WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

THE MADOFF SCANDAL: MONEY MANAGERS SHOULD PREPARE NOW FOR INCREASED SCRUTINY BY INVESTORS

Last week, Bernard L. Madoff was arrested for what might be the largest financial fraud in history, with investor losses potentially totaling up to $50 billion. According to a complaint filed by the Securities and Exchange Commission, Mr. Madoff had for years been paying returns to some investors out of the principal received from other investors — a classic, but exceptionally large, Ponzi scheme. Wealthy individuals, charitable foundations, and hedge funds and other sophisticated financial institutions have been affected by the alleged fraud.

Although details are still emerging, press reports indicate that Mr. Madoff conducted the scheme using the investment advisory arm of Bernard L. Madoff Investment Securities LLC ("BMIS"), which was registered with the SEC as both a broker-dealer and an investment adviser.[1] It is not clear how the scheme escaped the attention of the SEC or the Financial Industry Regulatory Authority, the self-regulatory organization responsible for regulating broker-dealers.[2] The SEC's Chairman has stated that Mr. Madoff may have kept several sets of books and false documents, and may have provided false information to investors and regulators. Some press reports indicate that the scheme might have been run out of an unregistered investment fund managed by Mr. Madoff, although this too is not entirely clear. At any rate, the Madoff scandal and the failure of regulators to identify it is certain to be a factor in discussions next year about possible reform of the U.S. financial regulatory system.

In the immediate aftermath of the announcement of Mr. Madoff's arrest, investors have begun to ask their money managers questions designed to identify red flags that might have put investors on alert that their assets were not safe with Mr. Madoff. We anticipate that the trend of increased investor scrutiny into the operations of money managers will continue and we recommend that money managers consider strategies for communicating to their investors how their operations differ from Madoff's.

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1 On Monday, December 15, the Securities Investor Protection Corporation, which maintains a special reserve fund authorized by Congress to help investors at failed brokerage firms, announced that it had begun liquidating BMIS.

2 SEC Chairman Christopher Cox has issued a statement announcing that the SEC's Inspector General will conduct an internal review of, among other things, "past allegations [made to SEC staff] regarding Mr. Madoff and his firm and the reasons they were not found credible." *Statement Regarding Madoff Investigation*, SEC Press Release No. 2008-297 (Dec. 16, 2008). The full statement is available at www.sec.gov/news/press/2008/2008-297.htm.

In the remainder of this memorandum, we identify two apparent and related red flags that have been widely reported in the press and that investors might be expected to inquire about. The first is Mr. Madoff's use of potentially unqualified or affiliated key service providers. The second is the reported lack of transparency in the operations of Mr. Madoff's advisory business. We also provide some considerations for money managers to use in developing a strategy for communicating with investors in response to inquiries.

Selection of key service providers. Established, reputable service providers, such as auditors, custodians, administrators, brokerage firms, and law firms, can play an important gatekeeper role for money managers. They often participate in the money manager's daily operations and they recognize that their own reputation, and potentially their own legal liability, can be entwined with that of the money manager. As such, their services can form, in effect, a risk control system for a money manager.

Many commentators have reported that investors (as well as regulators) should have been concerned with Mr. Madoff's choice of key service providers, in particular the selection of auditor and custodian.[3] Mr. Madoff's advisory unit managed at least $17 billion in assets according to regulatory filings, but was audited by what appears to be a relatively unknown, three-person firm.[4] By all accounts, the firm appeared to be ill-equipped to audit such a sizeable business. In addition, it appears that Mr. Madoff used BMIS as custodian and administrator for his advisory business. While the use of a related custodian is permitted by law, taken together with the selection of an auditor whose qualifications are not necessarily clear, it meant that there was in effect no independent verification of the existence of investor assets held by Madoff entities.

Because of the prominence in the press of the role of Mr. Madoff's auditing firm in the alleged Ponzi scheme, money managers should anticipate investor questions about the identity and independence of their auditors, custodians, attorneys, and other key service providers. Money managers should explain to investors, when appropriate, that they use independent auditors and other key service providers that are reputable and that have significant, demonstrated experience in their fields. Money managers that use related key service providers, such as an affiliated custodian, should be prepared to discuss this practice and to discuss any independent verification of the related-party activity. Such a money manager might explain, for example, that an experienced, independent auditor reviews the assets held at the related custodian.

Transparency. Another red flag raised by commentators was Mr. Madoff's lack of transparency in the operations of BMIS's advisory business and in the "investment process" that yielded unusually consistent and positive returns regardless of market conditions. It is not clear, for example, that Mr. Madoff provided any written description of the objectives and strategies he

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3 *See*, *e.g.*, *Fees, Even Returns and Auditor All Raised Flags*, Wall Street Journal (Dec. 13, 2008).

4 Other recent scandals, including the one relating to Bayou Management LLC, involved the use of fictitious auditors. That does not appear to have been the case here.

was pursuing, or descriptions of permissible investments, material risk factors, and the material terms of investments in the advisory business of BMIS, including how BMIS generated fees. Press reports further indicate that Mr. Madoff was highly secretive regarding his trading activity, and that the investment strategy he claimed to employ was improbable for such a large amount of assets.[5]

Money managers should anticipate questions about the transparency of their operations and be prepared to disclose to investors how they make investment decisions and how they generate fees. One way to establish transparency could be to prepare responses to the model investor due diligence questionnaire published in 2007 by the Managed Funds Association.[6] The questionnaire, which was designed to identify the kinds of questions that a potential investor may wish to consider before investing in a hedge fund, elicits the type of transparency that seemed to be lacking with respect to Mr. Madoff's activities. Information requested in the questionnaire includes, among other things:

- General information about the money manager, including a description of the firm and its personnel and organizational structure.

- Information about the money manager's key service providers, including information about the money manager's auditor and audit history, third-party marketing agent, and legal counsel.

- An overview of the advisory activities of the money manager, including a description of the investment vehicles or advisory accounts managed, and any conflicts of interest or related-party arrangements.

- Information about the money manager's trading, portfolio management, and post-trade reconciliation and accounting infrastructure.

- Information about the money manager's compliance system and registration with regulators.

- Detailed information about the funds managed, including the funds' terms and capital base, performance history, risk management and valuation practices, and key service providers.

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[5] According to press reports, Madoff purported to use a "collar" strategy, which involved buying stocks and simultaneously selling a call option and buying a put option on those stocks, thereby generating modest but reliable gains.

[6] The questionnaire is available at www.managedfunds.org/mfas-isound-practicesi.asp.

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If you have any questions concerning the foregoing or would like additional information, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com), David W. Blass (202-303-1114, dblass@willkie.com), or the attorney with whom you regularly work.

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December 17, 2008