Hedge Funds:

Due Diligence, Red Flags and

Legal Liabilities

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The following excerpts of articles, arranged mostly in chronological order and derived from the *Wall Street Journal*, *New York Times*, *Reuters*, *Los Angles Times, Barron's, MarketWatch, Bloomberg, InvestmentNews* and other sources, deal with due diligence in hedge fund investing. They describe "red flags." They discuss the hazards of trying to recover funds from failed investments. The sponsor of this website provides additional commentary.

"[T]he penalties for financial ignorance have never been so stiff." --- *The Ascent of Money* (2008) by Niall Ferguson

"Boom times are always accompanied by fraud. As the Victorian journalist Walter Bagehot put it: 'All people are most credulous when they are most happy; and when money has been made . . . there is a happy opportunity for ingenious mendacity.' ... Bagehot observed, loose business practices will always prevail during boom times. During such periods, the gatekeepers of the financial system -- whether bankers, professional investors, accountants, rating agencies or regulators -- should be extra vigilant. They are often just the opposite." (WSJ, 4/17/09, "A Fortune Up in Smoke")

Our lengthy website contains an Index of Articles. However, similar topics, *e.g.,* "Bayou," "Madoff," "accountant," may be scattered throughout several articles. To locate all such references, use your Adobe Reader/Acrobat "Search" tool (binocular symbol).

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"Hedge Funds Can Be Headache for Broker, As CIBC Case Shows"

"On Wall Street, hawking hedge funds has become hugely profitable. But a recent arbitration award against **Canadian Imperial Bank of Commerce** shows the downside for brokerage firms that market these lightly regulated investment vehicles. A three-person arbitration panel this month ordered the bank's brokerage arm, **CIBC World Markets**, to pay almost $3.6 million to 11 wealthy investors who lost $5.5 million investing in a New York-based hedge fund marketed by the firm. One of the investors was former professional baseball player Bobby Bonilla. The case is a cautionary tale for both brokers who are pushing hedge funds more aggressively and for investors who are putting more of their savings into them. … In the CIBC case, the aggrieved investors claim that the bank's brokerage conducted almost no 'due diligence,' or research, on the fund that it sold its client, part of a hedge-fund family known as **Red Coat**, and failed to disclose that some of Red Coat's other funds were losers. Then, after they learned that the fund was tanking, they weren't allowed to cash out-even though a CIBC employee involved in the brokerage's marketing efforts for Red Coat was allowed to pull his money… CIBC … said it did extensive background research on Red Coat and argued that the investors were well aware of the risky nature of the investment, having signed agreements stating Red Coat was 'designed for sophisticated persons who are able to bear the risk of substantial loss.'… The CIBC case is one of the first big ones involving a hedge fund to snake its way through the arbitration process, so it could be a harbinger. … Red Coat also steered stock-trading business-and the commissions it paid for such services-to the CIBC brokerage. That provided an added incentive for CIBC brokers to steer investment clients to Red Coat…. [C]lients were persuaded to invest in Red Coat by CIBC in early 2001-without being told that Red Coat's other funds weren't doing very well. … In September 2001, the hedge fund's performance took a turn for the worse, and CIBC canceled its sales agreement with the hedge fund a month later. But CIBC's clients were locked into the fund because they had signed documents agreeing to keep their money in the fund for a year unless the fund gave them permission to withdraw earlier." (Wall Street Journal, 2/22/05, "Hedge Funds Can Be Headache for Broker, As CIBC Case Shows") A major issue involved in the securities arbitration process is whether the FINRA requires recusal of arbitrators who desire to follow the law. A corollary is whether the FINRA utilizes arbitrators who have little or no knowledge of applicable securities law so that a disgruntled party may not set aside the award on the grounds of manifest disregard of the law --- as the arbitrator could not consciously disregard a law that he/she did not know existed. For information pertaining to material problems/abuses of the securities arbitration process, see http://www.LGEsquire.com/LG_Links.html.

"Scandal Puts Spotlight On Hennessee Group"

"**Lee Hennessee** … an adviser who helps investors choose hedge funds … finds herself in the middle of a battle over the apparent collapse of … hedge-fund firm, **Bayou Management LLC**, and the possible disappearance of hundreds of millions of dollars. She and her husband, **Charles Gradante**, run **Hennessee Group**, which vets hedge funds for wealthy investors…. On their advice, Hennessee clients say they had invested tens of millions of dollars in Bayou. The Bayou scandal has trained an uncomfortable

