver Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:5). The following redemption requests were processed and paid in part (Weaver Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:5):

- i. On 3 November 2008 redemption requests of US\$138,4 million was processed and US\$7,6 million was paid;

- ii. On 1 December 2008 redemption requests of US\$54,7 million was processed and US\$72,3 million was paid which included payments in respect of the unpaid redemptions of November 2008;
- iii. On 1 January 2009 redemption requests of US\$30 million was processed and US\$7,6 million was paid; and
- iv. In February of 2009 payments of US\$10,2 million were made.

The total redemption requests amounted to US\$223,1 million and by the end of February 2009 US\$125,4 million was still unpaid. Redemption payments were deferred on 13 December 2008, until the Macro Fund had undergone a structured voluntary liquidation process and the Macro Fund's liquidity position improved enough to retake the redemption payments (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:5).

Pressure from Cahranpreet Dabhia, another director of WCUK led to the appointment of PricewaterhouseCoopers LLP (PwC) to assist the Macro Funds' illiquid position (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4).

Upon inspection of a draft balance sheet for the 2008 financial year of the Macro Fund, the following was noted by PwC during March 2009 (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4):

- i. Cash and cash equivalents of US\$22,248,842;
- ii. Non-cash assets excluding the IRS transactions with WCF, of US\$7,2 million;
- iii. The IRS contracts with WCF was stated as having a value (on a mark-to-market basis) of US\$637,121,094;
- iv. Redemptions payable to third party shareholders totalled US\$132,622,413; and
- v. Total Net Assets amounted to US\$506,307,035.

The sum of the assets stated above is US\$666,569,936, which, upon liquidation of the assets, would have been sufficient to pay the redemption requests. However, if the IRS contracts were excluded the total sum of assets was only US\$29,448,842, which was not enough to cover the redemptions payable (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4).

PwC determined that the Macro Fund's portfolio consisted of the following (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:4):

- i. United States Government-backed securities that were illiquid, unleveraged and bound to a repurchase agreement and therefor had no considerable value;
- ii. Net option positions of US\$40 million, and
- iii. Interest rate swaps with WCF with a value of approximately US\$600 million.

The Macro Fund entered voluntary liquidation on 19 March 2009 at the request of its only voting shareholder Codan Trustees (BVI) Limited, as a trustee of the M.P. Number One Trust, the trust of Magnus Peterson (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:6).

On 24 April 2009, WCF was served with an order for provisional liquidation in the British Virgin Islands and on 2 June 2009, an order was made for the winding up of WCF (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:6). WCUK also went into administration on 19 March 2009 and received an order by the High Court of England and Wales to wind up the Macro Fund (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:6). WCUK's liquidators were appointed on 8 October 2008 and initiated the High Court proceedings in to seek relief (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:6).

3.2.6 Misrepresentations made to investors

For a long period of time, investors were led astray due to various documents prepared and distributed by Magnus Peterson and the Macro Fund that contained false representations (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:6) as will be discussed below:

3.2.6.1 Offering Memorandum and due diligence questionnaires

The first of these documents was the Offering Memorandum of the Macro Fund (Offering Memorandum). The Offering Memorandum is the initial contract base for an investors' application and included in the Offering Memorandum that was the Macro Fund's investment strategy.

The investment strategy indicated the following (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5):

- i. The Macro Fund will invest in fixed income markets using bonds, money market instruments, as well as its derivative instruments, mainly futures and options;

- ii. The Macro Fund would have a balanced portfolio with a diversified risk profile;
- iii. The Macro Fund would maintain an active and meticulous approach in its risk management;
- iv. The Macro Fund would manage its investments with the aim of limiting the exposure of the gross assets of the fund to the solvency of a counterparty to 20 per cent;
- v. The Macro Fund would not have “management control of the issuer of any of its underlying investments”; and
- vi. The Macro Fund followed the standards of diversification when using derivatives.

Another publication that made similar statements about the Macro Fund’s investment strategies were the two due diligence questionnaires distributed to investors. The Macro Fund stated in their due diligence questionnaires that most of their trades are exchange trades, which makes the valuation thereof very simple and prevents any pricing discrepancies (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:3). The Macro Fund also specified that their positions in terms of a number of instruments and exposure was expressed as 75 per cent in options and 25 per cent in futures (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:6).

The Macro Fund clearly contradicted their Offering Memorandum, as well as the due diligence questionnaire by entering into the OTC FRA’s and IRS swaps with a related party, as they are not exchange-traded instruments (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:11). The value of the IRS contracts in comparison to other trade instruments of the Macro Fund varied up until 2006, but from thereon it was 70:30 in relation to the NAV of the Macro Fund, which also does not comply with their diversified risk profile strategy (Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson and Hans Ekstrom, 2011:7).

The IRS/FRA contracts with WCF, exposed the Macro Fund’s investors because WCF was a related party that was not creditworthy and illiquid and therefore the swaps could not be worth more than the assets of WCF to the Macro Fund (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:11). The Macro Fund therefore did not apply proper risk management, as stated in their Offering Memorandum. Magnus Peterson tried to calm the situation by stating that WCF had assets of close to £77 million, but PwC found that it was grossly overstated (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5).

An example of Magnus Peterson's overstatement was an investment that WCF made in a music video company. This investment, which was bought for £50, was valued at US\$37,25 million even though its net liabilities doubled after the year in question (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5). Similarly, the value of an investment in a failed stage musical was dramatically overstated and joins the list of absurd valuations that Magnus Peterson made (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5).

In addition to these overstated items PwC also concluded that there were US\$260 million of unpaid redemptions and that there were close to 30 IRS transactions with WCF, which led to the Macro Fund being placed into liquidation and WCUK into administration and later on into liquidation (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5).

In another section of the due diligence questionnaire, the Macro Fund was required to declare any current or potential conflict of interest or relationship that may influence their trading. The Macro Fund did not declare any conflict or relationship of that nature (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:18). The Macro Fund also expressed that investors were informed when changes were made to trading, risk and money management, but investors were never properly informed when the Macro Fund started entering into the OTC transactions with WCF (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:26).

3.2.6.2 Investor strategy document and other documents

Investors received a strategy document in November 2008 where the Macro Fund maintained their stance on their investment strategy and emphasised that they traded in very little OTC instruments, even though the IRS contracts made up 91,31 per cent of its NAV (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:7).

Investors also received other documents containing a layout of all the positions of the Macro Fund, but these documents did not include the IRS contracts, as the Macro Fund had to keep investors convinced that they stuck to their investment strategy of primarily exchange-traded instruments (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:7).

3.2.6.3 Monthly performance summaries

WCUK prepared monthly performance summaries of the Macro Fund and distributed these summaries to investors, even though PNC were appointed as the fund's administrators and

should have compiled these performance summaries (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:7). None of these monthly performance summaries included any reference to the IRS contracts, but the NAV disclosed in the summaries, calculated by PNC, did include the IRS contracts (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:26).

Furthermore, investors received daily and weekly NAV's of the Macro Fund, but these figures were not the NAV's calculated by PNC, but rather figures that Magnus Peterson gave Eduard Platt to include in the circulations (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:21). This was done to give investors the impression that the Macro Fund was not volatile, even though the daily actual estimates, updated by Eduard Platt, had very volatile fluctuations (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:21).

3.2.6.4 Supposed exchange-traded securities and not over the counter transactions

Since April 2005, Magnus Peterson was questioned on several occasions, usually by other asset management firms, about the Macro Fund's attitude towards OTC transactions but Magnus Peterson continued with his explanation that the Macro Fund did not enter in too many OTC trades and that the Macro Fund had a very liquid position and could be sold off in one day (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:7).

Magnus Peterson also argued that the statements made in the Offering Memorandum and due diligence questionnaires were not misleading, as the Macro Fund held more exchange-traded securities than OTC interest rate swaps and that the term "trading" did not include OTC transactions (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:24).

Firstly, Magnus Peterson's explanations were not satisfactory for Justice Proudman, as the value of the instruments should be inspected when determining the ratio between exchange-traded and futures instruments, not the volume (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:24).

Secondly, Magnus Peterson's implied context of the term "trading" was never set out in the due diligence questionnaires and lastly, as interest rate swap transactions were not exchange-traded, they should not have been valued according to LIFFE (the London International Financial Futures and Options Exchange) (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:24).

3.2.6.5 Related party transactions

The due diligence questionnaires also stated that WCUK only had one fund under management (Macro Fund), which was not the case, as they managed WCF as well. Furthermore, WCUK also stated that they had no conflict of interests to declare (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:6). This statement in the due diligence questionnaire gave the impression that related party transactions would not be a concern for investors (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:6).

In another section of the Offering Memorandum under the heading of “Risk of Special Techniques” the Macro Fund is given the mandate to invest in unlisted securities or OTC contracts if the counterparty is a major bank (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:6). However, the counterparty of the IRS contracts was never disclosed as a related party and investors gave evidence that if they had known that this was a related party trade, they would have taken action much sooner (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:14). Only in the unaudited half-year financial statements of 2004, did the Macro Fund disclose a related party FRA transaction with WCF, but no further reference is made to any major banks or WCF in the following years, as the counterparty of FRA agreements or IRS contracts (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:15).

International Audit Standard (IAS) 24 sets out the disclosure for related parties and defines a related party transaction as a transfer of resources, services, or obligations between related parties, irrespective of whether a price is charged (Deloitte, 2009). The Macro Fund did not comply with IAS 24 standards, as the Macro Fund’s investors all testified that they were not aware that the Macro Fund held large OTC swaps with a related party (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:15). Investors could not have known this as the Macro Fund did not disclose the counter party to the OTC swaps in any of the documentation circulated to investors (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:15).

It is clear that WCUK did not comply with their own conflict of interest policy, as they chose not to declare their relationship with the Macro Fund or WCF (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:6). This, in turn, led the Macro Fund to contradict their Offering Memorandum, as WCUK had control over the instruments they supposedly managed (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:5).

Upon examination of various other marketing materials of the Macro Fund, Justice Proudman found no mention of the interest rate swaps, OTC transactions or counterparty risk (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:26). It was thus the intent of Magnus Peterson not to disclose the related party transactions, the deviation from the investment strategy and the credit risk of the counterparty to these transactions (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:26).

Due to these misrepresentations to investors, the claimants to this case deemed the OTC interest rate swap transactions as having no economic substance and classified them as shams (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:27).

The judgement concluded that the interest rate swap transactions were created to manipulate the NAV of the Macro Fund to impress investors and were never intended to be legitimate securities (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:40).

3.2.6.6 Financial statements

In connection with the audit of the 2005, 2006 and 2007 financial statements, the Directors signed representation letters addressed to Ernst & Young (in June of the year following the financial year under audit) (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:22) and with each of the financial statements there was a Directors' Report signed by the Directors. In the Directors Report, the directors stated that the development of the Company's business was reviewed (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:22). They also explained the investment objective and strategy and the results, activities and future developments (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:22).

The financial statements also show that the Macro Fund had not taken any counterparty risk into account with the valuations of the swaps (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:15).

3.2.7 Justice Proudman judgment concerning Magnus Peterson's conduct of the Macro Fund and documents used

Justice Proudman concluded her judgement by discussing whether a case of fraud had actually occurred. The first thing that Justice Proudman considered was Magnus Peterson's opinion that

the OTC interest rate swaps were authentic trades that were part of the Macro Fund's strategy, even though he stated in his closing statement that the interest rate swaps were only made available to extend the Macro Fund's product range and were not trade transactions at all (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:17). Justice Proudman was of the opinion that Magnus Peterson's statements were unclear and that he never addressed the related party concealment towards investors (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:17).

Justice Proudman also referred to the fact that the value of the interest rate swaps was similar to the value of the losses that the Macro Fund incurred, through trading in exchange-traded instruments, and that the inclusion of the interest rate swaps, had no value. The interest rate swaps were included in the NAV calculation to create the impression that the Macro Fund was performing as expected (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:7). It was also proven that the OTC transactions made up a material part of the NAV and by the end of 2008, the OTC transactions had a value higher than 100 per cent of the fund's NAV (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:18). The OTC transactions exceeded the NAV due to some negative positions the Macro Fund had, that decreased the NAV. This means that if the interest rate swaps did not exist, the Marco Fund would have had no value.

Justice Proudman also found that Magnus Peterson contradicted the Macro Fund's Offering Memorandum because he used a related party, WCF, which was not creditworthy as the counterparty to the OTC transactions (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:25). Justice Proudman viewed these related party transactions as unjustified and did not agree with Magnus Peterson's explanation that the outcome of the swaps would have been similar with an independent third-party, (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:25).

Justice Proudman also found that counterparty risk was never included in the Macro Fund's valuation of the OTC transactions, which led to its value being overstated by approximately £110 million, on the assumption that WCF was liquid. However, if WCF was illiquid then the value of the interest rate swaps would have been equal to the value of WCF's distributional assets (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:18). In actual fact, WCF had very little assets and lost 70 per cent of the income it received from the Macro Fund through the IRS swaps in August 2008 in just seven months of trading (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:20).

Justice Proudman stated a lack of payments and receipts between the Macro Fund and WCF was concerning. Dr Okongwu's analysis of the interest rate swaps, as accepted by Justice Proudman, showed that the Macro Fund should have paid £274 million to WCF and received £608 million from WCF for the entire period that the swaps existed (Weaver Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:19). The actual cash flow between the parties were almost non-existent, as the majority of the swaps were closed out before the applicable payment date (Weaver Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:19). Magnus Peterson tried to explain away the lack of payments and receipts by saying that WCF compensated the Macro Fund with a variety of futures and option trades or some futures and options hedges, but he failed to convince the court, as he had no supporting evidence to prove his statement (Weaver Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:19).

Another event that Magnus Peterson failed to explain was the material reduction of the OTC swap holdings with no compensation from WCF in a time where the Macro Fund was overwhelmed with redemption requests (Weaver Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:19). If the OTC swaps were legitimate transactions, it would not have made sense to forfeit the interest rate swaps towards the end of 2008, as was the case, because with the drop in the LIBOR rate, due to the financial crises, the Macro Fund would have made a profit of US\$220 million (Weaver Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:19). Once again, Magnus Peterson's explanation of the actions taken by the Macro Fund did not make sense and was unsatisfactory to the court. Magnus Peterson said he gave up the interest rate swaps so that he could sell the options that hedged the transaction to be able to pay the redemptions, but it was plain to Justice Proudman and the court that if the interest rate swaps were making a profit, then the options would be making losses and the sale of options making losses would not be able to pay the redemptions (Weaver Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:19).

Justice Proudman also commented that there were only five reported interest payments, which were from the Macro Fund to WCF, but never the other way around which was concerning. Magnus Peterson stated that he could not recollect how the interest payments were made and that they were probably done in a different manner, which he could not prove (Weaver Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:19).

