How to Avoid Hedge Fund Fraud – An (Extra) Ounce of Prevention

Bernard L. Madoff Securities LLC - $65 billion

Bayou Hedge Fund Group - $450 million

International Management Associates - $115 million

These are just a few examples of the amounts lost by investors in the many hedge fund scandals that have been uncovered over the last few years. In order to invest in a hedge fund an individual must meet certain high income and liquidity tests which technically deem them a “sophisticated investor.” So how is it that more than 1,300 sophisticated investors lost billions by investing in a hedge fund managed by Bernie Madoff that appears to have not even made a trade in over 13 years? Why would sophisticated investors pour $450 million in a hedge fund over 8 years that never once made a profit? How could financial advisors to star athletes condone investing over $30 million in a fund that could not produce any real evidence that the underlying investments actually existed? Because a hedge fund is unregulated, is not subject to examination by the SEC, does not have to have an audit (unless mandated in the fund’s governing documents), and the fund manager is usually given carte blanche to manage as he/she pleases….in other words CAVEAT EMPTOR!

Since there are many legitimate hedge funds in operation, what can an investor do to reduce the risk of hedge fund fraud? Most people would say that exercising due diligence (“an ounce of prevention”) before investing would help to avoid such pitfalls. However, you may want to go the extra mile in due diligence to see if you spot any red flags. This would certainly have helped Dan Lipton, the CFO of Fairfield Greenwich which was a feeder fund to Bernie Madoff’s hedge fund to the tune of about $7 billion. Lipton fielded a call from a client who had a question about Madoff’s auditing firm (Friehling & Horowitz CPA), which turned out to be a one-man operation. However, Lipton sent the following email to the client: “Friehling & Horowitz CPAs are a small-to-medium-sized audit and tax firm specializing in broker dealers and other financial services firms. They have hundreds of clients and are well respected in the local community.” Lipton’s subsequent interview with regulators shone a bright light on the depth of his due diligence:

Q: How did you determine they had hundreds of clients?

A: That's what the partner said on the phone to me.

Q: Did you corroborate it in any way?

A: No

Q: How did you determine that they were well respected in the local community?

A: That's what our conversation – my conversation with one of the partners at Friehling & Horowitz – that's what was told to me.

While Lipton's inquiries were sound, he should have directed them to someone other than the firm he was investigating. That's like asking the fox if there's a need for a lock on the hen house.

Now that we have the benefit of hindsight, what can potential hedge fund investors do to reduce the risk of fraud? The short answer is that proper due diligence should be performed on the fund manager's third party administrators ("TPA") to determine that they are competent, independent people who will help you keep an eye on your money.

A typical hedge fund comes into being when a professional money manager decides he/she would rather manage their own fund rather than work for an investment bank, so they leave their job and become their own boss. Realizing they can't do it all on their own, they usually employ the help of third party service providers. There are usually four main third party service providers that a fund manager uses:

- Attorney
- Fund Administrator
- Prime Broker / Custodian
- Auditor / Tax Accountant

The first service provider is an investment attorney who guides them through setting up an entity (e.g., Limited Partnership) that will govern the fund. Another entity is also established that will act as the General Partner to the fund, which essentially is the fund manager. The attorney will also counsel the fund manager on the start-up and on-going compliance issues of hedge funds. The easiest way to conduct due diligence for an attorney is to contact the state bar association where the attorney practices to verify he is a registered attorney and find out if there are any complaints on file.

Now that the entities are established, it is up to the fund manager to send out the proper subscription agreements to potential investors and start raising capital. Once the capital is collected and invested it will need to be accounted for and profits/losses distributed according to the terms of the operating agreement. The fund manager usually taps the services of a fund administrator to perform these functions. Some accounting firms offer this service, as well as companies specifically established to operate as fund administrators. A good fund administrator will have direct access to the prime broker to verify that trades are being made and all funds are accounted for. Chances are that the fund administrator will not be located in your area but, if so, you can visit their offices to verify their existence. Even if they are not located nearby you should find out how long they have been in business and even get a list of references of past and present clients. You can also ask for written documentation that there is no "related party interest" between the fund manager and the fund administrator. I say this because even Bernie Madoff had a fund administrator….owned by Bernie Madoff! That being said, there are some large hedge funds that perform their own fund administration in-house. While this is certainly legal, an independent fund administrator can be your best friend since they account for the fund assets at least monthly and sometimes daily as well as interact directly with the prime broker; thus being in the best position to monitor assets.

A prime broker is a broker which acts as a settlement agent for trades placed by the fund manager and provides custody for the assets and cash held in the account. The prime broker will provide supporting documentation for all trades placed as well as the corresponding gain/loss for each trade and any interest/dividends earned. Examples of prime brokers are firms like Goldman Sachs, Bank of America, and Wells Fargo. Or, a prime broker could be a regional branded firm that clears trades through one of the larger brokerage houses. The fund manager will state who he/she uses as a prime broker and you should be able to call the broker and have them confirm that relationship. They will not be able to give you detailed information about the account but they can at least confirm its existence. Confirmation of the account detail will come from the fund administrator and auditor. Once again, Bernie Madoff used his own firm as prime broker which provided him the full circle needed to perpetrate fraud. Therefore, you should verify that the prime broker is not affiliated with the fund manager.

The fourth service provider is the fund auditor and tax accountant. Generally, the firm chosen to perform the audit also provides the corresponding tax work for the fund. This is not only legal but cost efficient since most accounting firms will offer a discount for doing both the audit and tax work thus saving the fund money. Large funds (> $250 million) typically employ the services of a national, "Big 4" firm such as PriceWaterhouseCoopers but there are several regional firms that specialize in alternative investment audits that are highly competent and more cost efficient for small-to-medium sized hedge funds. The fund manager usually informs potential investors who the fund auditor will be. If the audit firm has more than one office, you will need to find out which office will be doing the work and contact that office to verify the engagement. Once you verify with the audit firm that they have a signed engagement letter from the fund manager, you can call the American Institute of Certified Public Accountants (AICPA) to get information regarding the accounting firm.

If you don't have time to perform a thorough due diligence on the fund manager and their third party service providers, you can hire the services of a due diligence firm to perform these tasks for you. A due diligence firm will perform a thorough background check on the fund manager as well as his/her service providers to verify existence, competency, independence and any related legal issues. This is equivalent to hiring the services of a professional home inspector before buying a house. Note that these suggestions are not a guarantee that you will not fall victim to fraud but it will certainly give a higher comfort level that the risk of fraud is much lower than if you had not performed proper due diligence.