

Red flags regulators, advisers and others missed with Bernard Madoff

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In hindsight, the signals look so clear. The near miraculous *results* Wall Street maven **Bernard Madoff** produced with the consistency of a Swiss watch; his eschewing performance fees, while having his books blessed by a rinky-dink accounting firm.

Now an ankle bracelet monitors the whereabouts of the once-swaggering pillar of the Street, who allegedly swindled billions from celebrities and the common man, and whose name appears destined for the pantheon of infamous fraudsters like **Charles Ponzi**, thanks to the criminal enterprise authorities allege the two shared.

The aftershocks of perhaps the world's biggest investment shell game - estimates come in around \$50 billion lost - have the **SEC** reeling, advisers worrying and investors wondering who they can trust.

"This is a real black eye for investment advisers," says **Reed Kathrein**, an attorney for **Hagens Berman Sobol** in Berkeley, Calif., who has already filed a class action lawsuit against an unregistered adviser who invested a client's funds with Madoff. "It really undercuts the trust people have in them."

The SEC's role

The SEC shares the shiner. Chairman **Christopher Cox** has ordered an investigation into why Madoff's "vast scheme remained undetected by regulators and law enforcement for so long." In a rare move, the SEC announced the New York Regional Office "completed two inquiries" of Madoff's firm in 2005 and 2007, and OCIE staff dropped by for a broker-dealer exam in 2005, finding only minor best execution violations.

Madoff's firm registered as an investment adviser in 2006. The adviser should have been examined within its first year of registration but this didn't occur.

The SEC could have been fooled, too. "Even the best investigator may never have caught on," says **Jacob Frenkel**, a former SEC attorney and now with **Shulman Rogers Gandal** in Rockville, Md. "Someone attempting to perpetrate a massive fraud ... is also artful at concealment and deceit."

However, he predicts the SEC will toughen inspections of advisers to repair its hobbled reputation. Also you can expect investors to request more redemptions thanks to Madoff, he adds.

"The inspection process at the SEC needs badly to be repaired. It's been broken for a long time," says **Harvey Pitt**, former SEC chairman and now CEO of **Kalorama Partners** in Washington. He favors paying private, independent examiners to visit investment managers every year or two and forward complaints to professional staff, but Pitt couldn't get his vision adopted while at the Commission.

Risk to advisers

Expect advisers who funneled clients' cash to Madoff to face legal challenges, says **Michael Missal**, a partner with **K&L Gates** in Washington. It can be hard for plaintiffs to prevail on claims of breach of fiduciary duties, he adds. Kathrein says he may also pursue claims of negligence.

Funds of funds that failed to conduct sound due diligence of Madoff could especially be at risk. Offering documents in the feeder funds should have adequately disclosed how the funds would be invested, notes **Matthew Eisenberg**, a partner with **Finn Dixon & Herling** in Stamford, Conn.

Red flags

Ask tough questions upfront (see the box below) - even of a hedge fund manager who seems popular, politically connected and respected by sophisticated investors. "An adviser needs to kick the tires," says Frenkel.

"The real red flag to me was the guy wasn't charging a performance fee," says **Julian Mann**, an analyst at **First Pacific Advisors** in Los Angeles. "That's suspect." He had met one of Madoff's sons years ago and knew of the firm's approach.

Also suspect are **returns too good to be true**. "Returning between a percent and a percent and a half a month for a decade in a row defies the law of nature," says **James Hague**, a portfolio manager with **The Millburn Corporation** in Evanston, Ill. His fund of fund was approached by Madoff but Hague turned a thumbs-down.

Inquire of the investment strategy. Madoff's collar or split-strike strategy was never "going to kick off those kinds of returns," says Mann, who long harbored suspicions about Madoff's operation.

Examine the vendors. A firm the size of Madoff's should have had a quality accounting firm digging into its books, says Eisenberg. Hague echoes that the firm should have boasted of top-notch lawyers, accountants, brokers and the like. That Madoff self-cleared his trades also flutters as a red flag, he adds.

Conduct references. Get a sense of who the other investors are and what questions they have asked. Contact other advisers who invested in the fund and probe the thoroughness of their due diligence, recommends Hague. One of his favorite questions to ask is what's the worst thing you've found out about the manager. "None of us are perfect," he says. The answer could unfurl more red flags.

16 areas to probe in your due diligence Avoid legal risks when investing in funds by asking penetrating questions of investment managers. This list of topics to cover, courtesy of **Tony Turner**, principal at **Financial tracking** in Greenwich, Conn., could serve as a template. "Just because you do your due diligence doesn't mean that you uncover everything," he concedes. But this list "helps you get under the hood." Review or ask about:

1. Financial statements, including historic records
2. The capital expenditure program
3. SAS #70II documents
4. References
5. IT security documents, such as data flow diagrams and processes and the system and network architecture
6. Clients' wins and losses
7. Business continuity plans and ongoing test results
8. Security documents with all appendices
9. Privacy policy, code of ethics, employee background check and policies and procedures
10. Clients who represent more than 5% of annual sales. Talk with these clients.
11. Commercial liability insurance and amounts
12. Management flow chart and changes. Review the management experience of the C-level executives
13. The offices
14. Firm ownership and capital structure
15. Any pending government investigations and proceedings and
16. Citations and notices from governmental agencies/regulators

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