When it came to the swap valuations, Justice Proudman agreed that the value of the swaps was grossly overstated. For example, when PNC, the company responsible for the NAV calculation of the Macro Fund, asked Markit, a third-party valuation company, to value the swaps as at 28 September 2007, Markit valued it at £79 million, whereas Eduard Platt valued the swaps as

£94 million (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:20). In his defence, Eduard Platt admitted that he did not know how to properly value the swaps and that he did the best he could (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:21).

Another point of discussion was whether the value of the OTC swaps violated the 20 per cent investment restriction that applied to the investment strategy of the Macro Fund (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:23). Justice Proudman concluded on this matter to say that the 20 per cent restriction had been violated, as the gross assets of the Macro Fund were exposed to the risk of WCF's insolvency (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:24).

In addition to with all the misrepresentations that were made, various discrepancies were identified in documents pertaining to the interest rate swap trades with WCF. One of the most important documents regarding trade in derivatives is the International Swaps and Derivatives Association (ISDA) Master Agreement. Justice Proudman viewed the ISDA Master Agreement between the Macro Fund and WCF as sub-standard and that the adjustments made to the agreement rendered the agreement practically useless (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:21).

Secondly, the trade tickets of the swaps were examined and important fields of information were not completed on the trade tickets for the swaps. The interest rates reported on the tickets and the corresponding trade blotter did not match up and not all of the trade tickets were filed for later use, which led to some tickets being missing (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:21). Similarly, to the trade tickets, trade confirmation documents were missing for 43 of the 80 swap transactions and the documents that were available had various discrepancies such as showing WCF as the acceptant of both the fixed and floating interest payments, no report on the frequency of interest rate payments and wrong dates of transactions (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:22).

It was also found that a lot of documentation contained forged signatures and was backdated, which implies that these documents were only created after the swap transactions had taken place (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:22). Magnus Peterson admitted to forging the signature of Ekstrom and Stefan Peterson, directors of WCF, on various documents from 31 December 2007 to 31 October 2008 (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:22). In Weaving Macro Fixed Income Fund Limited (in liquidation) vs Stefan Peterson

and Hans Ekstrom 2011, Ekstrom and Stefan Peterson denied having authorised Magnus Peterson to sign on their behalf's, as Magnus Peterson claimed in his own defence.

Magnus Peterson became a director of WCF by the end of 2007, but continued, as he had done prior to 2007, to sign under the names of the other directors, because he understood that confirmations of trades should be done by directors independent of the Macro Fund and WCUK (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:22).

3.2.8 Outcome of civil proceedings

Claims of negligence were submitted against the directors of WCUK and Eduard Platt in Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012. The test for negligence considered by Justice Proudman was whether the defendant's actions were that of a reasonable director of a hedge fund management company in their position, with their experience, knowledge and intelligence and whether they acquired the necessary knowledge to perform their duties (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:28). Justice Proudman ruled that the defendants did not meet the test and found them guilty of negligence (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:28).

The claimants also submitted various monetary claims, all claims in this regard, except a claim of £85,000 were proven and awarded to the claimants by Justice Proudman (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:44).

Lastly, a claim of deceit or civil fraud was submitted against Eduard Platt and Magnus Peterson. A civil claim of deceit has its precedent though (Bradford Equitable B S. v Borders, [1941] 2 All ER 205, HL), where "deceit is a tort (a wrong) arising out of a false statement of fact made by one party, knowingly or recklessly, with the intention that it should be acted upon by another party, who suffers damage as a result". Justice Proudman dismissed the claim against Eduard Platt but upheld the claim against Magnus Peterson (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:46).

This brought an end to the civil court proceedings of Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012.

3.2.9 Final judgement of criminal proceedings against Magnus Peterson

The end of the civil proceedings inspired the UK Serious Fraud Office to reopen an investigation that was launched in 2009 concerning interest rate swap transactions between the Macro Fund

and WCF, but was closed in September 2011 (Serious Fraud Office, 2016). The investigation was reopened in July 2012 and Magnus Peterson was charged with sixteen offences by the UK Serious Fraud Office on 11 December 2012 (Serious Fraud Office, 2016).

The criminal trial began 13 October 2014 and Magnus Peterson was found guilty of eight counts of fraud, forgery, false accounting and fraudulent trading and sentenced to 13 years in prison (Serious Fraud Office, 2015).

3.2.10 Conclusion on Weaving Capital

Fenwick *et al.* (2015:104) states that the Macro Fund was insolvent from its inception and although Magnus Peterson was not appointed as the director of the Macro Fund, he was responsible for the concealment of the Macro Fund's failure by initiating OTC transactions between the Macro Fund and WCF, which he owned and controlled.

The investment strategy as per the Macro Fund's Offering Memorandum was to invest in fixed income markets using bonds, money market instruments, as well as their derivative instruments, mainly futures and options. The Macro Fund did not act according to their Offering Memorandum, as the Macro Fund entered into several over the counter FRA/ IRS transactions with a related party. The flexibility of the investment strategy of the Macro Fund was an element of the Macro Fund that made it susceptible to economic crime, as over the counter transactions are not uncommon within the hedge fund industry.

Governance of the Macro Fund was another element that contributed to the susceptibility of the Macro Fund to economic crime. All the companies bearing the Weaving name were related parties and Magnus Peterson acted in a management capacity, whether formally appointed to do so or not, at all of these companies. The directors of WCF, WCM and the Macro Fund was Magnus Petersons' stepfather, Hans Ekstrom, and brother, Stephan Peterson. The related parties were acting as investment managers for each other, with Magnus Peterson making all the material decisions, which enabled him to enter into the IRS swaps with WCF, who was an illiquid related party.

Despite appointing Ernst and Young as their auditors and PNC as the fund's administrators, there was still a lack of internal controls and subjective fund valuations. Misrepresentations were being made to investors for several years in the financial statements and investor reports. Lack of internal controls, especially segregation of duties, and control of third-party service providers and administrators made the Macro Fund susceptible to economic crime.

Magnus Peterson made misrepresentations when reporting on the Macro Fund's performance to investors. The over the counter transactions and the counter-party risk involved was never

properly disclosed to investors. The Macro Fund was thus susceptible to economic crime because Magnus Petersons controlled both parties of the over the counter transactions and reported the desired performance results to investors and not the actual performance results.

Furthermore, as the performance fees of hedge fund managers are directly proportional to the performance of the hedge fund, the reversal of the investment losses and the steep growth in NAV of the Macro Fund would have to a noteworthy change in the amount of performance fees due to Magnus Peterson, which had been close to £5.8 million from 2005 till 2009. This incentive is available to all hedge fund managers and is another element that made the Macro Fund susceptible to economic crime.

Magnus Peterson could manipulate and state the performance of the hedge fund as he pleased. This led investors to believe that the Macro Fund complied with its investment strategy and that these investment transactions were all supposedly at arm's length. There was no third-party valuation despite having appointed two third party companies. Magnus Peterson was able to smooth over any valuation queries if any. As a result, an overstated internally generated valuation of the IRS transactions or the Macro Fund's NAV compromised the Macro Fund and contributed to the susceptibility to economic crime of the fund.

Magnus Peterson character was described as charismatic, reactive, confident, but also as arrogant and that his personal view of how to conduct business within the industry was the only one that mattered (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012:9). Magnus Peterson created an accepted culture where trust was relied on, inquisition ignored and where the wealth of the funds was entirely dependent on his thoughts and actions. Reliance on the reputation of Magnus Peterson and the investors trust on the internally generated performance reports made the Macro Fund vulnerable and created an opportunity for Magnus Peterson to manipulate the results of the Macro Fund.

In conclusion, Magnus Peterson, violated the investor's trust when investors were misled with fictitious returns and invested US\$780 million in the Macro Fund (Serious Fraud Office, 2015). The net loss that investors suffered was approximately US\$536 million, as the Macro Fund had no assets to pay the redemption requests of the investors (Serious Fraud Office, 2015). This was one of the first UK hedge fund prosecutions post the 2008 financial crises (Serious Fraud Office, 2015).

3.3 Relative Value Arbitrage Fund

The Relative Value Arbitrage Fund (RVAF) was incorporated as an investment company in South Africa in 2004 and it was presented to investors as a hedge fund (Garvitte Herman Lombard v Impact Financial Consultants CC and Michal Johannes Calitz, 2014). Its ultimate

collapse in 2012 was highly publicised in the local media and its manager, Herman Pretorius, committed suicide, after killing his business partner, causing the biggest scandal in the South African hedge fund history. The events pertaining to this hedge fund will be discussed according to various civil actions initiated by investors against investment managers and financial advisors, as summarised in the table below.

Table 4 - Summary of civil actions discussed pertaining to RVAF

No.	Case name	Investment manager involved
1.	Rynette Pieters, <i>et al.</i> v Susan Ann Pretorius N.O. (2013)	Not applicable as Susan Ann Pretorius is the widow of Herman Pretorius
2.	Lambertus Von Wielligh Bester N.O., <i>et al.</i> v Abraham Jacobus Stephanus Richter, <i>et al.</i> (2015)	Not applicable as the action was brought by trustees against investors
3.	Loredana Hansen v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz
4.	Johannes Enoch Hartshorne v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz
5.	Fiona Avery King v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz
6.	Erika Elise Kruger v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz
7.	Garvitte Herman Lombard v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz
8.	Ralie Johanna Blignaut and Jacob Stephanus Neethling v Vaidro 1743 CC t/a Vaidro Investments and Andrea Moolman (2015)	Andrea Moolman
9.	The Trustees for the time being of Johnnie Pringle Investment Trust IT1280/2004 v Vaidro 1743 CC t/a Vaidro Investments and Andrea Moolman (2015)	Andrea Moolman
10.	Hendrina Amedje Rautenbach v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz

No.	Case name	Investment manager involved
11.	Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz
12.	Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton (2016)	Llewellyn Claudius Loxton
13.	Gail Colleen Sheel v Mark Alexander Investment CC and Mark Alexander Eiserman (2016)	Mark Alexander Eiserman
14.	Lean Van der Walt v Vaidro 1743 CC t/a Vaidro Investments and Andrea Moolman (2015)	Andrea Moolman

3.3.1 Background to the RVAF and related entities

3.3.1.1 RVAF

The incorporation of the RVAF (Pty) Limited (RVAF) as an investment company, occurred in 2004 with Herman Pretorius being appointed as its director and hedge fund manager (Garvitte Herman Lombard v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:2). The RVAF was advertised as a hedge fund and this occurred prior to any regulatory requirements of hedge funds in South Africa being in place and therefore it did not register with the Financial Sector Conduct Authority (FSCA), previously the Financial Services Board (FSB) (Lambertus Von Wielligh Bester N.O., *et al.* v Abraham Jacobus Stephanus Richter, *et al.*, 2015:2).

RVAF was thus not a registered investment company but the investment managers listed in Table 4, supported the RVAF as a legitimate hedge fund. The investment managers also indicated that they were under the impression that the management team, namely Herman Pretorius, of the hedge fund had significant experience in the financial services arena and they also referred to the Hedge Fund Manager of the year award that the Abante Group received in 2008 (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:10).

3.3.1.2 Abante Capital

Abante Capital, previously known as Management Advisory Trust, was established in 1993 (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:7). Abante Capital was a registered investment manager with the FSCA, previously the FSB, and

obtained its licence in 2004 (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:7).

Abante Capital was the holding company of the RVAF. Investors were informed that their funds were going to be invested in the RVAF with no investment costs, and that the investment portfolio of the RVAF was held with Abante Capital with a 20 per cent share of the profits (Hendrina Amedje Rautenbach v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:4). The RVAF thus formed part of the Abante Group.

Abante Capital transferred its license to Polus Capital (Pty) Ltd in 2008, in which Abante Capital had a majority shareholding (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:7). Herman Pretorius remained a director of Abante Capital for the relevant period from 2004 to 2012 (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:7). Herman Pretorius thus managed both Abante Capital and the RVAF.

3.3.1.3 Relative Arbitrage Management

The appointed investment managing company of RVAF was Relative Arbitrage Management (Pty) Ltd, also managed by Herman Pretorius, as he was the sole director (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:17).

3.3.1.4 RVAF Trust

Another entity that formed part of Herman Pretorius' empire was the RVAF Trust (Rynette Pieters, *et al.* v Susan Ann Pretorius, 2013:2). The RVAF Trust was established on 6 March 2004 and the Trust Deed between Matt Securities, represented by Herman Pretorius and the trustees was signed on 24 March 2004 (Lambertus Von Wielligh Bester N.O., *et al.* v Abraham Jacobus Stephanus Richter, *et al.*, 2015:2). Herman Pretorius and Edward Brand were the co-trustees of the RVAF Trust. However, Edward Brand later claimed that Herman Pretorius was the only person with access to the RVAF Trust funds and that he was only a trustee on paper (Rynette Pieters, *et al.* v Susan Ann Pretorius, 2013:8).

The RVAF Trust was created by Herman Pretorius as the actual investment vehicle that was used for receiving investments in the RVAF, but investors were not aware that their investments were paid into a trust company (Lambertus Von Wielligh Bester N.O., *et al.* v Abraham Jacobus Stephanus Richter, *et al.*, 2015:2). The RVAF Trust thus received the investment funds, while investors were under the impression that they invested in a hedge fund (RVAF) and that RVAF then invested their funds according to its investment strategy. (Lambertus Von Wielligh Bester

N.O., *et al.* v Abraham Jacobus Stephanus Richter, *et al.*, 2015:2). However, no transfers were ever made between the RVAF Trust and the RVAF, as will be discussed later in section 3.3.4.

In conclusion the RVAF was advertised as a hedge fund that could achieve positive returns between 20 to 30 per cent, but it was, in fact, a trust fund, and some of the documents circulated to investors of RVAF were styled RVAF Trust IT 932/2004 (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:18).

3.3.1.5 RVAF administrator

There was no external administrator appointed by the RVAF, instead, RVAF performed their own administrative functions while managing investors monies (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:13). These administrative functions included accounting, the provision of statements for investors and the handling of withdrawals (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:13). As RVAF provided intermediary services for their own benefit, RVAF also qualified as a Hedge Fund FSP, as defined by Board notice 89 of 2007 of the Registrar of Financial Service Providers (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:13).

3.3.1.6 RVAF presented as a partnership

Investors were misled that they could subscribe to RVAF through an *En Commandite Partnership* agreement (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:17). It was later found that this agreement was not a partnership agreement even though it was styled that way, but that it was an investment management agreement (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:17).

Even though the documents were styled as being an *En Commandite Partnership*, RVAF was not a partnership, but a trust used to receive investors funds as stated in section 3.3.1.4 (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:24).

