A CAT Scan of the Madoff Scandal:
Diagnosing Fraud Inside The Black Box

While many investors may think the Madoff scheme is unprecedented, rest assured it is not. Over the past 10 years the SEC has investigated numerous instances of investor fraud, on the scale of $100-million to one billion dollars. Daily headlines are now revealing fresh examples. The alleged fraud in the Madoff scheme has set a new and shocking dollar bar, but the financial and operational elements that are the recipe for such a disaster have been around for quite a while and we will likely see more such events in the future.

The complexity of hedge fund strategies combined with investor desire for "above average" returns, along with the elite lure of a private, exclusive investment realm, have resulted in an atmosphere ripe for fraudulent practices. Due diligence, audit statements, and understanding of investment strategy – traditional tools of prudent investors – often have been cast aside in recent years. Instead, whispered social relationships accompanied by regular reports of fund success and individual wealth building were the key attributes of many "sophisticated investors".

As we now enter a period of more sober consideration stemming from the economic crisis in general and the Madoff meltdown specifically, it will be vital that the correct lessons are learned from the current situation.

This article is for investors, advisers and lawyers on the phenomenon of hedge funds and other similar Unregulated Multi-Level Investment Structures ("UMLIS"). The intent is to illuminate the investment pitfalls inherent in this nearly impenetrable area of investment and what steps can be taken to prudently take advantage of the opportunities as the market is redefined.

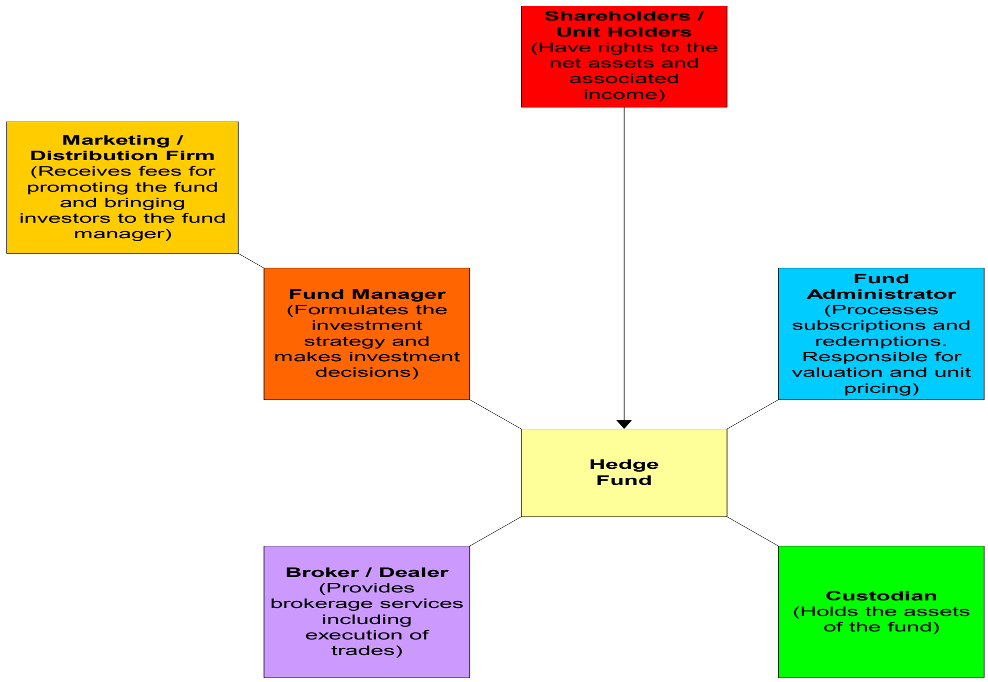
In this article we will:

1) explain the structure of a typical UMLIS;
2) illustrate how Madoff deviated from it;
3) explore the difficulty inherent in monitoring and valuating a UMLIS; and
4) demonstrate how a more integrated approach to reputational and financial due diligence by forensic experts can help detect the potential for fraud and otherwise provide confidence in making investments in this arena.

