The Madoff Identity:

A New Operational Due Diligence Paradigm in a Post-Madoff World

March 2009

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The initial details concerning the largest alleged financial fraud in history are just beginning to come into focus, yet one thing is already clear, the repercussions of the Madoff scandal have elevated both regulators and investors concerns related to hedge funds operational (i.e. non-investment related) risks to heighted levels of justified paranoia. Initially it seemed as if the Madoff scandal was the final supernova in a galaxy of unbelievable institutional failures and fraudulent activities throughout 2008.

Unfortunately, with details of other new alleged fraudsters continuing to emerge at an alarmingly steady rate such as the vanishing Arthur Nadel[1)], the brash Nicholas Cosmo[2)], the Texan cricket hero R. Allen Stanford[3)], the bold Paul Greenwood and Stephen Walsh[4)], the audacious Ray M. White[5)], the brazen Tom Petters[6)] and the bizarre Rod Cameron Stringer[7)], it seems as if Madoff was only the brightest star in an expanding constellation of hedge fund fraud. 2008 even saw hedge fund managers themselves allegedly duped by purported scams such as the one allegedly perpetrated by lawyer Marc Dreier who is charged with, among other things, selling fraudulent securities to hedge funds and impersonating other attorneys[8)].

After the wave of alleged frauds and failures that was 2008, it is clear that once established investment norms, former confidence in sterling reputations and long standing institutional legacies are all susceptible to failure and change. Now more than ever, the ability to adapt in this post-Madoff environment is the benchmark against which hedge funds will be measured. Unfortunately in most investor's minds, particularly those whose homes are now for sale as a result of losing virtually everything with Madoff[9)], duplicity and mistrust are the new market mantras.

Preliminary reports surrounding the allegedly huge Ponzi scheme that was Madoff Investment Securities LLC, are bringing to light a blurry portrait of the firm's seemingly bi-polar founder and namesake Bernard (aka: "Bernie") Madoff. Madoff, a former NASDAQ chairman was ostensibly best known for being a hallmark of integrity, who clearly understood the deep import of the seemingly blind trust bestowed upon him by celebrities, wealthy country club golfers and unfortunately charities. Yet many still find it hard to believe that this once stalwart bastion of ethics has been relegated to the status of a common thief. As when similar frauds, such as Sam Israel's Bayou Hedge Fund Group, first hit the news a number of articles have been written seeking to point the finger at the obvious usual suspects including Mr. Madoff himself, the SEC, fund of hedge fund managers, Swiss private banks, capital introducers, etc. When a fraud of this magnitude takes place there is obviously no shortage of culpability to go around.

Did Madoff start his firm off as a total scam from the very beginning? While we may never know the true answer, it is reasonable to assume that he did not. Most investment frauds of this magnitude rarely start off with the intent to defraud investors. Indeed, hailing back to the days Charles Ponzi's universal postage stamp[10], it is an essential element of a large scale fraud to have some shred of genuine credibility. In Madoff's case, people were receiving handsome returns on their investments. Just as Ponzi did, if investors wanted to pull their cash out, Madoff paid them. The problem it seems was with the recent extended market turmoil followed by too many requests for redemptions in a short period of time, there was no longer enough cash to continue to feed the machine and the house of cards collapsed. Yet a number of burning questions remain outstanding, including one of the most intriguing - who was the real Bernie Madoff?

The Madoff Identity: Genius or Mad-Man?

Assuming that Mr. Madoff did indeed perpetrate this fraud, it seems that he had been living a life of dual identities for a very long time. On one hand, there was the elusive ethical market genius who was active with charitable organizations[11] and had found a way to produce an unbelievable continued steady stream of profits over an extended period of years in both up and down markets. Adding to his aura, Madoff was in such high demand that he refused to take investments from people on numerous occasions[12].On the other hand, there was the alleged fraudster who manufactured false investor statements in order to steal money from investors. Such split personalities between a fraudster's public face and private actions are nothing new, not even to the modern hedge fund industry. The uniqueness of the Madoff scandal lies not only in the magnitude of the losses, estimated at $50 billion, and its scope, but more importantly in the fact that such a well respected individual fooled so many.

Was this Jekyll and Hyde act a secret to which Madoff himself was only privy? Details are now emerging that the Securities and Exchange Commission is looking into the potential involvement of other parties. The list of potential suspects being questioned includes Madoff's relatives who were employed at his firm and longtime Madoff employee Frank DiPascali who was described as being "evasive" during questioning by Securities and Exchange investigators.[13]

Also coming under scrutiny is Madoff Investment Securities LLC three-person "auditor" Friehling & Horowitz who curiously for the past 15 years has been informing the American Institute of Certified Public Accountants that they do not actually perform audits[14].

Of course, hindsight is 20/20 and now there are a host of individuals claiming that they passed on Madoff because they didn't believe his incredulous returns[15]. Others claim they saw enough red flags to suspect Madoff's operations were a sham. Unbelievably, Harry Markopoulos even reported his suspicions about Madoff to the SEC on numerous occasions to no avail[16].