A trust and a partnership are a different legal entity and all payments pertaining to the investments in RVAF were made to the RVAF Trust (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:24). RVAF was not registered as a partnership and investors were thus misled when told that by investing in RVAF they could subscribe to the *En Commandite Partnership* (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:24).

3.3.2 Background to RVAF investments

Just before July of 2012 RVAF had investments from more than 3,000 investors that amounted to more than US\$250 million (Maglich, 2012). To attract new investors, Herman Pretorius paid commissions to investment managers to direct business to the RVAF (Maglich, 2012). These commissions ranged from 7,5 to 12 per cent of the new business directed to RVAF (Maglich, 2012).

In the civil actions against the investment managers, it was found that the investment managers did not apply their own investment strategies, but that they trusted Herman Pretorius' reputation, and convinced their clients to invest in the RVAF. These Investment Managers received the investor funds and then transferred it to the RVAF Trust (Loredana Hansen v Impact Financial Consultants CC and Michal Johannes Calitz (2014), Ralie Johanna Blignaut and Jacob Stephanus Neethling v Vaidro 1743 CC t/a Vaidro Investments and Andrea Moolman (2015), Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton (2016) & Gail Colleen Sheel v Mark Alexander Investment CC and Mark Alexander Eiserman (2016)).

It became evident that Herman Pretorius was running a Ponzi scheme when the new investments in RVAF could not keep up with the redemption requests received because of an allegation by a journalist that it was a Ponzi scheme (Maglich, 2012). When the financial records of RVAF were examined it indicated that the funds received from investors were never invested in any shape or form (Rynette Pieters, *et al.* v Susan Ann Pretorius, 2013:5). Instead, these new investments were used to pay redemptions of older investment redemptions (Rynette Pieters, *et al.* v Susan Ann Pretorius, 2013:5). From this, it was clear that Herman Pretorius was operating a Ponzi Scheme.

Herman Pretorius had successfully run this scheme since 2002 till July 2012 (Rynette Pieters, *et al.* v Susan Ann Pretorius, 2013:6). This leaves one wondering how he managed to run this scheme without discovery for ten years.

3.3.3 RVAF investment strategy

In Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton (2015:5) reference is made to an introductory letter called 'INVESTMENT WITH ABANTE CAPITAL (PTY) LTD'. In this introductory letter, it is stated that Abante Capital makes use of the arbitrage techniques when investing and the introductory letter also specifically referred to the investment strategy as "pairs trading" (Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton, 2015:5). It should be noted that this introductory letter did not make reference to the RVAF, but to the holding company Abante Capital's investment strategy.

This means that RVAF applied a combination of statistical and fundamental models to identify circumstances where similar groups of shares with similar economic exposure are priced differently in the different markets (Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton, 2015:5). The variance in the pricing of these shares is the factor of this investment strategy that is ultimately responsible for the profits of the investment (Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton, 2015:5).

Abante Capital also made presentations that classified the RVAF as a market neutral fund that took long and short positions, did pairs trading and strived to achieve diversification of an investor's portfolio (Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton, 2015:5). Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz (2014:23) supported this statement.

Herman Pretorius also explained the applied strategies of RVAF to investors and investment managers (Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton, 2015:8). This presentation by Herman Pretorius elaborated on the structure of RVAF and explained that the entire portfolio of RVAF was divided between five investment managers of RVAF, where each investment manager was responsible for a different type of pair investment strategy, thus taking into account the different markets and spreading the risk across the various markets (Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton, 2015:8).

In reality, no pairs trading or any other investments were made and thus the investment managers did not represent different markets. However, the presentation made by Herman Pretorius to investors provided them with a certain level of comfort, as the risk was spread amongst the five investment managers, each with a different pair trading instrument (Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton, 2015:8). Using this investment strategy, RVAF reported low margins, but the high monthly volume of trades resulted in above average returns (Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton, 2015:8).

In Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz (2014:3) the investment manager responded to a query from an investor pertaining to a loss of capital due to bad judgement pertaining to the long or short positions. The investment manager, Michal Johannes Calitz, answered by saying that although there is a possibility of capital loss, the RVAF has performed above expected levels and has generated an annual return of approximately 20 per cent (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:3).

This reported return rate of 20 per cent was high compared to normal market performance at the time. It was due to these steady returns, that investors were interested in RVAF, and as these returns were capitalised within RVAF, that only resulted in capital gains when investors withdrew the funds (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:7).

According to *Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz* (2014:28) investors paid no fee to the RVAF, but the RVAF claimed 20 per cent of the profits made. As the profits generated have a correlation to the level of risk of investments made, a hedge fund manager's ability to manage the risk is the most important factor in an investment (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:3).

In RVAF's case, investment managers were confident in the risk management process of the RVAF and were of the opinion that the RVAF would be considered a low-risk hedge fund in the general hedge fund market, as the hedge fund was not influenced by unsteadiness in the market (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:10). This statement was echoed in *Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, (2014:3). Herman Pretorius himself made a similar statement and confirmed that the risks associated with RVAF are relatively low (*Leon van der Walt v Vaidro 173 CC t/a Vaidro Investments and Andrea Moolman*, 2015:6).

Based on these statements the RVAF investors appeared to be comfortable with the level of risk and relied on the investment strategies as advertised by the RVAF.

3.3.4 Unravelling of the RVAF

Initially, investors had queries pertaining to the FSB registration of Abante Capital and its investment funds, that included the RVAF. Upon making these enquiries, Herman Pretorius assured investment managers that Abante Capital was registered with the FSB (*Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton*, 2015:9). Further enquiries showed that Abante Capital did not hold an FSB license anymore, but once again Herman Pretorius responded to these queries by explaining that the license was now being held by Polus Capital, the fund manager of RVAF (*Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton*, 2015:9). Herman Pretorius provided further assurance by stating that Abante Capital registered with the South African Hedge Fund Association on behalf of the investment funds within the Abante Capital group and therefore did not require to be registered with the FSB (*Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton*, 2015:9).

In *Loredana Hansen v Impact Financial Consultants CC and Michal Johannes Calitz* (2014:4) it is stated that there was a supposed conflict between Herman Pretorius, his former business associate Julian Williams. Julian Williams was the director of SA Superalloys Limited, a company that was involved in the misuse of investor funds as discussed in section 3.3.5. This conflict made the investor managers, as listed in Table 4, uneasy, as Julian Williams began warning investors about RVAF (*Loredana Hansen v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:4).

When one of the investor managers, that represented the majority of RVAF investors, Michal Johannes Calitz, tried to withdraw the investors' funds in July 2012 the withdrawal was unsuccessful and the RVAF Trust was placed into final sequestration soon thereafter (*Loredana Hansen v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:4). On 1 August 2012, the RVAF Trust was placed under provisional sequestration. (*Rynette Pieters, et al. v Susan Ann Pretorius*, 2013:1).

It was determined by the High Court that the total amount of investments that are unaccounted for, exceeds R2 billion, which includes the R5,2 million regarding Rynette Pieters (*Rynette Pieters, et al. v Susan Ann Pretorius*, 2013:4).

There were no documents to provide evidence as to where these funds may be, as it could not be proofed that Herman Pretorius used all of the funds for his personal gain (*Rynette Pieters, et al. v Susan Ann Pretorius*, 2013:4).

Even though the claims of defrauded investors surpassed the value of assets belonging to Herman Pretorius, the estate of the deceased Herman Pretorius was placed under sequestration to provide investors with some form of restitution (*Rynette Pieters, et al. v Susan Ann Pretorius*, 2013:5).

3.3.5 Misrepresentation to investors

RVAF continuously reported above average returns, usually higher than 20 per cent, which attracted the potential investors and this performance measurement was frequently used by investment managers to persuade their clients to invest in this fund (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:3). This resulted in various misrepresentation to investors that will be discussed below:

3.3.5.1 Misrepresentation regarding the partnership agreement

Documentation pertaining to the investment in the RVAF, indicates that investors become *En Commandite* partners in the RVAF (*Craig Stewart Inch v Impact Financial Consultants CC and*

Michal Johannes Calitz, 2014:12). An *en commandite* partnership is a type of partnership where there is one or more silent partner that contributes funds but is only liable for the capital invested and if defined, matters of the registered scheme of liability (Olivier & Honiball, 2011: 167).

In *Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman* (2016:17), the judge found that even though the application form refers to a partnership agreement, the actual document provided by the respondent was headed, 'Investment Management Agreement'. It is therefore a management agreement between Relative Arbitrage Management (Pty) Limited, being the investment manager of RVAF, and the RVAF *En Commandite* Partnership, being the hedge fund (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:17).

Herman Pretorius controlled Relative Arbitrage Management (Pty) Limited and thus had absolute control over the investment management agreement. The appointment of Relative Arbitrage Management (Pty) Limited, as the investment manager of the RVAF was not an arm's length transaction, as they were related parties and the level of investor protection was reduced (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:18).

Subscribers in the *En Commandite* Partnership were misled, as they were not entering into a partnership, because the only document was an investment management agreement. Furthermore, Relative Arbitrage Management (Pty) Limited was appointed as the investment manager of RVAF that availed all its assets to Relative Arbitrage Management (Pty) Limited.

3.3.5.2 Lack of contact details

Upon examination of the partnership documentation of the RVAF, it was noted that there was no contact number or details pertaining to any individual serving as a contact person on the document (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:12). This fact was also confirmed in *Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman* (2016:18). This was of some concern to the judge in *Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz* (2014), as this indicated that investors did not know who was involved in their investments or who they could contact should they have any queries. This concern was reiterated by the judge in *Leon van der Walt v Vaidro 173 CC t/a Vaidro Investments and Andrea Moolman* (2015).

The first indication of an address for RVAF was contained in a letter dated 8 April 2010 from Eduard Brand with the subject of the letter being "for and on behalf of RVAF EN COMMANDITE PARTNERSHIP" (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes*

Calitz, 2014:13). Another Acknowledgement of Investment letter between an investor and RVAF *En Commandite* Partnership dated 5 November 2010 with the same subject as the letter mentioned above, was also one of the first documents to provide contact information of the party involved (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:4).

The letter dated 8 April 2010 did not refer to any partners of the RVAF and therefore investors did not know who represented the counterparty and who would be responsible for the actions of RVAF (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:13). These letters were soon followed by investment statements sent out by RVAF, which included the same contact information contained in the letters mentioned above (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:14). These letters were headed RVAF Trust IT 932/2004 (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:14).

3.3.5.3 Control of investor funds

As mentioned earlier, RVAF had complete control over the funds of investors (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:14). RVAF had no nominee company or nominee account which meant that the investors' funds were deposited directly to RVAF Trust account (Leon van der Walt v Vaidro 173 CC t/a Vaidro Investments and Andrea Moolman, 2015:7).

The bank details provided to investors for payment, was of concern to the Office of the Ombud for Financial Services Providers in Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz (2014), as it belonged to the RVAF Trust and not to a nominee company (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:13).

This concerning statement regarding the bank account details provided to investors was also repeated in Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz (2014:13).

Section 8(2) of the Discretionary Code of the FSCA, requires the use of a nominee account to receive investor funds as a control measure to insure a level of investor protection. RVAF did not comply with this requirement of the FSCA and as a result the level of investor protection was reduced and created an opportunity for RVAF to manage the funds invested as they pleased (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:16).

In *Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz* (2014:16) it was stated that this type of management was in clear violation of Section 8(2) of the Discretionary Code of the FSCA, previously the FSB (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:16).

3.3.5.4 Lack of financial statements and accounting records

Herman Pretorius did not keep proper books and records which made performing due diligence on RVAF difficult (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:22). In *Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz* (2014) and *Leon van der Walt v Vaidro 173 CC t/a Vaidro Investments and Andrea Moolman* (2015) both judgements concluded that the investment managers, were never concerned about the fact that the RVAF never produced financial statements and blindly accepted the communication received from RVAF that supported the alleged returns.

It was also implied in *Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz* (2014) that this type of ignorant behaviour of investment managers meant that the investment managers did not care to understand the business activity of RVAF or the method followed to generate returns (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:23). This was repeated in *Leon van der Walt v Vaidro 173 CC t/a Vaidro Investments and Andrea Moolman* (2015:3), when the judge stated that the investment manager, in this case, could not have understood the business activities of the RVAF, as the investment manager never received a fact sheet or financial statements of the RVAF.

3.3.5.5 Commissions earned by investment managers

The judge also found in *Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz* (2014:29) that investors were not aware of the high level of commissions that their investment managers earned. As referred to earlier in the section, these commissions that ranged between 7,5 and 12 per cent were paid out to investment managers that directed new business to RVAF (Maglich, 2012). These commissions were only disclosed to investors in a report dated 13 June 2013 that the trustees of the insolvent estate of the RVAF issued to its creditors (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:24).

The Tribunal found that at this time it would be reasonable to conclude that the investor managers in this case have become oblivious and ignorant of the warning signs and the possible impacts they might have (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:13).

3.3.5.6 Investment managers conducting business with an unlicensed financial service provider

In *Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz* (2014:21) it was found that no documentation or marketing material confirmed that Herman Pretorius or the RVAF was licensed with the FSCA, previously FSB, as required by Section 8(b) of the Financial Advisory and Intermediary Services (FAIS) Act (37 of 2002). In fact, in *Leon van der Walt v Vaidro 173 CC t/a Vaidro Investments and Andrea Moolman* (2015:8), it was determined that the RVAF was not mentioned anywhere in the document, namely the Symmetry Multi-Manager South African Hedge Fund Survey, that was used to support this investment decision.

As mentioned, Section 7(1) of the FAIS Act prohibits a person to act or to offer to act as a financial services provider, unless such person has been issued with a license under Section 8 (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:15). In Section 7(3) an authorised financial services provider may only conduct financial services activities with a person providing financial services if that person has, where lawfully required, been issued with a license for the provision of such financial services (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:15).

As Herman Pretorius and RVAF were not licensed, any investment manager that conducted financial service activities with these two parties were in breach of the Sections stated above (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:15).

Investors invested approximately US\$250 million in the RVAF over a period of 10 years (Maglich, 2012). Investment amounts varied, and some amounts were more than R1 million, but once it was announced that RVAF was a Ponzi Scheme, investors then lost their investments in RVAF in July of 2012 (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:2).

3.3.5.7 Management of the RVAF trust

Herman Pretorius acted in isolation of other relevant investment managers and trustees when it came to managing companies in his empire (*Rynette Pieters, et al. v Susan Ann Pretorius*, 2013:8). This was also confirmed by a co-trustee of the RVAF Trust, Eduard Brand, when he stated that Herman Pretorius was the only person who had access to investor funds and information (*Rynette Pieters, et al. v Susan Ann Pretorius*, 2013:8).

