Concepts…

DAEDALUS OVERSIGHT

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Identifying Hedge Fund Fraud:

"All that glistens is not gold"- Shakespeare, "The Merchant of Venice"

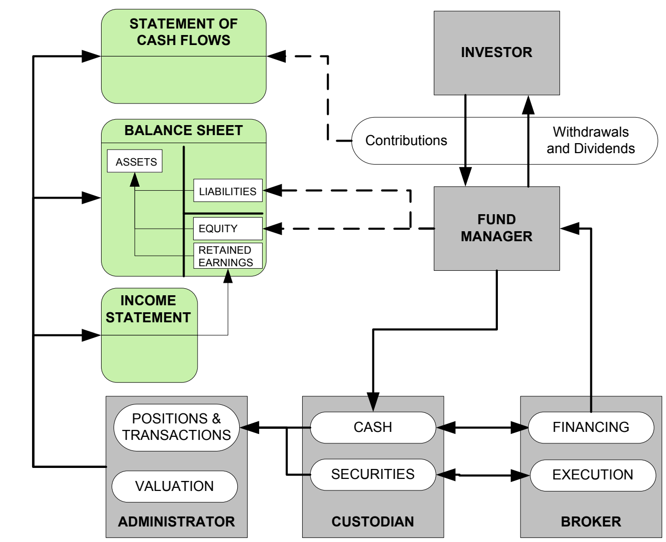
In the famous play, Portia's suitors had to choose between gold, silver and lead caskets. If the chosen casket contained her portrait they had won the right to marry her. The key was to focus on *contents* of the caskets rather than the appearance of the *exteriors*. In the Hedge Fund world much attention is given to the *exterior* cleverness of a strategy, the historical returns and name of the investment manager rather than the financial soundness or *contents* of the fund. With recent corruption, hedge fund managers have to prove they are not the next "Madoff" and investors want to know they are not invested in one! Just as the 'dull lead' casket was the way to Portia's hand, 'dull' accounting will reveal the true soundness of a fund.

Investors are often distracted by the complexity of the investment industry and its parochial terminology. Fundamentally, a fund is run as a company and a company's soundness can be determined by analyzing its standard financial reports: i.e. Balance Sheet, Income Statement & Statement of Cash Flows.

How are the Financial Reports of a Fund constructed?

Just as a manufacturing company uses investors' money (equity) and borrowed funds (liabilities) to buy a factory and inventory (assets) to make products at a profit, a Hedge Fund takes investors money and borrowed funds to buy and sell securities to make a profit. As the investments grow it generates a return and this return, net of the funds' fees & expenses, provides the Profit or Loss on the Income Statement to the fund and the Retained Earnings on the Balance Sheet. The Statement of Cash Flows should show incoming cash (contributions, securities income etc) and the outgoings (client withdrawals/dividends, fund management fees, service provider fees etc) consistent with the Assets Under Management (AUM), transaction volume and strategy employed.

How are the financial statements linked to the fund's investments? The linkages are shown in the diagram and described below. The Broker executes trades and those trades are cleared and settled at the custodian. The assets may be held by a third party or the Prime Broker as collateral for financing. The key point is that there is an auditable list of securities with various parties. The various parties feed their positions & transactions to the Administrator who provides an independent valuation and the financial reporting on the fund. It is common for an Administrator to oversee the Transfer Agency function which oversees the contributions and withdrawals for investors.



Investment Flow & Financial Reporting

How did Madoff fool the investors? Madoff was a classic Ponzi or pyramid scheme, where past investors were paid dividends or withdrawals based on contributions from new investors. Consider the following: Nine investors give the fund $10MM each, for a total of $90MM. With addition of one more investor, the fund manager can spend the $90MM how he wants. The last investor's $10MM can pay all the investors $1MM (10%) each in interest and everyone is, for the moment, happy. As long as the perpetuator manages the gross cash flows he would never be discovered. However, a look at the real balance sheet would show diminished assets and equity, which could not possibly justify the returns or revenues in the income statement. The statement of cash flows would show a low net positive or worse negative cash flow relative to the investment returns or AUM. The manager fees would be disproportionately high to the returns and AUM as well. Madoff's records were obviously falsified.

