Madoff is not representative of the hedge fund industry

The Madoff Fraud is bound to have investors running from hedge funds. However, one should realize that Madoff was not structured as a typical hedge fund. The Madoff structure was unique, and allowed ample latitude for fraud.

Investors in Madoff:
-Did not buy shares in an offshore entity advised or managed by Madoff.
-Did invest in an offshore entity which in turn placed funds in a brokerage account.
-Had the said brokerage account held at Madoff Securities.
-Therefore had their assets custodied, managed, executed and reported by Madoff Securities.
-Lost an independent source of information and were thus vulnerable to fraud among other things.

The typical hedge fund is structured as follows:
-investors buy shares in an offshore entity.
-the entity would appoint an independent custodian to hold its assets.
-the entity would appoint an independent administrator to manage it on a day to day basis, such management to include the calculation and determination of the gross and net asset values.
-an investment manager would manage the assets of the entity.
-the investment manager would execute trades through independent third party brokers.
-the investment manager would not be able to operate the bank accounts of the company or limited partnership without the involvement of the third party, independent administrator.
-the company or limited partnership would engage reputable and independent third party auditors.

It is sad that a long standing and prominent member of the hedge fund community has succumbed to fraud. The reputational impact to the industry is significant, however, with time it is hoped that investor faith will be restored.

It is likely that the Madoff Fraud will precipitate certain changes in the industry. Whether these changes are useful or not is not the issue.

-Investors will lean towards having managed accounts.
-This will allow them to use service providers and counterparties of their choice, or at least influence the choice of service providers and counterparties.
-A managed account will provide investors better transparency as well confidence.
-This will allow them to live test the portfolio from time to time, albeit at a cost.
-Bespoke mandates eliminate style drift and allows better segregation of risk factors.
-Places control back in the hands of the investor.