The quarterly returns due to investors were reported to Eduard Brand, the co-trustee, to distribute the information to investors, but no records were ever attached to support these return figures (*Rynette Pieters, et al. v Susan Ann Pretorius*, 2013:9). Upon examination of the RVAF

financial records, it appeared that the funds received from investors were never invested in any shape or form, but those new investments were used to pay redemptions of older investment redemptions (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:6). Based on this it confirms that Herman Pretorius was operating a Ponzi Scheme.

3.3.5.8 Misappropriation of investor funds by Herman Pretorius

Herman Pretorius did not have any other source of income except for the income derived from the investment scheme and his wife has been unemployed since 1991 (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:6). Despite having only one source of income, Pretorius had immovable property totalling R116,9 million and approximately R146 million worth in shares, investments and loans according to an asset statement dated 2012 (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:6). Several vehicles were included in the asset statement, one of which was an Aston Martin DBS that was paid for, in April of 2009, with monies that originated from the RVAF (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:7).

Furthermore, amounts of R22,72 million have been received by Herman Pretorius from the RVAF funds either directly or indirectly, via another entity under his control, over a period of five years (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:7).

In summary it appears that Herman Pretorius thus diverted approximately R285,6 million from the RVAF investment funds to finance his personal lifestyle.

3.3.5.9 Loan to Exotic International

Another instance of misuse of investors' funds was a loan that Herman Pretorius granted from the RVAF funds to a grape farming company called Exotic International in 2009 (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:7). The loan was an interest free loan and the loan amount was just over R32 million (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:7). Even though the loan was granted by the RVAF to Exotic International, the repayment of the loan had to be made by Evstasa to SA Superalloys Limited, a company owned by Herman Pretorius' former business partner Julian Williams (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:7).

In the audited financial statements of SA Superalloys Limited for the 2011 financial year, a personal loan claim was listed for Herman Pretorius of approximately R30,9 million (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:7). This claim of Herman Pretorius was created due to the repayment of the loan granted by RVAF to Exotic International.

3.3.5.10 Offshore hedge fund Mat Worldwide Limited

Another scheme that Herman Pretorius was involved in during the same period as the RVAF, was a hedge fund in the British Virgin Islands called Mat Worldwide Limited (MWL) to attract investors that wished to invest offshore (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:7). Herman Pretorius was the only director and shareholder of MWL and thus had sole control over this hedge fund and its bank accounts (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:7). MWL held two bank accounts, one in US dollars and the other in British sterling, where investments had to be paid into, but not all of the funds were deposited into these accounts. Some of the investments made, were not paid directly into MWL's bank accounts, but to a Nedbank bank account held by Herman Pretorius, as he gave the impression that he would transfer these funds to the offshore accounts (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:8).

Some investors that deposited funds into this Nedbank bank account, received payments for their redemptions from the RVAF Trust bank account, which provides further confirmation that Herman Pretorius made payments to old investors with new investors' money (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:6).

The total amount invested in MWL amounted to £13 million, of which only £450,000 is accounted for. (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:8). The whereabouts of the remaining £12,55 million are still unknown.

3.3.6 Civil and criminal proceedings

In Pieterse vs Pretorius (2013), it was determined that there was a *prima facie* case that Herman Pretorius conduct was of a fraudulent nature as he was running a Ponzi Scheme.

According to Kane (cited by Niinimäki, 2012:12) a Ponzi scheme is a fund-raising initiative with little or no underlying assets, that is normally required to generate income to settle debts with lenders and investors, but instead the entity increases the level of liabilities faster than interest and dividend payments, as the entity uses the funds from new investors to pay the interest and dividends owed to lenders and investors.

The missing investor funds of RVAF as well as MWL, exceeding amounts of R2 billion, have not been found (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:8). Herman Pretorius had successfully run these schemes from 2002 till July 2012 (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:1). This leaves one wondering how he managed to run this scheme without discovery for ten years.

Due to the suicide of Herman Pretorius a criminal action could not be brought against him. Investors did however, bring civil actions against their investment managers, as well as the wife of the deceased Herman Pretorius. In *Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman* (2016:2) it was found that Herman Pretorius operated RAAF as a Ponzi scheme.

The table below summarises the orders that were given as a result of these civil actions brought against various parties involved in the RAAF investments:

Table 5 - Summary of civil actions brought against parties involved in RAAF investments

No.	Case name	Brought against	Summary of order given
1.	Rynette Pieters, <i>et al.</i> v Susan Ann Pretorius N.O. (2013)	Susan Ann Pretorius, the widow of Herman Pretorius	The deceased estate of the late Herman Pretorius was provisionally sequestered.
2.	Lambertus Von Wielligh Bester N.O., <i>et al.</i> v Abraham Jacobus Stephanus Richter, <i>et al.</i> (2015)	11 investors that invested in RAAF	The plaintiff in this action was the joint trustees of RAAF Trust. The application brought requested a summary judgement for all cases against the 11 investors. The applicants stated that the amount that RAAF Trust paid out to these investors exceeded the amounts that they were due. A summary judgement was refused and the defendants were granted the opportunity to defend their cases individually.
.	Loredana Hansen v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R630,000.
4.	Johannes Enoch Hartshorne v Impact Financial Consultants CC	Michal Johannes Calitz, Investment	The Respondents were ordered, jointly and severally, to pay the complainant the amount of

No.	Case name	Brought against	Summary of order given
	and Michal Johannes Calitz (2014)	Manager	R460,000.
5.	Fiona Avery King v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R493,674.
6.	Erika Elise Kruger v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R800,000.
7.	Garvitte Herman Lombard v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R700,000.
8.	Ralie Johanna Blignaut and Jacob Stephanus Neethling v Vaidro 1743 CC t/a Vaidro Investments and Andrea Moolman (2015)	Andrea Moolman, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R143,500.
9.	The Trustees for the time being of Johnnie Pringle Investment Trust IT1280/2004 v Vaidro 1743 CC t/a Vaidro Investments and Andrea Moolman (2015)	Andrea Moolman, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R285,006.
10.	Hendrina Amedje Rautenbach v Impact	Michal Johannes Calitz, Investment	The Respondents were ordered, jointly and severally, to pay the

No.	Case name	Brought against	Summary of order given
	Financial Consultants CC and Michal Johannes Calitz (2014)	Manager	complainant the amount of R701,350.
11.	Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz (2014)	Michal Johannes Calitz, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R500,000.
12.	Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton (2016)	Llewellyn Claudius Loxton, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R120,000.
13.	Gail Colleen Sheel v Mark Alexander Investment CC and Mark Alexander Eiserman (2016)	Mark Alexander Eiserman, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R800,000.
14.	Lean Van der Walt v Vaidro 1743 CC t/a Vaidro Investments and Andrea Moolman (2015)	Andrea Moolman, Investment Manager	The Respondents were ordered, jointly and severally, to pay the complainant the amount of R206,000.

3.3.7 Conclusions on RVAF

RVAF stated in its investment strategy that it applied pairs-trading through arbitrage techniques. RVAF reported positive returns that ranged between 14 and 25 per cent and investors relied on the investment strategies advertised by RVAF. However, RVAF did not invest investor funds according to its investment strategy or made any other investments as it was functioning as a Ponzi scheme. This deviation from the investment strategy was the first element that made RVAF susceptible to economic crime.

Another element that led to RVAF's susceptibility to economic crime was the lack of independent third parties due to Herman Pretorius' conflict of interest and the involvement of related parties. Herman Pretorius was the hedge fund manager of RVAF and RVAF appointed Relative Arbitrage Management (Pty) Limited as their investment management company, which was part of the Abante Group. Both Relative Arbitrage Management (Pty) Limited and the Abante Group were controlled by Herman Pretorius. Herman Pretorius also served as a trustee of the RVAF Trust. Due to this lack of independence, any transactions or agreements entered into between these parties were related party transactions and created a conflict of interest that contributed to the misappropriation of investor funds.

Herman Pretorius also used MWL, a hedge fund in the British Virgin Islands, to attract investors that wished to invest offshore and he was the only director and shareholder of MWL. Herman Pretorius was the only director and shareholder of MWL and thus had sole control over this hedge fund and its bank accounts. Some of the investments in MWL were not paid directly into MWL's bank accounts, but to a Nedbank bank account held by Herman Pretorius, as he gave the impression that he would transfer these funds to the offshore bank accounts. Herman Pretorius did not transfer all of these funds received in his Nedbank bank account to MWL's bank accounts. Some investors that deposited funds into this Nedbank bank account, received payments for their investment redemptions in MWL from RVAF Trust's bank account, which provides further confirmation that Herman Pretorius misappropriated investor funds of both RVAF and MWL.

RVAF had no independent administrator and RVAF performed their own administrative functions. RVAF did not appoint a nominee company or a nominee bank account where investors could make their deposits, which meant that these investor funds were received directly in the bank account of RVAF Trust. All of the above gave Herman Pretorius free access to investor funds and this enabled him to direct these funds as he chose. No third-party administrator or service providers and the lack of internal control contributed to RVAF's susceptibility to economic crime.

The lack of independent investor reporting and independent financial performance valuations made RVAF susceptible to economic crime. The parties involved in the hedge fund, namely Relative Arbitrage Management (Pty) Limited as the investment manager company and Herman Pretorius serving as trustee/director for both RVAF Trust and Relative Arbitrage Management (Pty) Limited, was not disclosed to the investors. RVAF never provided financial statements but investment managers stated their support of the reported returns, as per the communication received from RVAF. However, the financial performance of RVAF was determined and communicated by Herman Pretorius to investment managers and investors, which made the reporting to investors subjective.

RVAF's financial performance was fabricated by Herman Pretorius and communicated to Edward Brand to distribute to investors without any supporting documentation. No financial statements of the RVAF were sent to investors. The only information the investors received were investor reports containing the performance results of RVAF, as calculated by Herman Pretorius.

To keep up appearances of a valid hedge fund, performance fees were still charged to keep up the pretence that RVAF was trading and performing as reported, even though it had not made any valid investments. This performance fee, received by Herman Pretorius, served as an incentive to continue with the Ponzi scheme, and was another element that made RVAF susceptible to economic crime.

Herman Pretorius performed the valuation of RVAF as no independent valuation was performed. This subjective valuation of RVAF made it susceptible to economic crime because Herman Pretorius was able to create misstatements and misrepresentations due to the lack of independence.

Lastly, investors relied on their investment managers and the reputation of Herman Pretorius. Investors did not question the lack of supporting documentation or the lack of third-party involvement. This reliance on the reputation of Herman Pretorius and the trust they placed on their investment managers made RVAF susceptible to economic crime.

In *Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz* (2014), the final judgment stated that investors never received sufficient information to assist them in making informed decisions and fell victim to the inherent risks of this specific investment, which was the responsibility of the investment managers.

Investors' profile and needs were not taken into account when evaluating whether the investment in RVAF as a hedge fund would be suitable for the investor, as was the requirements according to Section 8(1)(c) and Section 9 of the Code (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:12). It was also emphasised that investments were made before any documentation was signed by the investors, which is also in breach of the FAIS Act (*Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz*, 2014:26). There was a lack of understanding of the business of RVAF and its sustainability (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:26). Investors could thus not make an informed decision as required by Section 8(2) of the general code and the respondents failed to comply with the FAIS Act (*Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman*, 2016:25).

Herman Pretorius and RVAF were both not registered in any way with the FSCA, which meant that most investment managers were violating Sections in the FAIS Act. Some investment managers argued that even if all legislative requirements were adhered to, Herman Pretorius would have still continued to commit fraud. Although this statement may have carried some truth, it is still not a valid point as the investment managers needed to perform basic due diligence, which almost all of them failed to do (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz 2014:22). Basic due diligence would have prevented investors from investing in RVAF and their investments would not have been exposed to high levels of risk due to several red flags (Craig Stewart Inch v Impact Financial Consultants CC and Michal Johannes Calitz, 2014:22).

A Department of National Treasury Public Comment Matrix pertaining to the Framework for the regulation of Hedge Funds in South Africa, published on 13 September 2012, calls the RVAF scandal the South African equivalent of the Ponzi scheme that was run by Bernard (Bernie) Madoff in the USA (Department of National Treasury, 2012:81). This is a significant comparison as Bernie Madoff ran his Ponzi scheme over several decades and this is still the most infamous Ponzi scheme in recent history (Lewis, 2011:296).

Furthermore, the judgement of Rynette Pieters & 2 Others N.N.O. and Ralph James Barry Taylor & 21 Others v Susan Ann Pretorius N.O. (2013) determined that there was a *prima facie* case that Herman Pretorius conduct was of a fraudulent nature and that he was running a Ponzi scheme and it is highly likely that criminal proceedings would have been initiated if he had still been alive.

3.4 Conclusion on the case studies

DDCM had a hedge fund, the Growth Premium Master Fund, and two feeder funds that generated the funds for the Growth Premium Master Fund. The main investment strategy of the Growth Premium Investment Fund was causing substantial losses for the fund and its manager, Alberto Micalizzi (Micalizzi) was searching for ways to turn around the performance of the Growth Premium Master Fund. Micalizzi found a solution in the form of investing in bonds with an underlying asset of diesel oil, the Asseterra Bonds. However, having entered into these contracts without due diligence and without disclosing the initial losses incurred by the fund, the Asseterra Bonds were determined to have no economic substance and any profit recorded pertaining to these bonds were fictitious. Micalizzi lost his licence awarded to him by the FCA and although he was not criminally charged, he received a fine of £2,7 million. The financial crises of 2008 and due diligence performed by the lenders of the Growth Premium Master Fund were the reasons why these misrepresentations and fraudulent bonds were uncovered.

In the Weaving Capital case study, the Macro Fund suffered losses due to its main investment strategy and therefore its manager Magnus Peterson created fictitious assets and income for the Macro Fund by entering into several OTC transactions with related parties. The Macro Fund started experience hardship once the redemption requests, post the 2008 financial crises, started to come in. It became clear that there were not enough funds to repay the investors and eventually the fund was liquidated and Magnus Peterson was sentenced to 13 years in prison.

In the previous two case studies, incurred losses seem to be the trigger that mobilised the hedge fund managers to get creative on how to convert those losses into profit, but in the case of the RFAF there were no losses incurred, because funds were never invested. Herman Pretorius, the hedge fund manager, used the hedge fund as a vehicle to run his Ponzi scheme. Incoming funds from new investors were used to pay withdrawals, dividends and interest to old investors.

By studying the above three case studies, each of them had a unique scheme, but the contributing factors that created a vehicle for misrepresentation were very similar in every case. These factors will be elaborated on in chapter four of this study.

CHAPTER 4

IDENTIFYING ELEMENTS OF HEDGE FUNDS THAT ARE SUSCEPTIBLE TO ECONOMIC CRIME

4.1 Introduction

In this chapter the case studies discussed in chapter three of this study will be analysed in conjunction with the elements of hedge funds discussed in chapter two to determine whether these elements are susceptible to economic crime.