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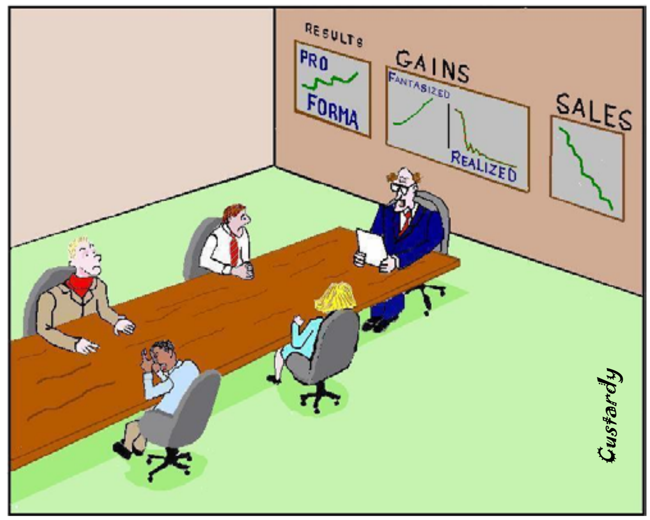
How did Madoff falsify his records? Madoff was not a fund but an investment advisor with his own registered broker dealer. For his brokerage accounts, it was reported that the Madoff Broker cleared its own trades. The brokerage accounts were custodied and reported internally and were audited by a small independent accounting firm, allegedly related to Madoff. Basically Madoff could use the "Cash" in the accounts how he pleased and "account" for it however he wanted. This was also possible due to the investments being unregulated as Madoff was only claiming to be a financial advisor to a limited number of clients. There was also self-admitted poor oversight of the Madoff Broker Dealer by the SEC and lax due diligence by the investors.

How can you tell when a fund is falsifying its records? You can't without an independent audit. However, a normal fund could not hide fraudulent activity as, the positions held at the various custodians would not be sufficient for the Administrator to generate valuations to justify any dividends for current investors or valuations required to sell units to new investors. Service providers are normally regulated entities so the extent and methods by which they are audited should also be explained and proven. The fund's Administrator should have an independent auditor provide a statement to say it follows the correct accounting practices and has demonstrated control of their processes. Independent responsibility for the various investment functions is more transparent, however, if a fund does control most of the investment functions then the transparency of the fund combined with the independence and integrity of the auditor is paramount.

What can a fund do? I would suggest a proactive creation of a due diligence package for investors demonstrating control procedures, segregation of duties, independent audits and sample transactions walked through the accounting plan to show the posting, calculation, reconciliation and reporting of returns and expenses. An independent validation of positions, valuation and accounting is a powerful and reassuring statement for investors and will not reveal any underlying trading strategy. Your service providers, particularly your Administrator, can help collate this information.

What can an investor do? I would suggest demanding the above from your fund or an independent review of the above from your Accountant or Due Diligence Consultant.



So! The new strategy is to focus on our new 'Core Competencies': Management Faux Pas, Bankruptcy Advice & Spin Doctoring!

What can a regulator do? I would suggest the definition of agreed industry best practices and more thorough reviews which should include several, diverse, end-to-end transaction samples validated against the accounting plan. Also I would suggest an annual posting of positions, valuations and financial reports for a confidential review by an authorized entity.

Conclusion:

There is no substitute for thorough due diligence. Madoff had no accounting statements and no viable audit reports. As in the dramatic conclusion to 'The Merchant of Venice', you may demand your metaphorical 'pound of flesh' as a review of a fund's soundness and integrity but it is worthless or unenforceable if you don't include the accounting 'blood'.

Paul F. Dowding

Daedalus Oversight would be pleased to discuss the realization of these concepts with you further. We thank you for your consideration.

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