Due Diligence in the Post-Madoff Era | Alrroya

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As the old adage goes, fool me once, shame on you, fool me twice, shame on me. The saying is as true today as ever.

In 2008 and 2009 investors were harshly reminded of the importance of rigorous due diligence. Most painful was the 2008 revelation of Bernard Madoff's multi-billion-dollar Ponzi scheme, which defrauded hundreds of individual and institutional investors and whose ramifications are still being felt. But Madoff was not the first – or the last – to victimize unwary investors.

The "Ponzi Scheme" is named after Charles Ponzi, whose misdeeds led him to notoriety in the 1920s. Other financial schemes date back even earlier. After the stock crash of 1929, concerns over fraud and poor financial governance led to the development of "due diligence" as both a legal standard and business practicality.

The Securities Act of 1933 identifies due diligence as a legal defense for financial professionals accused of making inadequate disclosures to investors, especially with regard to the purchase of securities. Other legislation soon followed that required companies to conduct due diligence, and federal agencies stepped in to investigate suspicious investment programs. But despite government oversight, the investment world still remains a perilous environment for the unwary investor. Individual investors have often lacked the resources and understanding to conduct their own due diligence on the people and institutions who are managing their money.

Although Ponzi schemes and financial malfeasance continued through the 20th century, Madoff's massive scam brought unprecedented attention to the issues of fraud and due diligence. After seeing billions of dollars vanish before their eyes, investors are determined not to be fooled twice. In an effort to mitigate the risk of fraud and poor fund management, investors are increasingly demanding more transparency, liquidity, governance, and controls. When executed carefully, these demands converge via an investment through a managed account (or managed account solution).

A managed account that is structured properly will have the investor's assets in custody with a firm that is independent of the hedge fund manager. The hedge fund manager has limited power attorney which typically only grants authority to place trades in a specific account, and usually with specific guidelines. Under this process, the hedge fund manager will still get paid based upon performance, but will not retain control of the assets, nor access the assets. In essence, the hedge fund manager cannot touch the cookie jar.

Savvy investors recognize that they should be paying the hedge fund managers for producing alpha (i.e. adding value), and there is no need for the hedge fund manager to have control over the assets in order for them to be able to achieve this. The benefits to investors using a proper managed account solution include transparency, liquidity, and a great reduction in the probability of fraud.

Hedge Fund managers which balk at granting a managed account, are not adapting to the changing landscape and may be needing a reminder of exactly whose money that they are trading. It might be rightfully asked if these hedge funds have a strategy that is so special that they can dictate the terms to the clients who pay their bills, then why don't these hedge funds just become a private proprietary trading shop (i.e. don't take any external clients, and just trade the money of the owners)?

Under a Managed Accounts solution system, Madoff's fraud would not have been a possibility (the client would immediately detect that Madoff's "trading strategy" was not making trades, and it would not have been possible for Madoff to touch the money; Madoff's power of attorney would be revoked, and no damage the client would not have suffered any damage. This highlights the importance of transparency. Indeed, the following quote astutely summarizes one of the key benefits of transparency:

“Transparency is the best antiseptic” - Aleks Kins, Founder & CEO of AlphaMetrix

The quote above refers to the fact that people do not tend to act dishonestly if they know that they are being watched. More and more investors are learning that the importance of proper governance should not be neglected.

Meanwhile, earlier this year, another high-flying lawyer Scott Rothstein was found guilty for running a $1.2 billion investment Ponzi scheme from 2005 to 2009 that had fake investments. Fool me once, …

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