

Madoff

Last week Bernard Madoff decided to throw in the towel on his own Ponzi scheme and confess to one of the largest cases of alleged fraud in the hedge fund industry, known to date. The list of direct investors includes astute and reputable investors. The details of the scheme are as yet unknown but the opportunity for fraud and the vulnerability of the structure of the fund is immediately apparent and indeed has been apparent to investors since inception. In fact, the fund documents are transparent as to all the structural weaknesses of the fund.

How does one invest in a fund managed by Madoff? Unless one has a sufficiently large checkbook, the only way to invest is through a feeder fund. Madoff's business model is based on scale and to this end, rather than have in house distribution and marketing, Madoff uses intermediaries to raise capital in what is sometimes known as white labeled or private labeled products. An intermediary sets up a fund and raises capital for that fund. This fund then invests substantially all of its assets in a 'fund' or more accurately in the case of Madoff, a managed account managed by Madoff. Typically in a white labeled agreement, a feeder fund invests in a master fund. That is, an investor puts money in the feeder fund. The feeder fund then invests that money in the master fund. Corporate governance requires that each fund will have its own investment advisor, independent administrator, prime brokers, custodian banks, auditors. In the case of Madoff, the feeder funds did have their own investment advisor, independent administrator, prime brokers, custodian banks, auditors. The master accounts with Madoff Securities, unfortunately, did not.

In the typical structure of a Madoff run fund, the white labeled fund into which the end investor puts their money would have a reputable independent administrator, custodian, auditor (usually one of the big 4). The investment advisor would be the sponsor (and marketer) of the fund. The fund, however, would establish an account at Bernard L Madoff Investment Securities Inc, a registered broker dealer it should be noted, who would trade the account. The prime broker and custodian of the fund would also be Bernard L Madoff Investment Securities Inc. And here the independence is lost. Without independent oversight, the opportunity for fraud became abundant. One should note that the structure itself was not the fraud, it was the weakness in control that the structure introduced that provided the opportunity for fraud.

The marketing materials of many of these white labeled funds would often refer to the transparency that they were getting from Madoff Securities, and there is no reason to doubt this claim, however, one should question the value of receiving said transparency from a custodian which was a connected party to the fund manager.

In a sense, the white label sponsors were conspirators after the fact since it would have been very difficult to perpetrate a fraud without their involvement. An investor investing directly with Madoff, had there been such a fund offering would have seen the weakness of not having an independent custodian, let alone prime broker, let alone administrator. The auditors would have had to face individual investors for each and every round of due diligence. Too often, an end investor gaining access through the white labeled fund would have seen only the service providers of the white labeled fund and been satisfied with the quality of these service providers without delving further and asking the same questions of the managed account at Madoff.

At the heart of the problem is NOT a failure of due diligence, since the weaknesses of the structure were fully disclosed in fund due diligence materials and offering memoranda. There was no effort to misrepresent the structure or to cover it up. Investors therefore invested with full information or at least access to sufficient information to make an informed judgment. Why would reputable sponsors attach their reputations and fortunes to a deficient structure, and why did end investors knowing invest?