Prior to the early 1990s, economic crime within hedge funds was not a subject worth researching, as there were seldom cases reported, but with the increase of economic crime to unseen levels in the 1990s, that all changed (Johnson, 2010:252). Although most hedge fund managers do not set out to defraud investors from day one, many clearly have done so by capitalising on the lack of regulation and diverse nature of hedge funds to escape the pressure from investors and the financial markets. According to Johnson (2010:261) among the 100 hedge fund fraud cases that he studied in the USA, 52 per cent of the fraudulent acts were preceded by substantial financial investment losses.

The types of hedge fund fraud charges according to William H. Donaldson, the chairperson of the U.S. Securities and Exchange Commission (SEC), as set out in section 2.4 above, can be split into two main categories which are: misrepresentation of investments and secondly misappropriation of funds.

According to Capco's white paper (2005), a company based in the USA and Canada, misrepresentation of investments is the act of creating or instigating the production of reports and valuations with false and misleading information and disclosing these false reports to their investors. The misrepresentation of fund investments and activities makes up 41 per cent of the operational risks that hedge funds fall subject to (Capco, 2005). This is clearly a problem in both its prevalence among failed hedge funds and its relationship to other issues and risks. Examples of misrepresentation of investments are where managers modify the valuation of their hedge funds and/or their investment results to hide the actual fund/investment performance and making false or misleading statements in offering documents (Capco, 2005).

Misappropriation of funds can be executed either as a downright theft or to cover pre-existing trading losses, by investment managers who intentionally move money out of the hedge fund for personal benefit (Capco, 2005). In other words, the loss suffered by the hedge fund is followed by the theft of the remaining investment or a part there of (Johnson, 2010:262) and can take the

form of unnecessary and undisclosed commission payments. Another example of misappropriation of assets is market manipulation in a variety of guises and fraudulently allocating investment opportunities to the benefit of the fund manager (Ben-David *et al.*, 2013: 2422).

Although these schemes are not unique to hedge funds, the fundamental characteristics that differentiate hedge funds from any other fund, allows hedge funds to be more susceptible to economic crime and these elements are identified and discussed in the sections below.

4.2 Deviation from investment strategies

4.2.1 Background

As stated in section 2.3.6 mutual funds have limited charters regarding investment strategies that are driven by regulators and industries, whereas hedge funds have a broader spectrum of investment styles driven by achieving absolute positive returns (Lhabitant, 2011:54). Hedge fund managers can adapt to market conditions by implementing these diverse investment strategies (Lhabitant, 2011:55). The ability of hedge funds to implement diverse investment strategies also enables hedge funds to deviate from its primary investment strategy to achieve absolute positive returns.

A significant deviation from the hedge funds' investment strategies were high volumes of investments in derivative instruments. Investing in derivative instruments have been the cause of several hedge fund failures, but it was a significant factor in the failure of several financial institutions in the last financial crises (Martin, 2012:99). Considering the case studies discussed, investments (whether genuine or fictitious) were made in derivative instruments, which made it difficult for the investor to understand the investments that were being made.

4.2.2 Case studies

When considering the case study regarding the Dynamic Decisions Capital Management (DDCM) fund, the deviation from its main investment strategy and failure to disclose this to investors was one of the first elements of the hedge fund that made the DDCM fund susceptible to economic crime. The hedge fund of DDCM was advertised as a low risk, market neutral fund that engaged in pairs-strategy. Furthermore, the Offering Memorandum's of the DDCM fund prohibited the investment in property and commodities and limited the exposure to counterparty solvency to less than 20 per cent of gross assets of the hedge fund.

The investments in the Asseterra Bonds were in contradiction with the Offering Memorandum's investment restrictions because it entailed investing in an underlying commodity, namely diesel

oil. By the end of 2008, the Growth Premium Master Fund had invested 55 per cent of its assets in the Asseterra Bonds, which exposed more than 20 per cent of the hedge fund to the solvency of another party. If investors were more intuitive, they would have noticed that the Asseterra Bonds' value increased with almost ten per cent during a period that the underlying commodity, namely diesel oil, experienced a drop-in price. This would have been a clear indication that something was amiss.

By entering the investment in the Asseterra Bonds these investment restrictions were clearly breached and investors were only informed about the investment in the Asseterra Bonds two months after the investment had supposedly been made.

In addition to transgressing its own Offering Memorandum, the Growth Premium Master Fund did not adhere to the investment limitations set out by its lenders. The Asseterra Bonds were not market related and illiquid and even though DDCM was not supposed to invest in commodities, there was also no underlying commodity to the investment. This deviation from the main investment strategy was most likely induced by the pressure of the ongoing trading losses incurred due to the main investment strategy of the Growth Premium Master Fund and secondly by Micalizzi's statement that it was the goal of the hedge fund to increase its assets under management from its current US\$500 million in 2008 to US\$1 billion in 2009 and an unlevered growth of seven to eight per cent.

Secondly, when considering the Weaving Capital case study, there was once again a deviation from the Macro Fund's main investment strategy, as was the case with DDCM. The investment strategy as per the Macro Fund's Offering Memorandum was to invest in fixed income markets using bonds, money market instruments, as well as their derivative instruments, mainly futures and options. The Macro Fund was supposed to limit their exposure of its gross assets to the solvency of a counterparty to 20 per cent. The Macro Fund also stated in their Due Diligence questionnaires that most of their trades are exchange trades, which makes the valuation thereof very simple and prevents any pricing discrepancies.

However, this was not the case, as the Macro Fund entered into several Over the Counter (OTC) Interest Rate Swaps (IRS) transactions with a related party, which was a clear deviation from their main investment strategy. Furthermore, it exposed the Macro Fund to more than 20 per cent of a counterparty's solvency, which was a restriction according to the Offering Memorandum. The Macro Fund did not apply a diversified risk profile strategy, as stated in their Offering Memorandum, as the ratio of IRS contracts to other trade instruments was 70:30 from 2006 onwards.

Lastly, the Relative Value Arbitrage Fund (RVAF), as part of the Abante Group, had an investment strategy that stated it applied pairs-trading through arbitrage techniques. This means that RVAF applied a combination of statistical and fundamental models to identify circumstances where two financial instruments within the same sector are priced differently in the market. The advertised returns of this investment strategy ranged between 14 and 25 per cent. With such a high return rate in the South African economy, RVAF attracted several investors and investment managers could easily persuade their clients to invest in this hedge fund.

It was due to these steady returns that investors were interested in RVAF. Investors relied on the investment strategies advertised by RVAF, but when RVAF was unable to meet its redemption requests, investors realised that like the other two case studies, RVAF did not invest according to its investment strategy, but was running a Ponzi scheme instead, by paying older investors with new investor funds.

4.2.3 Conclusion

From the above, it is very clear that with all of these case studies, the hedge funds advertised a certain investment strategy, but did not keep to it. Why did investors not know about this deviation? An element of hedge fund investment strategies is that it is common practice for hedge funds to be secretive about their investment strategies. According to Gregoriou and Lhabitant (2009:12), the quality of the hedge fund's operations will be expressed through some level of transparency by the hedge fund. This ties in with disclosure of hedge funds and will be discussed below in section 4.6.

The type of investments that are possible for hedge funds, as well as the investment strategies at its disposal, is one of the elements that make hedge funds very unique but is also an element that makes hedge funds susceptible to economic crime. As discussed with all of these case studies, the hedge funds advertised a certain investment strategy, but did not keep to it.

4.3 Hedge fund liquidity

4.3.1 Background

Hedge funds are more often than not, in an illiquid position. The level of minimum investment and the lock-up periods before investors are entitled to redemptions, are both elements of hedge fund investments that contribute to the incentive to misreport returns (Cumming & Dai, 2010:838). Cumming and Dai (2010:838) found that the high level of minimum investment might lead to hedge fund managers to misreport returns. The larger the minimum investment, the higher the incentive is for the hedge fund managers to misreport returns to attract new

investments. Redemption limitations, on the other hand, impacts the liquidity of a hedge fund. Most hedge funds require a notice period for investor redemptions, which is usually around 30 to 60 days with some hedge funds locking up the investor's initial investment for a whole year or longer (Martin, 2012:100).

If investors are eligible for monthly redemptions rather than yearly redemptions, the hedge fund becomes less liquid, as the level of redemptions may surpass the level of investments. This may serve as an incentive to misreport returns, in order to attract new investments that can cover the redemption requests (Cumming & Dai, 2010:838). Cumming and Dai (2010:852) concluded that hedge funds that do not have a lockup period have a higher chance of misreporting monthly returns due to the threat of constant redemptions. This puts pressure on the hedge fund manager to secure capital continuously, which might be achieved by positive fund performance (Cumming & Dai, 2010:852). These limitations on when investors may request redemptions of their investments in combination with the riskier investment strategies applied by hedge funds, can very easily place a hedge fund in a very illiquid position and cause a high level of risk for the investor (Martin, 2012:100).

4.3.2 Case studies

In the DDCM case study, the Asseterra Bonds that the Growth Premium Master Fund invested in were proven to be illiquid, as the underlying asset of the bond was illiquid. The supposed investment in the Asseterra Bonds increased the net asset value of the Growth Premium Master Fund without any cash flow taking place between the parties involved. Unable to meet the redemption payments owed to investors, the Growth Premium Master Fund was insolvent. This insolvency was due to the fact that the Asseterra Bonds comprised 85 per cent of the hedge funds NAV and could not be sold again.

In the Weaving Capital case. Magnus Peterson advertised the Macro Fund as being highly liquid and able to be sold off in one day. This was not the case. The IRS transactions entered into by the Macro Fund were with Weaving Capital Fund (WCF), an illiquid related part. WCF did not have a lot of assets, was not creditworthy and the IRS payments due to the Macro Fund kept on increasing. Once again, as was the case in the DDCM matter, there was a lack of cash flow with these IRS transactions. The IRS transactions with WCF were found to be worthless and this placed the Macro Fund in an insolvent position.

According to Shefrin (2016:109), a Ponzi scheme is in a constant state of illiquidity as Ponzi schemes do not have underlying assets or actual investments that can be traded at a profit. More often than not, this leads to insolvency as the Ponzi scheme does not have sufficient cash

flow to service their debts. RVAF was operated as a Ponzi scheme, which means it is insolvent from the start.

4.3.3 Conclusion

It is noted from the relevant case studies the initial investments that were made placed the hedge funds in illiquid positions, which then forced the hedge fund managers to source new investments in some way. This resulted in DDCM investing in the Asseterra Bonds, Weaving Capital in the IRS transactions with a related party and RVAF running a Ponzi scheme. Most hedge funds invest in risky and illiquid instruments with the expectation to achieve high returns, but the high level of risk does not guarantee high returns (Muhtaseb & Yang, 2008:200). Liquidity of a hedge fund is an element of hedge funds that places enormous amounts of pressure on its managers to report liquid positions and thus is an element that makes hedge funds susceptible to economic crime.

4.4 Governance issues

4.4.1 Related parties and conflict of interest

4.4.1.1 Background

As mentioned in section 2.3.4, hedge funds have four key participants, who are the hedge fund founder, the investment manager, the hedge fund administrator and lastly the legal advisor of the hedge fund. This flattened organisational structure leads to hedge fund managers enjoying an increased level of managerial ownership and managerial discretion compared to other institutional investors and investment vehicles (Cao *et al.*, 2016:930).

This increased level of managerial ownership can be to the advantage of the hedge fund, but it can be seen in the relevant case studies that it was to the disadvantage of the hedge fund investors, as the hedge fund managers did not apply their discretion for the benefit of the investors as their decisions caused financial losses for its investors. Why would hedge fund managers act in this way?

Hedge funds experience intense competition for investor funds to produce positive performance without extreme levels of risk and they are also pressurised by career concerns, because the reputation of a hedge fund manager is a make or break factor within the industry (Cao *et al.*, 2016:930). This type of pressure is enough to make a hedge fund manager do whatever it takes to achieve and maintain positive returns.

4.4.1.2 Case studies

Alberto Micalizzi (Micalizzi) performed the management of DDCM in isolation, as he served as the director and Chief Executive of DDCM. Micalizzi also personally orchestrated the investment in the Asseterra Bonds that was a deviation from the investment strategy. As mentioned in chapter three, DDCM was also the investment manager of its own hedge fund, the Growth Premium Master Fund. Furthermore, no other independent parties were actively involved in the Asseterra Bond investments and no external third party was involved with the fund management or fund valuation. Because of this control by Micalizzi, he was able to back date transactions and make the Asseterra Bond investments. Furthermore, the fact that there was no due diligence performed on the Asseterra Bonds, by DDCM or the Growth Premium Master Fund or Micalizzi it should have alerted investors as well.

When examining the case pertaining to Weaving Capital, all of the companies bearing the “Weaving” name were related parties. Magnus Peterson was the director, Chief Executive and principal investment manager of Weaving Capital (UK) Limited (WCUK). Magnus Peterson was also the primary shareholder of WCF, the principal investment advisor of the Macro Fund since 2003. The directors of WCF, Weaving Capital Limited (WCM) and the Macro Fund was Magnus Petersons’ stepfather, Hans Ekstrom, and brother, Stephan Peterson.

WCUK was the investment manager of WCM and WCM in return was the investment manager of the Macro Fund. Thus, the related parties were acting as investment managers for each other, with Magnus Peterson making all the material decisions. These decisions included the appointment of WCUK as the investment manager, the initial investment strategy of the Macro fund, investment in the IRS/FRA transactions and the level of disclosure to investors. No conflict of interest or relationship was ever declared by WCUK in relation to WCF and the Macro Fund or by the Macro Fund in relation to WCF. Investors did not know that the OTC transactions were being entered into with a related party and that WCUK, in essence, controlled the instruments that the investors invested in.

RVAF was part of the Abante Group, and Herman Pretorius was the hedge fund manager of RVAF, as well as the director and manager of the Abante Group. It was also stated in *Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman* (2016) that Herman Pretorius also managed the investment advisors and the investments. This statement should have raised some concern as investment advisers and investment managers should be independent and always place the interests of the investors above anything else in order not be influenced by a hedge fund manager.

Furthermore, the Investment Management Agreement between RAAF and Relative Arbitrage Management (Pty) Limited, where Herman Pretorius controlled both entities, meant that they would be related parties and that any transactions or agreements would be entered into as related parties. This investment management agreement made the assets of RAAF available to Relative Arbitrage Management (Pty) Limited, managed by Herman Pretorius, which is of concern to the investors, as a party that should not have access to their funds. This investment management agreement reduced the level of investor protection to an alarming level due to the conflict of interest as Herman Pretorius managed both RAAF and the Relative Arbitrage Management (Pty) Limited.