The Typical UMLIS Structure

The typical organizational chart of a domestic hedge fund (*see Figure 1*) is composed of a related group of entities whose objective is to manage the pool of contributions that investors make to the fund. We can begin to quickly appreciate the multiplicity of roles that go into making up such an investment vehicle.

FIGURE 1. The Structure of a Typical Domestic Hedge Fund



In the usual set-up, the Broker/Dealer and Custodian are the same and often are referred to as the Prime Broker. The Fund Manager also is often the General Partner or founder of the fund. The Fund Manager charges a management fee in the 1%-3% range and a performance fee in the range of 20% of the profits.

While it is common to refer to the entire entity as a fund, in most cases the actual fund is a separate partnership whose sole assets are the investments themselves. Therefore, the fund itself has no employees or even an office.

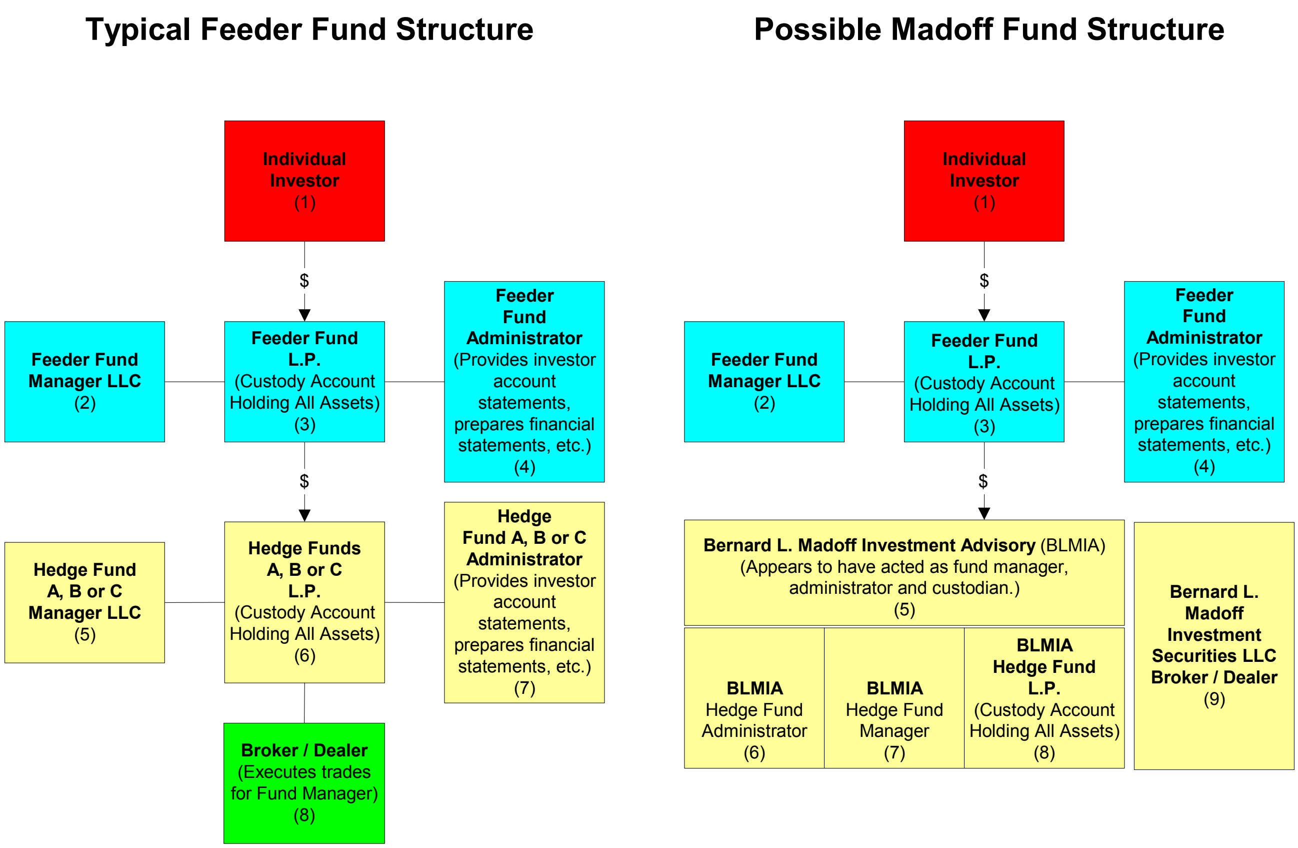
In appearance, hedge funds resemble the more generally familiar mutual funds in that money can be invested in a wide range of investments through a common group, and where the cost of doing so is shared. However, there are several critical differences investors need to be aware of before considering a hedge fund or UMLIS investment.