Regardless of who knew what, when, and how, one thing is certain – change in the hedge fund industry is inevitable. It is likely that this change will take place across many fronts, and in particular via increased regulation[17)]. However, even with increased regulation, it is impossible for investors to predict with any certainty the next major fraudulent scheme. Beyond that, there is a justified heightened importance which investors must place on evaluating the quality and nature of a hedge fund's operational infrastructure. As such, investors will still bear the onus of performing effective operational due diligence, or hiring capable investment advisors to perform this due diligence on their behalf.

The Duality of Diligence: A Transparency Tug of War

Madoff's dual identity is emblematic of the transparency tug of war that is operational due diligence. In the post-Madoff world hedge fund operational due diligence will represent a constant struggle between investors and hedge funds that will focus on:

- access to information
- the rate (i.e. – timeliness) at which this information is released

How exactly will this delicate informational balance be struck in a post-Madoff world? It is worth considering this question from the perspective of both parties to the hedge fund operational due diligence process – investors and hedge funds.

The Investor's Perspective

Hedge fund investors will likely place an increased responsibility on themselves and their advisors, to collect and monitor more information about the operational risks of hedge funds. Anything short of collecting and digesting even a minimum base-level amount of operational information would border on the blindly naïve assumption that all the Madoff's of the world have already been caught. Furthermore, hedge fund investors are beginning to come to grips with the cold fact that a hedge fund organization can fail not just because of poor investment performance of outright fraud, but for a host of other non-investment related reasons including poor operational risk management, business continuity and disaster recovery, reputational risks, valuation risks, improper accounting risks, legal and compliance risks, regulatory risks, etc.

Even beyond issues of outright failure, a poor operational infrastructure, reduces the overall efficiency of the hedge fund organization which can have a series of negative repercussions for an organization including reduced performance. A concept which is known as Operational Drag℠.
In summary, in the post-Madoff world the hedge fund operational due diligence process from the investor perspective is likely to be altered in the following major ways:

- Institutions which invest in hedge funds and in particular money managers like fund of hedge funds will dedicate more resources to due diligence with a particular focus on operational due diligence

- Hedge fund investors will take greater ownership and involvement in the operational due diligence process and no longer completely outsource operational due diligence to professional hedge fund allocators such as fund of hedge funds and consultants

- There will be a marked increase in both investment committee voting authority and veto power extended to operational due diligence analysts at more hedge fund allocation organizations

- Investors will increase both the scope and depth of operational issues covered during a due diligence review, with a particular focus being placed on operational risk

- Investors will place a premium on those hedge funds that allow them both:
    - i) access to operational information; and
    - ii) pro-actively provide this information on a frequent basis

- Hedge fund investors will increase the frequency with which they perform operational due diligence reviews

The Hedge Fund's Perspective

Those hedge funds that have survived 2008, have now found themselves in the midst of an operational due diligence quandary. On the one hand, they want to ensure that those investors that have stayed with them have all the information they need to remain comfortable that their hedge fund organization has taken steps to properly mitigate operational risk. Additionally, these same hedge funds want to attract new capital from investors who are looking for operationally strong organizations. Yet on the other hand, these same hedge funds do not want to provide full transparency, particularly when it may expose any operational weaknesses which may be present. Successful operational risk management in the post-Madoff world will require hedge funds to walk a tightrope of continually boosting investor confidence in a fund's operational risk management capabilities, while not destroying and competitive advantages or informational edges through the dissemination of this information.

Hedge funds may not be prepared for the increased breadth and depth of investor reviews in this post-Madoff environment. No longer will it be sufficient for investors to rely on generic due diligence questionnaires or to be granted a meeting with a hedge fund's senior operational professionals for a few hours once a year for an annual review. Investors will likely request much greater detail on a host of different operational issues ranging from legal and compliance issues, information technology, cash management and valuation. Hedge fund investors will also likely increase the frequency with which they want this operational information. In effect, it is likely that hedge funds will likely need to deal with a normalization of the broad temporal disconnect between the almost real-time monitoring of a hedge funds investments by investment analysts and the extremely infrequent monitoring of operational risks.

These increased due diligence requirements will require hedge funds to be prepared to devote more resources to each individual investor's operational due diligence reviews across a number of different areas including on-site meeting, document preparation and due diligence questionnaire completion. As intimated earlier in this discussion, compounding this problem is the increased frequency with which these operational due diligence reviews will likely take place.

All of these additional burdens will require a hedge fund to dip into their already strained resources and will likely lead to slimmer overall profit margins. Consequently, hedge funds will be incentivized to ensure that they have detailed, cost-effective plans for dealing with the on-going requirements of operational due diligence.