Herman Pretorius also used Mat Worldwide Limited (MWL), a hedge fund in the British Virgin Islands, to attract investors that wished to invest offshore and he was the only director and shareholder of MWL. Despite having two offshore bank accounts, some of the investment deposits were made into a local Nedbank bank account held by Herman Pretorius. Once again Herman Pretorius had unlimited access to investors funds. These conflict of interests contributed to Herman Pretorius running a Ponzi scheme with investor funds.

4.4.1.3 Conclusion

Hedge fund managers enjoy an increased level of managerial ownership and managerial discretion compared to other institutional investors and investment vehicles, which make them susceptible to economic crime as discussed in the three case studies.

In all three case studies the hedge fund managers could not perform their duties impartially due to conflict of interests. These undisclosed economic or personal interests that the hedge fund managers established influenced their investment decisions. These actions were not in the best interest of the investor or the hedge fund and not executed in good faith. These conflicts of interests resulted in a lack of independence, which contributed fraudulent investment decisions being made by key individuals.

4.4.2 Lack of verification by administrators, auditors and brokers

4.4.2.1 Background

Prime brokers and administrators are the primary administrative service providers for hedge funds (Cumming & Dai, 2010:836). It is not the norm for hedge fund employees to carry out any kind of support services as these services are usually outsourced to third parties (Cumming & Dai, 2010:836). By outsourcing these activities, hedge funds decrease the risk of collusion among hedge fund contributors to commit fraud, and also mitigates liability in the event the hedge fund contributors are accused of neglect or improper management (Cumming & Dai,

2010:836). Cumming and Dai (2010:855) also found that if there is a geographical restriction on these administrative companies, the risk of misreporting is significantly mitigated.

Service providers with an unreliable and a low-quality deliverable were found to be a contributing factor to the failure of the Lehman Brothers (Cumming & Dai, 2010:826). These service providers have an important role to fulfil within the hedge fund industry. Investors rely on them to provide due diligence services for the hedge fund, provide research on counter-party risk, and generally facilitate the execution of the fund's activities (Cumming & Dai, 2010:836).

When studying one of the most infamous hedge fund Ponzi schemes ran by Bernie Madoff, Gregoriou and Lhabitant (2009:11) determined that there was a very high degree of family influence when it came to the management and governance of the fund. Family members were positioned in key positions of control, which put any reliance on independence at risk and diminished investor protection to an alarmingly low level (Gregoriou & Lhabitant, 2009:11). Family influence or lack of influence was clearly visible in the Weaving Capital case study, as will be discussed below.

Quality and reputation of hedge fund's auditors and administrators is an internal control discussed by Cassar and Gerakos (2016:1900). Auditors provide commentary on compliance of regulatory accounting standards and administrators provide more support in fields such as accounting, valuation and serving as liaison with investors (Cassar & Gerakos, 2010:1900). Including third parties into your governance and compliance structure may improve the asset valuations that are disclosed to investors and may decrease the risk of fraud, theft and other financial crimes (Cassar & Gerakos, 2010:1900).

According to Gregoriou and Lhabitant (2009:10) acquiring the services of obscure auditors may be a red flag that should be noted. Muhtaseb and Yang (2008:200) also highlight that the relationship between the hedge fund and its auditors is important, because if the hedge funds did not appoint one of the major international accounting firms, they either did not have any auditor, or the audit firms were owned by the fund manager or its brokers.

Similarly, to the auditors, Muhtaseb and Yang (2008:200) continue by stating that the relationship between the hedge fund and its brokers are as important, as its relationship with its auditors. Once again, in the cases studied by Muhtaseb and Yang, the hedge funds' brokerage houses were owned either by the fund manager or the big brokers on Wall Street (Muhtaseb & Yang, 2008:200).

Another unique ability that hedge fund managers possess is the fact that hedge fund managers can manage several hedge funds simultaneously. This enables hedge fund managers to shift capital, funds and debt between the funds, which could alter the actual position of the hedge

fund to one that looks attractive for its investors (Cumming & Dai, 2010:837). This factor contributes heavily to misreported returns and the creation of fictitious assets and fictitious investments (Cumming & Dai, 2010:838).

4.4.2.2 Case studies

In all three cases, the hedge fund managers either managed the relevant service providers, or they or their related parties controlled related funds.

In the DDCM case study, although PNC Global Investment Servicing (Europe) Limited (PNC) were appointed as the hedge fund's administrator, Alberto Micalizzi (Micalizzi) had complete control over what he disclosed to its administrator. PNC was mandated to provide financial statements, portfolio summaries and valuation services to the Growth Premium Master Fund. This, however, was not the case, as Micalizzi valued the Asseterra Bonds with no valuation performed by PNC to support his calculations. In addition to the valuations, Micalizzi provided the content for the financial reports that were being sent out to investors of the Growth Premium Master Fund and no reference was made regarding the losses that the hedge fund had incurred on its main investment strategy, but instead it reported a profit. Micalizzi, for example, hid the losses by not sending Repurchase Agreement One of the Asseterra Bond investment to PNC, thus the transaction was never recognised. Micalizzi also manipulated the financial statements of the hedge fund to portray an attractive position for investors and potential investors. This fact is evident *in lieu* of Micalizzi's admission to withholding Repurchase Agreement One from the hedge fund's administrators, which led to the high level of profit recognised for the Asseterra Bonds that month.

Weaving Capital appointed Ernst and Young as their auditors and PNC as the administrators, but despite this, misrepresentations were still made to investors by Magnus Peterson in the financial statements and investor reports. For years, PNC as the administrators, were under the impression that a third party were doing the valuations of the Macro Fund's investments. However, Eduard Platt, an employee of the Macro Fund that reported to Magnus Peterson, did the valuations. Another internal valuation with no third-party confirmation was the daily and weekly Net Asset Values (NAV's) of the Macro Fund that Eduard Platt circulated to investors. Eduard Platt received these figures from Magnus Peterson. This should have been noticed much earlier and addressed to prevent subjective valuations of investments, as performed by Eduard Platt. From the discussion above it is interesting to note that PNC was appointed as the hedge fund administrators for both the Growth Premium Master Fund, as well as the Macro Fund. Both DDCM and the Macro Fund's liquidators took action against PNC for negligence (PNC, 2018 and Carolan, 2011).

Furthermore, several documents in the Weaving Capital case study contained forged signatures and was backdated. These documents were created after the fact and Magnus Peterson admitted to forging the signature of Hans Ekstrom and Stefan Peterson, directors of WCF, on various documents from 31 December 2007 to 31 October 2008. Lack of independent oversight contributed to Magnus Peterson to back date these signatures and forge signatures.

Where the two case studies above did have third party administrators, RVAF had no independent administrator and governance and compliance was lacking in the RVAF management structure. Instead, RVAF performed their own administrative functions in addition to its responsibility pertaining to the control and management of the investor's monies. The way that RVAF managed investors' funds was questionable. There was no nominee company appointed or a nominee account where investors made their deposits, which meant that the investor's funds were deposited directly in the RVAF Trust's account.

RVAF continuously reported above average returns, usually higher than 20 per cent and these results were attractive to potential investors who converted their potential investment into actual investment. RVAF had complete control over the funds of investors, as there was no nominee company or nominee bank account in which the investments could be paid.

Herman Pretorius had free access to investor funds and this enabled him to direct these funds to himself, either directly or indirectly through entities under his control. For example, the interest free loan that was made by RVAF to Exotic International in 2009 was another channel that Herman Pretorius created to divert investor funds his way. This loan led to a personal claim for Herman Pretorius in the records of the entity, SA Superalloys Limited, that was responsible for the repayment of this loan. In other words, RVAF granted the loan to Exotic International, but the repayment of the loan would not be received by RVAF, but by Herman Pretorius in his personal capacity.

Another point of concern pertaining to the investment in RVAF and its governance is that the documentation completed by investors to make their investments did not contain contact information for the liaison of RVAF or the representative of RVAF. Investors could not have known whom they were dealing with and if they were intuitive enough, they would have questioned the lack of contact information.

4.4.2.3 Conclusion

Gregoriou and Lhabitant (2009:10) state that a hedge fund usually has an investment manager, broker, fund administrator and a custodian that provides services to the hedge fund. Gregoriou and Lhabitant (2009:10) go further to say that these service providers should be independent from the hedge fund and their services should be segregated.

There are instances where service providers may be dependant of the hedge fund, but then regular third-party controls should be implemented to mitigate the conflict of interest and to ensure the procedures followed (Gregoriou and Lhabitant, 2009:10).

In all three of the case studies, there was poor performance or a lack of independent parties when it came to the service providers of the hedge funds. The hedge fund managers in all three cases exercised total control over what type of information was sent to the fund's administrators, auditors and brokers. The ability of hedge fund managers to do the aforementioned is strengthened by the lack of independent parties within the management structure of hedge funds.

All these factors ensured a lack of delegation of authority and a lack of internal controls. The internal governance of a hedge fund with no structure is not sustainable. This leads to an increase in managerial discretion, lack of segregation of duties, decrease in disclosure, increase in risk taken and an increase in economic crime risk, as explained in the different case studies.

4.5 Regulation and investor reporting

4.5.1 Background

Historically, hedge funds were subject to relatively lax regulation, however the industry developed a concern over its ability to influence markets, due to its size and scandals of fraud such as the notorious Bernie Madoff affair (Cumming & Dai, 2010:830). This contributed to the culture of debate for the past several years pertaining to hedge fund regulation and mandatory disclosures (Malladi & Fabozzi, 2017:664). With the most controversial debate point being what the scope should be when it comes to disclosure of the hedge fund's underlying portfolio (Malladi & Fabozzi, 2017:664). Hedge fund managers are against any high level of disclosure, by stating that without confidential trading strategies, hedge funds will compromise their competitive position and they will not be able to reach the level of returns that they do reach when what they do is more secretive (Malladi & Fabozzi, 2017:664-668).

Malladi and Fabozzi performed an analysis of disclosed and confidentially treated hedge fund returns from March 1999 to December 2013 (Malladi & Fabozzi, 2017:675). The analysis indicated that:

- i. Daily returns of confidentially treated positions are higher than disclosed positions;
- ii. Confidentially treated positions are 1,9 times bigger in value than disclosed positions; and
- iii. The portfolio weight of confidentially treated positions is 2,29 per cent against the 0,29 per cent of disclosed positions (Malladi & Fabozzi, 2017:675).

Malladi and Fabozzi (2017:675) therefore proved that disclosed and confidential funds have very different statistical snapshots and does support the position of hedge fund managers to oppose increased disclosure. This creates a unique problem in the hedge fund industry because the success of the industry and the protection of investors now has to be weighed against each other (Malladi & Fabozzi, 2017:675).

According to Bollen and Pool (as quoted by Cumming & Dai, 2010:830), hedge fund managers have an incentive to report positive monthly returns rather than negative or zero return in order to attract investors. Cumming and Dai (2010:830) went on to identify that there is a noteworthy relation between misreporting and hedge fund regulation. Where hedge funds have minimum capital requirements and restrictions on the location of key service providers, Cumming and Dai (2010:830) found that misreporting occurs far less in this jurisdiction. If a hedge fund continuously reports positive returns, it should be common practice to query these reports and determine if they were misreported or a true reflection of the reality (Cumming & Dai, 210:832). It was also noted by Cumming and Dai (2010:832) that fewer hedge funds are reporting returns at zero levels or below.

Regulation of hedge funds also has a significant economic impact on misreported hedge fund returns (Cumming & Dai, 2010:853). The relationship between hedge fund regulation and performance, structure and capital flows were also established by Cumming and Dai (2010:855). This clearly indicates that regulation has a direct relationship with some of the most significant characteristics of hedge funds and is thus an important tool to enable satisfactory management and disclosure of hedge funds.

Another regulatory factor is the different regulations applicable to onshore and offshore hedge funds (Cumming & Dai, 2010:838). According to Cumming and Dai (2010:838), it is more likely that returns of offshore hedge funds will be misreported, as the regulation is laxer than onshore funds. Cumming and Dai (2010:828) continue by saying that according to La Porta, English common law countries have more stringent oversight than civil law countries and will therefore be less inclined to misreport investment returns.

Even though it is less likely that hedge funds operating in English common law countries will misreport returns, it does not eliminate the risk of misreporting, as all three cases that were discussed in this study operated within English common law countries, namely the UK and South Africa. Brown *et al.* (cited by Cici *et al.*, 2016:1035) also revealed that the fact that information may be verified does not influence the intention of hedge fund managers to misrepresent material information.

4.5.2 Case studies

Due to the secretive nature of hedge fund trade strategies, lack of regulation and disclosure requirements the performance results of the hedge funds could be overstated and manipulated to reflect expected and desired results, as will be discussed in the case studies below.

Investors of DDCM's hedge fund received monthly performance estimates from an employee of DDCM, Alena Pichlerova (Pichlerova). Pichlerova however only sent on the figures and calculations she received from Alberto Micalizzi (Micalizzi). Micalizzi was thus solely responsible for the content of financial reports that were being sent to investors and no reference was made to the losses that the hedge fund incurred. In fact, Micalizzi reported quite the contrary to investors. Micalizzi reported that the consolidated performance of DDCM was above the projected targets and above the market, as it was during the collapse of Lehman Brothers and the financial crisis of 2008.

This statement would have provided investors with a level of comfort that their investments were surviving the collapse of the global financial markets. However, investors were never informed of the investments in the Asseterra Bonds, or any other fixed income position from October 2008 to December 2008 when these investments were made. Micalizzi had the ability to include or omit purchase and repurchase agreements of the Asseterra Bonds as he pleased and chose which agreements to include in the financial statements and which agreements to send to the hedge fund's investors and administrators. This was supported by the testimony of investors, who stated that they were never informed of the investments in the Asseterra Bonds, or any other fixed income positions during the period October 2008 to December 2008. Investors were only informed of this change in investment strategy in February of 2009, two months after the transactions had been entered into.

Micalizzi also approved or wrote the monthly commentaries that gave the impression that the hedge fund was performing well, despite the challenging market circumstances. These figures were not an accurate reflection of the hedge fund, as the Asseterra Bonds were not valued as required and the bonds should have never been included in the financial records of the Growth Premium Master Fund.

Micalizzi was thus the creator and the approver of the hedge fund financial performance reports being sent to investors.

The Growth Premium Master Fund incurred trading losses of US\$5,25 million for October 2008. The investor reports received from Micalizzi indicated a return of 0,36 and 0,75 per cent for the fund's five different share classes, but no reference was made to the incurred losses. Instead the investment in the Asseterra Bonds was recognised as income and a profit of US\$90,19

million was included in the statement of profit or loss and other comprehensive income. This inclusion should have been questioned due to the lack of economic substance of the profit, as the source thereof was not disclosed and the improper valuation method applied in determining the face value of the Asseterra Bonds. Investors stated that if the deviation from the investment strategy had been reported, as well as the trading losses, they would have submitted a redemption request of 100 per cent of their investment.

