

Lessons from the Madoff Affair

To cap off an already devastating year on Wall Street, some investors discovered in December that they had been victims of a long-term fraud by a person of some eminence in financial circles. Bernard Madoff allegedly added several orders of magnitude to Mr. Ponzi's business model and turned it into an enterprise of astounding proportions. The figures in the press indicate a near total loss of something between \$17 and \$50 billion (the numbers are still uncertain – the upper end may include some amount of fictitious profits).

There has been much information, misinformation and opinion shared on this affair. This discussion is an attempt to isolate those apparent facts that relate to the hedge fund industry and to explore some of the lessons and impacts.

A fraud by hedge funds or a fraud on them?

First of all, it seems to be a commonly stated perception that the Madoff incident was one more example of hedge fund fraud. Actually, it is important to understand that current reports do not indicate that Madoff offered a hedge fund – he provided managed accounts to others. His investors included a large number of funds-of-hedge-funds and other outfits that formed funds to funnel money into large Madoff managed accounts, but the fraud appears to have occurred at the brokerage account level. Accordingly, hedge funds were the victims, not the victimizers.

What is currently known

In no particular order of importance:

- Mr. Madoff had what many considered impressive personal credentials. He was a former chairman of NASDAQ, plus his eponymous firm was a prominent and well-known market maker.
- The "marks" seem to have included many of Madoff's personal friends.
- It has been reported that part of the attraction was a sense of exclusivity about the investment. As things unraveled, that exclusivity apparently abated as Madoff desperately sought additional investors.

- Madoff's returns were reportedly remarkably steady, not remarkably high.
- Madoff's investment process has been described as proprietary, or "black box." It appears that the purported actual investment process was not disclosed.
- Assets were to be "held" at Madoff's brokerage firm. Apparently, he provided falsified daily transaction records that supported the returns he claimed. The use of his own brokerage firm was apparently justified because Madoff was "paid" by brokerage commissions, not asset-based fees or incentives. That meant an account at another brokerage firm was impossible – investors had to open an account at his firm.
- It has been reported that there may have been as few as three employees involved in the operation. It is unclear how so few could falsify so many records.
- No one is certain how long the fraud has been going on – whether it began as a fraud or, as it happens in many cases, things went awry later, and an attempt to cover up losses acquired a life of its own. However, officials at FINRA have reported that, "Our exams showed no evidence of trading on behalf of the investment advisor, no evidence of any customer statements being generated by the broker-dealer." So, it is possible that no trades were ever executed and that investment capital never hit the books of the actual broker-dealer that FINRA examined.
- Some individuals have claimed to have analyzed Madoff's returns, found them too consistent to be true, and declined to invest. At least one apparently conveyed those conclusions to the SEC, with no apparent effect. Many more, including some institutions regarded as highly sophisticated, were not so fortunate.

What is currently known continued

- The auditor of the Madoff brokerage firm was apparently a one or two person outfit (that has not been returning calls). *Note that a brokerage firm audit is different in many respects from the audit of a hedge fund, but clearly, if the auditor was genuine, Madoff wasn't sharing the set of fraudulent records. It has not been reported if any investors attempted to contact the auditor in their due diligence process.*
- The funds who invested in Madoff managed accounts were presumably audited by reputable firms, who were apparently also fooled by the falsified broker statements.
- There were a number of funds formed solely for the purpose of investing with Madoff. As opposed to the normal fund-of-hedge-funds model, all of the investment in these funds was being sent to one manager.
- In a number of cases, investment banks purportedly provided leverage so that Madoff's consistent though moderate returns could be juiced up a bit. In this structure, the investment bank might add, say, \$2 to every \$1 of investor capital and the fund would send \$3 to Madoff. Leveraged transactions involving a single manager are, in our experience, rare and would imply that Madoff also passed the due diligence processes of those lending banks.