The most important distinction between a UMLIS and a mutual fund is that the latter is regulated by both federal and even state governments and therefore operates within the narrower confines of a statutory framework. Mutual funds have trustees and/or boards of directors charged with the safeguarding of assets and the compliance with all of the relevant regulations. A hedge fund or UMLIS relies on its own internal rules and values without official watchdogs.

In the world of the UMLIS, investments are more complex, fast-moving and carry great risk. The potential of all this dynamic action is greater investor reward. But the investing takes place outside of the more universally understood rules of the road. On the UMLIS superhighway there are often no speed limits, no lane dividers, no police radar and the exits are not clearly posted.

The charts in Figure 2 illustrate the challenge in tracing an investor's original investment as it gets pooled, sliced and diced into a fund of funds and then commingled with other investor's contributions as the feeder fund wires the aggregated amount to the fund that actually executes the proprietary investment strategy (e.g. hedges, derivatives or options) through a broker/dealer, i.e., the Prime Broker. *(For an expanded view of Figure 2, visit http://www.holtzrubenstein.com/090203_charts.pdf)*

FIGURE 2. Typical Feeder Fund vs. Potential Madoff Fund



As you examine the above, consider all the distinct entities that may exist between the investor at the top and broker dealers at the bottom. With so many separate moving parts it is easy to see how difficult it can be to fully understand the route investment dollars travel.

Auditors who usually are relied upon to verify results and the correctness of operations have limited perspectives when examining UMLIS structures because their responsibility is only for the particular entity for which they are engaged. In most cases, there are different accounting firms at each level, as (we are now discovering) was the case in the Madoff operation.

Whether by design or consequence, the UMLIS structure obscures the view of the complete picture by avoiding a comprehensive look at the entire process.

Inside the Fund – The Valuation and Performance Conundrum

The financial marketplace of the 21st century has created instruments and investment vehicles that operate far beyond relatively simple stocks and bonds traded in an open market and valued by real time price quotes.

It is estimated that there are 8,000 to 10,000 funds, which have a wide variance of investment strategies and exotic instruments – and no standard system of classification. Although often grouped in either global, macro, directional, relative value, or miscellaneous categories, many strategies have a singular, private flavor – the real ingredients known only to the Fund Manager.

Of course, every fund has to invest in something. And that something has to be bought at a price and, eventually, sold or appreciated at a price. However, consistent measurement of performance gain or loss is mitigated by the length of time to maturation, the number of elements contained within an option, derivative, or collar, or the unique design of a particular investment. Nowadays, new concepts of valuation are based on "fair value," which the Fund Manager determines.

Investors confronted with the complexity and depth of this kind of investing often place their faith in the fund managers and the integrity of the monthly statement the fund issues. When the results are frequently positive and wealth is growing, at least on paper, this approach has understandable appeal.

The Madoff Fund Structure and the Mystery of the 17th Floor

In Figure 2 we also see an approximation of the outlines of the Madoff organization. The actual entity structure used by Madoff is not yet fully known. We do know Bernard L. Madoff Investment Services LLC ("BLMIS") was a market-maker business and a licensed broker/dealer subject to SEC and Financial Industry Regulatory Authority ("FINRA") oversight. It was one of the largest brokers on the NASDAQ Stock Exchange, of which Madoff was once chairman.