So what does all this gloom and doom mean for investors and hedge funds that are still left standing on albeit shaky ground? Corgentum's analysis of the situation is that vigilance and transparency are the new currency of hedge fund operational risk management. As such, in order to attract and retain capital hedge funds will now, more than ever, be able to maximize the return on investment of resources allocated to effectively preparing to effectively navigate the investor operational due diligence process. Mirroring the changes in operational due diligence from the investor's perspective, in the post-Madoff world the operational due diligence process from the hedge fund's perspective is likely be altered in the following major ways:

- Hedge funds will be faced with vast increases in both the frequency and thoroughness of operational due diligence reviews
- Hedge funds will face increased resource requirements and expenses in preparing for and executing investor operational due diligence reviews
- Hedge funds will face greater demands for increased transparency regarding operational issues
- Hedge funds will be required to provide operational information to investors with increased frequency and timeliness

CONCLUSION

A change in the modern approach to hedge fund investing and operational due diligence is underway. The repercussions of the Madoff crisis compounded with the recession like economic climate will have a significant impact on the nature of hedge fund due diligence, particular with respect to operational risk. Both investors and hedge funds will be forced to rethink previously rigid due diligence paradigms. In order to survive, both groups (and hedge funds in particular) must be prepared for the costs associated with the increased resources that will be allocated to effectively carry out operational due diligence in the post-Madoff world. Investors must be able to demonstrate that they can properly manage and mitigate operational risk via execution of efficient due diligence. Those hedge funds that are prepared for these increasingly rigorous due diligence reviews and which make the processes as seamless as possible for investors will be the most effective at not only attracting but retaining capital from increasingly sensitive investors.

REFERENCES

1) Nadel disappeared on January 14, 2009 after reportedly transferring at least $1.25 million from two funds to a secret bank account:
http://archives.chicagotribune.com/2009/jan/22/business/chi-thu-brf2-money-manager-jan22

2) Cosmo allegedly paid ex-convicts to recruit investors. He was court ordered to under extensive gambling therapy while previously imprisoned. Cosmo told Entrepreneur Magazine that he began his business with one employee in August 1999 – he was actually imprisoned at that time:
http://www.bloomberg.com/apps/news?pid=20601103&sid=ap1s5.ybUE1U&refer=news

3) Stanford was charged by the SEC with perpetrating an $8-billion investment fraud via false promises of high-interest returns on his bank's certificates. Stanford is well known throughout the Caribbean for promoting the sport of cricket:
http://www.latimes.com/business/investing/la-fi-stanford18-2009feb18,0,3859843.story

4) Authorities claim Greenwood and Walsh's WG Trading Company and Westridge Capital misappropriated approximately $667 million via a fraudulent enhanced indexing strategy:
http://www.nytimes.com/2009/02/26/business/26scam.html?_r=1&dlbk

5) The Commodity Futures Trading Commission charged Ray M. White and his company, CRW Management LP, with allegedly stealing millions of dollars to fund a lavish lifestyle which included Dallas Stars season tickets and sponsorship of his son's drag racing team:
http://www.hedgeco.net/news/03/2009/texas-hedge-fund-manager-bilks-109-million-from-250-investors.html

6)Petters was indicted by a federal grand jury for allegedly orchestrating a $3.5 billion Ponzi scheme: http://www.startribune.com/business/30631384.html

7) Stringer, via his RCS Hedge Fund, allegedly misappropriated millions from investors since 2001. In addition to running his hedge fund Stringer, who is an ex-car salesman, worked as a bail bondsman, tow-truck driver and a crop duster:
http://www.bloomberg.com/apps/news?pid=20601087&sid=a19JJSLP2A5M&refer=home

8) Dreier was accused of impersonating a lawyer from the Ontario Teachers Pension Plan named Michael Padfield:
http://online.wsj.com/article/SB123386241738953439.html?mod=googlenews_wsj

9) "My house is up for sale." Allan Goldstein, Madoff Investor:
http://www.npr.org/templates/story/story.php?storyId=99812134

10) Ponzi's original scam was a supposed arbitrage scheme involving international reply coupons for postage stamps.

11) Such as Gift of Life Bone Marrow Foundation: http://www.bloomberg.com/apps/news?pid=20601088&sid=apogZqbN9qUg&refer=muse

12) Barbara Fox, president of a Manhattan estate agency business, said she "literally begged" Madoff to take her money but he refused: http://www.thisislondon.co.uk/standard/article-23602414-details/Revealed:+Magic+Madoffs+family+piggy+bank+in+the+heart+of+Mayfair/article.do

13) http://online.wsj.com/article/SB123024966266334285.html

14) http://money.cnn.com/2008/12/17/news/companies/madoff.auditor.fortune/

15)Such as Ben Stein: http://www.nytimes.com/2008/12/28/business/28every.html?em

16) http://www.time.com/time/business/article/0,8599,1874218-2,00.html

17) http://online.wsj.com/article/SB123326027861829923.html?mod=rss_US_News

ABOUT CORGENTUM

Corgentum Consulting, LLC (www.corgentum.com), is a full service hedge fund operational risk consultancy practice. The firm utilizes proprietary methodologies and original operational risk research to partner with both hedge funds and investors to diagnose and mitigate operational risk exposures, and improve upon the overall efficiency and effectiveness of the operational due diligence process. Corgentum's primary practice areas include outsourced operational due diligence, development of operational due diligence functions, hedge fund operational due diligence meeting preparation, operational efficiency analysis and implementation management. Corgentum was founded by Jason Scharfman one leading experts in the field of hedge fund operational due diligence and the author of *Hedge Fund Operational Due Diligence: Understanding the Risks* (John Wiley & Sons 2008*).*