The Fallout

In addition to the direct financial damage, there is a fair amount of collateral damage:

- The fact that there were many sophisticated intermediaries – institutions and funds-of-funds who invested with Madoff – naturally creates some cynicism about the value of “sophisticated due diligence.” Of course, the real situation is that most funds-of-funds and institutions did not invest with Madoff.
- Single-manager feeder funds will probably become more uncommon. If one invests in a fund that is feeding 100% of its money to someone else, it

means that one is delegating some or all of the due diligence process to that intermediary. In a normal fund-of-funds with a due diligence team and a broad set of investments, this is probably an efficient delegation. But where capital is flowing directly through to a manager who is identified to the investor, the investor has more responsibility but less access to information. This structural challenge will likely make this set-up rare in the future. “Normal” funds-of-funds that provide access and diversification to a broad group of money managers should continue to make sense for many investors.

- Leverage from banks to funds-of-funds has already tightened. Several years ago, there arose the notion that one could create a fund-of-funds that never lost money and which, therefore, could be leveraged significantly without excessive risk. That concept apparently mutated into the notion that there were some managers who alone would never lose money. Certainly, this latter type of fund will be hard to leverage and banks will likely limit credit even to the well-diversified funds.
- Due diligence processes will become more intense.
- “Trust” as it applies to investments has taken a big hit (if you can't trust a former chairman of a national securities exchange or a friend, who can you trust?). We would expect more pressure for independent reporting and other checks. Although the Madoff affair was not, strictly speaking, a hedge fund fraud, one of the largest losers in the Madoff affair (Union Bancaire Privée) has already called for independent administrators on all hedge funds in which it invests.

Moving Forward

Unfortunately for those involved, hindsight must be very painful right now. For the rest, there are a number of things to underscore in due diligence processes going forward:

- 1. Independence.** It is a good rule to have as many independent service providers as possible when one is entrusting money to another person. In this case, insisting on a separate broker would have made one ineligible for the fraud. We would note that the vast majority of hedge funds have this protection: the manager is not the broker. The majority also have administrators, banks and securities custodians who are independent of one other. Virtually all have an independent auditor.
- 2. Verification.** It's not enough for an investment manager to say that he or she has an auditor or outside administrator, or, for that matter, a real brokerage account. The due diligence process should include a process for verifying the involvement of each significant service provider. To complete the picture and ensure that capital contributions don't end up in an account other than the one that has been checked out, one should seek confirmation of capital contributions from the administrator. In a normal hedge fund or fund-of-funds, the administrator will know each investor's involvement concurrently and, at year-end, the auditor will as well.
- 3. Diversification.** The most heartbreaking stories from this case are the many charities and individuals who apparently had a majority or all of their assets invested with Madoff.
- 4. Understanding Delegation.** Funds-of-funds will need to work in their marketing to distinguish between "normal" fund-of-funds and the single-manager conduit funds that were hit hardest in the Madoff affair. While the delegation of due diligence in those conduit funds was unwise in hindsight, "normal" funds-of-funds with a broad set of investments and robust due diligence teams will remain important investment vehicles.

5. Emotional and Social Components. Who can really tell the difference between a true investment genius and all the pretenders? Emotional and social components such as likability or status really don't belong in a due diligence process.

6. Results. If one doesn't know the "why" behind an investment process that is supposed to yield above-average results, what do the numbers really mean? Healthy skepticism would suggest that returns alone should never drive an investment decision; the numbers should support one's hypothesis for why a manager is successful. This is, by definition, impossible with a "black box" process. And, of course, that old axiom, if it looks too good to be true, it probably is, doesn't have to mean the returns are too high. In this fraud of the century, the returns were modest, but, in hindsight, they were too consistent to be true.

We should keep in mind that there have been frauds and thefts since the invention of bartering. Sometimes, things just aren't what they seem. The good news is that the modern investment landscape has more available protections than ever. In the hedge fund arena, if an investor goes through a reasonable due diligence process, requires third-party administration and a reputable independent broker and auditor, plus sees that there are reasonable financial controls, the opportunities for a Ponzi scheme fraud are minimized.

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