Furthermore, the DDCM case study also had instances of misreporting to lenders, namely Nomura and Nataxis. In both cases, the Growth Premium Master Fund did not report their transgressions of both lenders investment restrictions and misreported the nature and profit margins of the Asseterra Bond investments.

In the case of Weaving Capital, no mention was ever made to investors regarding the interest rate swaps, OTC transactions or counterparty risk and there was thus clear intent from Magnus Peterson to hide this from the Macro Fund's investors. None of the performance summaries, sent to investors, included any reference to the IRS contracts. However, the NAV disclosed in the performance summaries, calculated by PNC, did include the IRS contracts. The Offering Memorandum allowed for investments in OTC transactions if the counterparty was a major bank. However, this was not the case, as the undisclosed counter party to the IRS transactions was a related party, WCF.

Upon examination, it is clear that the Macro Fund's Offering Memorandum and the due diligence questionnaires were contravened when they entered into the IRS transactions with WCF. Apart from false reporting of the performance of the hedge fund, the Macro Fund failed to disclose the investment in the IRS transactions with WCF and they also failed to disclose the conflict of interest, as WCF is a related party. Thus, investors had no chance of knowing that these IRS transactions were entered into with an illiquid related party.

The inclusion of the IRS transactions in the financial statements of the Macro Fund led to an immense growth in its reported assets under management. It increased from US\$27 million in December 2004 to US\$583 million in December 2008. The inclusion of these fraudulent transactions overstated the value of the fund and led investors astray.

RVAF also never produced financial statements and any concerns that investors may have had were smoothed over by the investment managers by stating their support of the reported returns, as per the communication received from RVAFA. If investors or their investment managers requested the financial statements of RVAFA, the investors would have noticed that their funds were never invested, but that the funds of new investors were used to pay redemptions and dividends of old investments. Despite all of the above, investors invested

approximately US\$250 million in RVAF over a period of 10 years. The financial records of RVAF later showed that funds received from investments were used to pay redemptions of older investments, which indicates that Herman Pretorius was running a Ponzi Scheme.

4.5.3 Conclusion

All three of these cases occurred before the increase in more comprehensive hedge fund regulation. The lack of strict regulation and secrecy of hedge fund managers underlying investment portfolios were major factors in the susceptibility of these hedge funds to over reporting financial results that concealed economic crime.

Even though there was a lack of specific hedge fund regulation, certain international auditing and accounting standards such as International Auditing Standard (IAS) and International Financial Reporting Standards (IFRS) did apply in all three case studies. These standards were not adhered to as the hedge fund managers of all three hedge funds succeeded to misreport the hedge fund performance results to reflect the results they wanted. This was possible once again due to a lax regulatory environment.

The Growth Premium Master Fund included income from the investment in the Asseterra Bonds to neutralise the investment losses the hedge fund incurred on its main investment strategy. The Macro Fund included income from the IRS investments, which had no economic substance and did not recognise the investment losses incurred. As RVAF was operated as a Ponzi scheme there would have been no actual investments made and any reported returns were fictitious.

In all three cases, the hedge funds grossly overstated their financial results by including fictitious income and understating any financial losses incurred.

4.6 Reputation of the hedge fund manager and investor trust

Another element identified by Gregoriou and Lhabitant (2009:12) was that a very small group of people managed a significantly large sum of money. In a study conducted by Muhtaseb and Yang of five hedge fund fraud cases in the United States of America (USA), they found that hedge fund managers took advantage of the trust that was placed on them in order to hide the hedge funds' losses and deter capital flight by the investors (Muhtaseb and Yang, 2008:199).

The quality and integrity of the hedge fund manager is thus an integral part of the occurrence of fraud within hedge funds (Muhtaseb and Yang, 2008:202). Why do many investors rely on the reputation of the hedge fund manager and the trust that the hedge fund manager has instilled in the investors? One of the reasons may be because most investors do not have sufficient

knowledge to question the hedge fund manager on the investment strategies applied or the hedge fund manager is too respectable to question and therefore investors rely on reputation and trust. According to the 2015 PwC Global Hedge Fund Distribution Survey (2015:18) the reputation of the investment manager is the fourth-ranked key factor that investors consider when selecting hedge fund investments.

This is perhaps the most dangerous element of hedge funds that make them susceptible to economic crime, because this leads to investors ignoring reason and trusting something that is not measurable, which is reputation and trust.

4.6.1 Case studies

Micalizzi of DDCM managed to incorporate the Asseterra Bond transactions into the Growth Premium Master Fund without much scrutiny from investors. Investors simply relied on what was reported to them by Micalizzi, because of his background and reputation as a Professor in finance and as a hedge fund manager.

In the Weaving Capital case study the investors of the Macro Fund did not take note of all the red flags when it came to the Macro Fund's disclosure and hedge fund performance. Investors relied on the reputation and previous experience of Magnus Peterson at a major Swedish bank and an independent US futures brokerage firm where he was an interest rate foreign exchange trader, and later Head of Proprietary Trading at the major Swedish Bank (Weaving Capital (UK) Limited (in liquidation), *et al.* vs Ulf Magnus Michael Peterson, *et al.* 2012).

In the case of RFAF there was no financial records and no supporting documents to prove that RFAF had legitimate trades and actual returns. Investors were once again not inquisitive enough and relied on trusting their investment managers and the reputation of Herman Pretorius. Herman Pretorius' experience was advertised as "significant experience in the financial services arena" in an introductory letter distributed to investment managers (Teresa Karwowski v L Loxton Nel and Associates CC and Llewellyn Claudius Loxton, 2015). Herman Pretorius' Abante Capital group also won the hedge fund manager of the year award in 2008 which was also used by investment managers to instil confidence in Herman Pretorius' abilities (Gail Colleen Sheel v Mark Alexander Investments CC and Mark Alexander Eiserman, 2016:10).

4.6.2 Conclusion

From the above, it can be noted that investors and the investment managers did not conduct in-depth research pertaining to the hedge fund managers' experience and reputation before investing. The investors trust and reliance were thus based on the reputation and experience of

the hedge fund manager, as repeated through the investment community or advertised. This element of blind investor trust of a hedge fund manager's reputation is an element of hedge funds that makes it susceptible to economic crime.

4.7 Investment performance and performance fees

4.7.1 Background

King and Van Vuuren (2016:884) state that there is a direct correlation between the performance of hedge funds and the investor capital that follows. Furthermore, when hedge funds succeeded and made profits, the hedge fund managers will receive a generous portion of the profits, normally at a rate of 20 per cent (Guasoni & OBŁOJ, 2016:269), as stated earlier in chapter two of this study.

In Guasoni and OBŁOJ (2016:269) the authors state that it is important for investors and regulators to understand these performance fees that are earned by hedge fund managers and how it can be incentivising them to make their hedge funds look more profitable. Guasoni and OBŁOJ (2016:270) goes on to ask whether these performance fees will lead to hedge fund managers taking more risk than its investors desired level and a higher level of leverage? This question was answered by examining hedge funds on the Lipper-TASS database and it was then observed that higher performance fees on average have higher leverage to attract new investors than funds with lower performance fees (Guasoni & OBŁOJ, 2016:271).

According to King and Van Vuuren (2016:884) managers have a major incentive to overstate the NAV of the hedge funds, as the performance fee structures are usually based on assets under management. Hedge fund managers will then incessantly report absolute returns to attract capital and report returns that maintain risk adjusted performance (King & Van Vuuren, 2016:884).

Cumming and Dai (2010:837-838) states that hedge fund performances are misreported due to two reasons. The first being that if the market is reporting steady and high returns, hedge fund managers feel the pressure to report similar or better results than the market, as they do not want current or potential investors to view the hedge fund as having a negative position (Cumming & Dai, 2010:837-838).

Secondly, hedge fund managers may have the incentive to misreport investment returns due to their performance fee. A greater incentive exists if a hedge fund manager's performance fee is calculated as a portion of the hedge fund assets under management. Misreported returns will then be more likely as the hedge fund manager would want to attract, as many new investors as possible to increase the performance fee that they are entitled to (Cumming & Dai, 2010:838).

This is illustrated with some of the models built by Cumming and Dai, where if the performance fees of hedge fund managers increase with ten per cent of the total fees, the probability of misreported returns increase with one per cent (Cumming & Dai, 2010:852).

Cumming and Dai concluded that hedge fund managers have an incentive to misreport monthly investment returns, if the investment returns are either zero or marginally negative to a marginally positive result to keep in reach of the market performance that will attract new investors and increase the performance fee due to the hedge fund manager (Cumming & Dai, 2010:855).

This statement is supported by King and Van Vuuren (2016:883) when they said that managers have an implicit incentive to smooth over returns around zero that results in an increase of positive returns and which then leads to an increase in management fees. A contradicting view is given by Le Marois (cited by King & Van Vuuren, 2018:885) when expressing that smoothing of investment returns is not necessarily an indication of fraudulent activity but rather part of a subjective valuation technique. These incentives make hedge fund managers concentrate their focus on investment performance and not necessarily on asset growth (Cao *et al.*, 2016:930).

Furthermore, as performance fees are determined by the hedge funds performance, it is important to also examine the transparency and disclosure of hedge fund performances. According to Stowell (2010:308), hedge fund managers were not required to provide a significant amount of investment transparency by investors in the past, but a global movement for transparency had been initiated post the financial crises of 2008. Some hedge fund managers oppose this movement as the argument against increased transparency is that hedge fund managers are concerned that this will expose their investment strategies and will benefit their competitors and reduce arbitrage investment opportunities (Stowell, 2010:308).

In the end, investors must ultimately decide if the level of transparency provided by hedge funds and its managers is enough in relation to the risks and benefits associated with making the investment in the hedge fund. This decision places a lot of responsibility on the investor to make an informed decision when choosing to invest.

4.7.2 Case studies

As mentioned in section 4.6 regarding disclosure, the performance results of the DDCM hedge fund, were prepared by Alberto Micalizzi (Micalizzi) and sent to investors via an employee of DDCM. It is of concern that the hedge fund's performance was prepared by one individual and that there was no second or third level review of these financial results. Micalizzi was thus solely responsible for the content of financial reports that were being sent to investors. The Growth Premium Master Fund recorded a profit of US\$90.19 million for the month of October 2008. This

figure included the profits made on the Asseterra Bonds, even though no agreements had been entered into or existed at the time.

These financial results were not an accurate reflection of the hedge fund's position, as the Asseterra bonds had no economic substance and thus inflated the returns of the hedge fund significantly. Micalizzi might not have entered into these Asseterra Bond transactions with the intent to maximise his performance fee, but if he did receive any performance or management fees, it would have been based on overstated performance figures and he would have received a lot more than what was due to him in reality.

The assets under management of Weavering Capital's Macro Fund increased from US\$27 million in December 2004 to US\$583 million in December 2008. Such a drastic and steep increase should have urged investors to query this high growth rate. This steep growth rate was attributable to the IRS transactions that the Macro Fund entered into with WCF, a related party, none of which was disclosed to investors. These IRS transactions reversed the investment losses that the Macro Fund incurred with its main investment strategy to mislead its investors and attract new investors on false pretensions. The Serious Fraud Office reported that Magnus Peterson earned a total of £5,8 million in fees from 2005 to 2009 despite the fact that the Macro Fund was illiquid (Serious Fraud Office, 2015). This suggests that this over reporting of the assets under management contributed to the performance fees received by Peterson.

As mentioned earlier, in section 3.3.4, the investors of RVAF were never provided with the financial statements of the hedge fund. The only information the investors received related to the investment returns of RVAF and these returns were communicated to the investment managers of the investors. This was done on a quarterly basis and they were sent by a co-trustee of RVAF.

However, the co-trustee received these investment returns from Herman Pretorius and were never supported by records or any sort of document. The method of how the investment returns were determined was never shared with investors. As RVAF was managed like a Ponzi scheme, no real investments were made, but performance fees would still be charged to keep up the pretence that RVAF was trading and performing as reported. The exact amount of performance fees is not known, but Herman Pretorius received payments totalling R22,27 million from RVAF's account from January 2009 until August 2012 (Rynette Pieters, *et al. v Susan Ann Pretorius*, 2013:7).

4.7.3 Conclusion

Apart from the performance of hedge funds itself the valuation thereof contributes to the susceptibility of hedge funds to economic crime. The question of whether hedge funds do in

actual fact outperform markets, has intrigued the finance industry for years but has proved to be difficult to answer because the evaluation of hedge fund performance is loaded with measurement difficulties (Cao *et al.*, 2016:929). The biggest challenge pertaining to the evaluation of hedge fund performance is the fact that returns are self-reported and is the victim of subjectivity (Cao *et al.*, 2016:929).

In the case of the Growth Premium Master Fund and the Macro Fund the primary catalyst to misreport the returns of the hedge fund was the concealment of significant investment losses and the threat of capital flight. RVAF misreported its returns to sustain the Ponzi Scheme, as the misreported returns would attract new investors. In all three cases these misrepresentations were possible due to the fact that the investment performances were calculated by the hedge fund managers with no third-party confirmation. With these overstated returns the management and performance fees due to hedge fund managers would have been calculated using these overstated results and the hedge fund managers would have received a higher fee than what they should have received.

It can be seen from the above case studies that whether the misreporting of investment performance was intentional or not, it would be linked to a performance fee and hedge fund managers would receive these fees either through intent or negligence but always to the prejudice of the investor. As the reward is high for successful hedge fund managers, they take more risks to chase these high level of performance fees.

4.8 Valuation of hedge fund investments

4.8.1 Background

According to Abdulali (cited by King & Van Vuuren, 2016:885) the valuation of financial instruments that are not actively traded does not depend on market pricing, but rather on various other sources that are not market related. Le Marois (cited by King & Van Vuuren, 2016:885) articulates that this type of subjective valuation is the norm in the hedge fund industry, as the instruments are often illiquid and difficult to price, resulting in hedge fund managers adopting subjective valuation methods.

A study by Capco titled Valuation Issues (cited by Muhtaseb & Yang, 2016:181) revealed that improper subjective valuation of hedge fund assets contributes to 35 per cent of hedge fund failures. The Capco paper (cited by Muhtaseb & Yang, 2016:181) continues by further specifying that 57 per cent of these valuation issues are caused by fraud and misrepresentation, 30 per cent by procedural or system problems and 13 per cent by mistakes or adjustments.