However, it is alleged that on the now infamous 17th floor, below BLMIS, Madoff operated an investment advisery business that oddly received no fees from BLMIS and was unregulated. By all appearances it was a black box, which domestic and international feeder funds and individual investors believed was a very successful hedge fund.

Madoff told investors his black box executed a "split-strike conversion" strategy to produce consistently positive results over many years. That was his story and he stuck to it.

The truth is, few people had any idea what really happened on the 17th floor. And few people tried to find out. The promise of robust returns even in down markets and the reputation of the Madoff firm and its founder, as well as the seduction of participating in a members-only investment club beyond the pale of inhibiting regulation, all contributed to an atmosphere ripe for fraudulent exploitation.

Warning signs were evident. Some analysts pointed out that the strategy of deftly using puts and calls against a basket of stocks was not sustainable on a regular basis or in some years was not even possible given market volume for such transactions. Still, these Cassandra concerns were masked by more powerful motives and were ignored even if known.

Due Diligence Versus Fraud

In the years ahead there will be many arguments, legal and otherwise, over what feeder fund managers and other investment advisers should have done to review BLMIS operations before placing investments with Madoff. Investors will question whether feeder fund managers even met the standards of their own private placement memorandums, let alone the standard actually necessary for investing large sums in this manner.

Already clear is that the prevailing market attitude of willful naiveté and ignorance towards UMLIS will have to be replaced by a more alert and cautious approach that involves an in-depth examination of any entities that seek to attract big investors.

The actual details of the Madoff debacle will emerge only after painstaking forensic investigative and accounting work is done, to unravel the relationships between the Madoff black box and those who poured the money into it. Those details and the possible conflicts of interests they reveal will help drive new laws through Congress and regulations through government agencies. This will doubtless result in a new definition of what constitutes due diligence, especially with respect to UMLIS.

The outlines of that "new" due diligence already are well known to those intimately familiar with the investigation of complex financial organisms and the entrepreneurs who create them.

Among the UMLIS inquiries likely to be made by forensic investigators and compliance teams going forward are:

- Performance measurement over time with close comparison with industry data
- Disclosed investment strategy
- Skeptical review of "great" historical returns
- Examination of underlying assets under management and the models created to test outcomes
- Testing the quality of audited financials
- Basis for fund valuation
- Discovery of data otherwise available from a regulated entity
- Details of all fund investment agreements and other terms
- Review of fund's risk assessment

Yesterday, some investors and managers of feeder funds doubtless saw such comprehensive reviews as expense drags on the fees and profits coming their way from doing business with the Madoff machine. Today, those still in business may find such procedures the new cost of doing business.

An Integrated Approach – Due Diligence With Teeth

Nowadays, due diligence too often is comprised of Internet searches for litigation histories and business stories that might speak to reputation, combined perhaps with some off the shelf quantitative analysis. In some respects there is a "don't ask, don't tell" quality to the anemic efforts undertaken.

Investment firms will have to put veteran forensic experts in the field armed with skeptical attitudes, multiple investigative skill sets, and a willingness to knock on 17th floor doors to ask hard questions in person. Proprietary investment strategies, high rates of return, and the invention of new financial instruments all should be subject to challenge by professionals with the requisite backgrounds in mathematics, law enforcement, and forensic accounting. The need for such an aggressive, savvy approach can now be seen in a different light.

Achieving substantive reputational and financial due diligence results requires getting beyond marketing puffery, self-serving narratives and the veil of secrecy surrounding a fund's operation. This all can be accomplished in a professional manner while respecting confidentiality. As in any successful transaction, there must be trust on both sides.

Confronted with the decision on a treaty between the United States and Russia regarding the reduction of nuclear warheads, President Reagan famously said: "Trust, but verify." This same advice should guide those who take on the daunting responsibility of investing tens of millions of dollars, to avoid devastation and ruin for themselves and their clients.

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