Verifying the valuation of these type of instruments is a very difficult task (Muhtaseb & Yang, 2008:200). According to Cici (2016:1013-1014), adjusted valuations that result in losses for investors and wealth transfers between current, new and redeeming investors is a key concern for the industry. Cassar and Gerakos (cited by Cici, 2016:1016) showed that hedge funds with less certifiable valuation sources and greater valuation discretion entrusted to its managers, report smoother investment returns which can be an indication of manipulation. Cici (2016:1015) also determined that there is a direct correlation between the valuation of hedge funds by their managers or advisors and investment return reporting irregularities.

Cassar and Gerakos (2010:1900) found that 9,2 per cent of hedge funds use at least one internal service and one external service to price investment positions and that 16,2 per cent of the hedge funds calculated the value of their portfolio internally. According to Cassar and Gerakos (2010:1900) this is often the case, when the assets of hedge funds are difficult to value, hedge fund managers have the mandate to use their own expertise to estimate the value of hedge fund investments. This mandate also increases the risk and opportunity for hedge fund managers to manipulate the value of their portfolios (Cassar & Gerakos 2010:1900). Lastly, Cassar and Gerakos (2010:1918) concluded that if hedge fund managers do not take part in calculating or reporting the NAV of the hedge fund to investors, a regulatory investigation for fraud will be unlikely.

4.8.2 Case studies

As mentioned in the previous sections in all three cases the hedge fund managers prepared the hedge fund performance results and NAV of the hedge funds.

Micalizzi valued the Asseterra Bonds in isolation with no third-party valuation to support his calculations. This method of valuation was found wanting by the Upper Tribunal. In November 2008 the valuation of the Asseterra Bonds increased with 7,36 per cent, but the underlying asset, namely diesel oil, experienced a drop in commodity price for the relevant period. In addition to the valuation of the Asseterra Bonds, Micalizzi provided the content for the financial reports that were being sent to investors of the Growth Premium Master Fund and no reference was made to the losses that the hedge fund had incurred on its main investment strategy. Instead, Micalizzi reported that the hedge fund was outperforming the market.

Magnus Peterson also provided daily and weekly NAV calculations of the Macro Fund to Eduard Platt that were sent to investors. These calculations were his own personal calculations, and not the NAV calculations performed by PNC, the hedge fund's third-party administrator.

These NAV calculations were thus internally generated by one individual with no objective party supporting the calculation. It is concerning to note that Magnus Peterson could manipulate and

state the performance of the hedge fund as he pleased. This led investors to believe that the Macro Fund complied with its investment strategy and that these investment transactions were all at arm's length.

Furthermore, the valuation of the IRS transactions of the Macro Fund was also performed by Eduard Platt, who admitted that he did not know how to properly value the interest rate swaps but that he did the best he could.

When it came to light that WCF was, in fact, an illiquid related party and that the IRS transactions could not be worth more than the assets of WCF. Magnus Peterson stated that WCF had assets close to EUR77 million, but PwC found that this was a gross overstatement of WCF's assets.

RVAF never provided their investors with financial statements, but the RVAF only sent investment results to the investment managers of the investors. This was done on a quarterly basis and the investment results were sent by a co-trustee of RVAF, Eduard Brand. The co-trustee received these investment results from Herman Pretorius and were never accompanied by any supporting documents. This led to the overstatement of investment results and assets by Herman Pretorius, and ultimately concealed the Ponzi scheme.

4.8.3 Conclusion

The fact that the hedge fund managers were involved in the valuation of the hedge fund with no third-party valuation is of some concern and an element that makes hedge funds susceptible to economic crime. This element provided the hedge fund managers with the opportunity to create value for investments, that did not exist. The hedge fund managers used this mandate to inflate the investment returns and to hide the losses suffered from its initial investment strategy from investors.

This situation created the opportunity for misstatements and misrepresentations and was made possible due to the lack in the segregation of duties between the hedge fund and its service providers. Furthermore, the failure of the service providers, if they were appointed, to question the hedge fund managers and report their actions was another contributing factor. In these case studies, the hedge fund managers were thus solely responsible for the content of the investment performance reports and valuations that were being sent out to investors.

4.9 Conclusion on hedge fund elements susceptible to economic crime

In conclusion, the following elements of hedge funds have been identified as susceptible to economic crime:

- i. Flexible investment strategies that resulted in deviation from investment strategies and investment losses;
- ii. Minimum level of hedge fund liquidity that resulted in illiquid investments with related or fictitious parties;
- iii. Streamlined governance structures that resulted in issues in respect of:
 - Related parties and conflict of interest in managing the hedge fund;
 - Lack of control by administrators and service providers; and
 - Lack of assurance and internal control.
- iv. Achievement of absolute investment returns that overstated financial performance and led to investor misreporting;
- v. The impact of regulation on the lack of disclosure of investment portfolios and financial misreporting to investors;
- vi. Reliance on the reputation of the hedge fund manager and investor trust that contributed to hedge fund managers concealing the actual performance of the hedge fund;
- vii. Investment performance and high performance fees earned by hedge fund managers that overstated financial performance and led to investor misreporting; and
- viii. Subjective valuation of investments and hedge funds used to conceal actual valuation of the hedge fund.

CHAPTER 5

CONCLUSION

5.1 Introduction

What elements of hedge funds make them susceptible to economic crime? By examining the three case studies, this was the question that this study aimed to answer.

Since its establishment in 1940, hedge funds have provided investors with an alternative approach to investing (Frush, 2007:7). For decades, hedge funds have been growing in popularity, as well as infamy (Desmet, 2008:1). Despite this fact, only a small number of people understand the nature of hedge funds, how they operate and the environment in which they operate (Desmet, 2008:1). This chapter aims to provide some insight on the above by addressing the research objectives and concluding on the problem statement.

To address the problem statement, the general and specific research objectives outlined in sections 1.3 and 1.4 were addressed through theoretical and conceptual studies of literature. The research aim of this study was to identify elements of hedge funds that are susceptible to economic crime within the context of three case studies. To make recommendations and conclude on the research aim and problem statement, the study had to address and elucidate the remaining research objectives of this study.

These remaining objectives were:

- i. To understand the term “economic crime”, “hedge fund” and “hedge fund fraud”, as outlined in Chapter 2;
- ii. To understand how hedge funds are used as a vehicle for economic crime by following a case study approach and performing an analysis of three cases regarding hedge funds and economic crime, as outlined in Chapter 3; and
- iii. Lastly, to identify elements of hedge funds that make them susceptible to economic crime, as outlined in Chapter 4.

This study followed a multiple holistic case study approach where the aim was not to increase the sample but to replicate the findings of one case across several cases. Although the conclusions of this study were formed based on the analysis of three case studies, this approach makes the conclusion and recommendations of the study applicable for the broader hedge fund industries of the United Kingdom (UK) and South Africa.

Conclusions and recommendations will be drawn in this final chapter of the study on each one of the primary and secondary research objectives of this study research based on the study objectives' findings.

5.2 Conclusion on specific research objectives

5.2.1 Understanding economic crime and hedge funds

Chapter 2 sets out to define the term “economic crime” and “hedge fund” to formulate a working definition for “hedge fund fraud”, as no statutory definition exists for hedge fund fraud in the UK and South Africa. The secondary objective was to identify and explain the key elements of hedge funds.

Through the review of literature as contained in chapter two, these objectives were addressed by means of discussing “economic crime” and “hedge fund” focussing on the UK and South African context and considering USA interpretations, and combining these concepts to create an understanding of hedge fund fraud.

The conclusion reached pertaining to the secondary objective was that the key characteristics of hedge funds are the reason that each hedge fund will differ from the other and may have an influence on the type of fraud scheme that could be used within the hedge fund. With important differences such as size, composition, strategies employed, culture, organisation structure, fee structure, regulation, investors, minimum investment, liquidity, performance and return ratios that inevitably lead to enormous variances in the levels of risk, volatility and performance of the hedge funds.

The characteristics of hedge funds afford them the ability to create a return on investment that is higher than the average return rate of more conservative investment vehicles like mutual funds. These high return figures come with a price that is a very high initial investment, as well as high rates for performance incentive fees charged by hedge fund managers. There is also an increased level of investor and investment risk, lack of transparency, reporting, and government regulation, lock-up periods for redemptions of and no secondary market for the trade of shares.

The conclusion reached on this research objective was that the understanding of hedge funds and economic crime is a critical part in the analysis of the susceptibility of hedge funds for economic crime, because hedge fund fraud schemes can only be identified and explained properly, once there is an understanding of the nature of hedge funds and how they invest.

It was concluded that hedge fund fraud, refers to fraud, used as a collective noun for different types of economic crime and/or business related irregularities, committed in relation to hedge funds.

5.2.2 Hedge funds as a vehicle for economic crime

Chapter 3 set out to provide an overview of the hedge fund fraud cases identified for this study and to identify the hedge fund fraud schemes within this context.

Through the analysis of reported case law as primary literature source, this objective was addressed by means of providing background of the relevant hedge funds, determining their investment strategies, reporting on the incidents that led to the failure of the hedge funds, identifying the actions that constitutes economic crime and identifying elements of the specific cases that made the hedge funds susceptible to economic crime.

The conclusion reached regarding the first case study, concerning the Growth Premium Master Fund was that its hedge fund manager Alberto Micalizzi (Micalizzi) invested in convertible bonds, namely the Asseterra Bonds, which were illiquid and had no economic substance. However, Micalizzi recognised this investment to reverse the losses incurred through its main investment strategy. The profits from the Asseterra Bonds were found to be fictitious as the underlying commodity did not exist and therefore it could never be converted into diesel oil. Despite the various purchase and repurchase agreements pertaining to the Asseterra Bonds, there were no actual cash flows for these agreements and no interest payments pertaining to the Asseterra Bonds. The investors and lenders of the Growth Premium Master Fund did not receive the necessary information about the Asseterra Bonds and the true position of the hedge fund was never disclosed to them. The financial crisis of 2008 and due diligence performed by the lenders of the Growth Premium Master Fund were the reasons why these misrepresentations and fraudulent bonds were uncovered. The Upper Tribunal ruled that Micalizzi's actions were dishonest and lacked integrity and the FCA revoked DDCM and Micalizzi's permission to perform regulated activities and fined Micalizzi.

The conclusion reached in the Weaving Capital case study, pertaining to the Macro Fund was that its manager Magnus Peterson created fictitious assets and income for the Macro Fund by entering into several Over the Counter (OTC) transactions with related a related party WCF to hide significant losses that the Macro Fund had incurred through its main investment strategy. The supposed proceeds of these Interest Rate Swap (IRS) transactions and FRA transactions reversed the incurred losses of the Macro Fund increased the Net Asset Value (NAV) of the Macro Fund significantly. However, no actual cash flow took place between the related parties to these IRS contracts and despite the increased NAV of the Macro Fund, the redemption

requests of its investors could not be met when the 2008 financial crisis occurred. It became clear that there were not enough funds to repay the investors and eventually the Macro Fund was liquidated and Magnus Peterson was sentenced to 13 years in prison for fraud, forgery, false accounting and fraudulent trading.

The conclusion reached in the case study of the Relative Value Arbitrage Fund (RVAF) is that Herman Pretorius used RVAF to operate a Ponzi scheme. RVAF did not have any incurred losses that it wanted to conceal, as RVAF did not make any investments. Herman Pretorius, the hedge fund manager, used incoming funds from new investors to pay withdrawals, dividends and interest to old investors. Investor reports sent to investors to inform them of the fund performance contained fictitious results prepared by Herman Pretorius that grossly overstated the hedge fund's performance, liquidity and financial position. RVAF was then placed into liquidation when they could not meet investor redemptions and investors entered into civil actions against investment managers in an attempt to recover some of their investments.

The conclusion reached on this research objective was that each of the case studies had a unique scheme, but the contributing factors that created a vehicle for committing economic crime were similar in every case. These factors will be concluded on in section 5.2.3 below.

5.2.3 Identifying elements of hedge funds that are susceptible to economic crime

Chapter 4 aimed to identify which elements of hedge funds make them susceptible for economic crime and discuss how these elements are used to commit economic crimes.

Through the review of the literature and reported case law as primary literature source, this objective was addressed by means of analysing the three case studies reported on in Chapter 3 and identifying elements of the hedge funds that make them susceptible to economic crime.

Several elements differentiate hedge funds from other investment vehicles, but these elements also serve as a long list of opportunities for hedge fund managers to exploit. Hedge funds share similar characteristics, as discussed in chapter two of this study, which makes understanding hedge funds in general a bit easier. However, when it comes to the detail of each hedge fund, hedge funds can be unique and complex, which means the information available on each hedge fund can differ enormously from the other.

The conclusion reached on this objective is that the following elements of hedge funds were found to be susceptible to economic crime as discussed in chapter 4:

- i. Flexible investment strategies that resulted in deviation from investment strategies and investment losses;

- ii. Minimum level of hedge fund liquidity that resulted in illiquid investments with related or fictitious parties;
- iii. Streamlined governance structures that resulted in issues in respect of:
 - Related parties and conflict of interest in managing the hedge fund;
 - Lack of control by administrators and service providers; and
 - Lack of assurance and internal control.
- iv. Achievement of absolute investment returns that overstated financial performance and led to investor misreporting;
- v. The impact of regulation on the lack of disclosure of investment portfolios and financial misreporting to investors;
- vi. Reliance on the reputation of the hedge fund manager and investor trust that contributed to hedge fund managers concealing the actual performance of the hedge fund;
- vii. Investment performance and high performance fees earned by hedge fund managers that overstated financial performance and led to investor misreporting; and
- viii. Subjective valuation of investments and hedge funds used to conceal actual valuation of the hedge fund.

The mysterious nature of hedge funds makes hedge funds susceptible to economic crime and the detection thereof difficult.

5.3 Conclusion on the problem statement

This study set out to answer the address the problem statement mentioned in section 1.3. The conclusion reached is that the elements identified in Chapter 4 and summarised above in section 5.2.3 are the elements of hedge funds that are susceptible to economic crime.

5.4 Recommendations for future research

The main research objective of the study was to identify elements of hedge funds that are susceptible to economic crime within the context of three case studies. This objective has been fulfilled by the study and from the study, it is clear that hedge funds are specialised investment vehicles that are not understood by many. This study aimed to provide insight on how this mysterious nature of hedge funds contributes to the susceptibility thereof to economic crime, especially fraud.

The study, however, also evidenced that there is a need for standards and regulation in the hedge fund industry. In recent years various countries, including the UK and South Africa implemented more stringent regulation of hedge funds. As this change in the regulatory framework is relatively new, with additional uncertainties such as Brexit looming, further research can be performed on hedge fund regulation to gain a more detailed and in-depth understanding of the future and sustainability of hedge funds and how the susceptibility of hedge funds to economic crime can be prevented.

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