light on the rapidly growing field of such consultants…. Hennessee and other consultants say their fee arrangements are free of conflicts, but there are some arrangements that critics say could skew consultants' judgment. Some consultants receive payments, fee discounts or brokerage commissions from hedge funds for steering clients their way. … In addition to her role at her eponymous firm, Ms. Hennessee is a registered representative of Bank of New York Securities, where many hedge funds she recommends do their trading. Some of the commissions on these trades are returned to Hennessee. And even if hedge funds serving her clients are trading elsewhere, they often agree to return 'soft-dollar' credits they get for heavy trading to Hennessee, which the consultant can use to buy research and other services. Ms. Hennessee said these arrangements cut fees her clients pay her. Hennessee charges clients 1% of their assets. Mr. Gradante, her husband, said that less than half of Hennessee's revenues come from such arrangements. Hennessee says it uses its clout -- its clients have more than $1 billion invested in 100-plus hedge funds -- to negotiate deals for its customers, including lower minimum balances and fees and quicker access to their money. Many Bayou investors are wondering why their consultants … didn't see any red flags at the firm, including a lawsuit alleging possible securities-fraud violations and several regulatory actions. … 'We stand behind the due diligence,' Mr. Gradante said. 'We don't think we could have done anything different or better.' … Hennessee clients began investing in Bayou in 2003 -- the same year that two former Bayou employees, a father and son from Louisiana, brought a lawsuit against Mr. Israel. They claimed they saw potential securities-law violations and alleged that money disappeared from an account. When a judge ordered the case into arbitration, many investors said they were comforted. Mr. Gradante said he recalls that the case prompted the National Association of Securities Dealers to scrutinize Bayou's books. 'The NASD report put that to bed for us,' he said. The NASD says it never looked at Bayou's hedge-fund books, because it only had jurisdiction over Bayou's brokerage operation. Hennessee also inspected Bayou's auditor, Richmond-Fairfield Associates, a firm that Bayou said was 'independent,' and went to its offices on Madison Avenue and talked to the landlord there. Hennessee was aware the accounting firm was registered in the name of Daniel Marino, a Bayou partner. 'He said he was once affiliated with Richmond-Fairfield and he was working on the audit on Bayou and Sam hired him away,' Mr. Gradante said. 'He says he discontinued any connection with Richmond-Fairfield.' Bayou marketing materials say Mr. Marino joined Bayou in 1996. He filed registration papers for Richmond-Fairfield in October 2000. Federal prosecutors alleged yesterday in a civil suit that the firm 'was a sham and conducted no audits, independent or otherwise.' … Ms. Hennessee, a North Carolina native, said she has never encountered a fraud since founding her company in 1987 as a division of E.F. Hutton. In 1997, Hennessee struck out on its own." (WSJ, 9/2/05, "Scandal Puts Spotlight On Hennessee Group") Did Hennessee ask others at Richmond-Fairfield whether Marino was still affiliated with that firm or for a copy of its latest audit report? Did the hedge fund maintain an account with or execute trades through the brokerage firm? If so, did the NASD lack jurisdiction to follow the money/transactions in the account?

"Clients Are Suing Hennessee Group Over Bayou Advice"

"A client to whom New York investment adviser **Hennessee Group** recommended a collapsed Bayou hedge fund sued Hennessee and its principals, alleging that they failed to thoroughly check out the funds and misrepresented facts about them. The client, **DePauw University** in Glencastle, Ind., said it invested $3.25 million in a Bayou hedge fund last year only after Hennessee said it had completed '5 levels of due diligence' on the firm.… Hennessee clients have said they invested tens of millions of dollars in Bayou funds, suggesting that more suits might follow. … The Bayou saga has given a black eye to consultants like Hennessee and funds of funds, which spread client dollars among multiple hedge funds and are the fastest-growing source of money for hedge funds. These outfits have long pitched themselves as sophisticated advisers to wealthy investors." (WSJ, 10/15/05, "Clients Are Suing Hennessee Group Over Bayou Advice")

"Firm that pitched Bayou facing questions"

"Hedge fund advisor **Hennessee Group** recommended **Bayou** to its clients. Now it's being sued. The firm says it regrets steering clients to Bayou but had reason to think at the time the hedge fund was legitimate. ... Hennessee Group admits it should have done a better job of spotting red flags at Bayou, including the fact that Bayou wasn't using a well-known auditor. Hennessee recently spoke out about Bayou, acknowledging that the firm didn't catch the fraud, but defended its review process nonetheless. ... Like other marketing and consulting firms in the investment world, Hennessee recommends hedge funds to clients for a fee. ... ... [H]ennessee officials stress this was the first time the firm has been hit by fraud.... Hennessee ... acknowledges that when Hennessee reviewed Bayou 'the relative size and reputation' of its bogus auditor was 'in question.' But because Hennessee knew Dan Marino, Bayou's CFO, and had been informed Bayou was using a well-known accounting firm to review Bayou's broker-dealer, Hennessee officials felt comfortable. ... A handful of other firms that match hedge funds with investors had also recommended Bayou to clients, including **Consulting Services Group** and **Altegris Investments**. But unlike Hennessee Group, these firms advised their clients to take their money out well before the scandal came to light. ... **Matthew Osborne**, vice president and chief investment officer for Altegris, said 'there was no one specific thing' that happened at Bayou to cause Altegris to advise its clients to get out, but that the firm became increasingly uncomfortable with what it felt was a lack of transparency from Bayou regarding its activities. Osborne would not comment further on Bayou. One investor, Indiana's **DePauw University**, has sued Hennessee over the Bayou debacle. ... DePauw's complaint charged that Hennessee said in its marketing material that the hedge funds it recommends 'undergo extensive analysis' including reviews of personnel, management, investment philosophy, risk management, performance and other factors." (CNN/Money, 11/5/05, "Firm that pitched Bayou facing questions") How well did Hennessee know Dan Marino to feel "comfortable"? How much was the total "fee" received by Hennessee and who paid it? Did Hennessee know that there is a difference between a hedge fund and a broker-dealer? Did other hedge fund advisory firms conduct due diligence on Bayou and pass? Was DePauw presented with a copy of Hennessee's

"extensive analysis" or the alleged audit statements of Bayou? Perhaps, the DePauw trustees have some questions to answer on their due diligence?

"Judge Dismisses Suit vs. Hennessee Group"

"A federal judge in Manhattan has dismissed a lawsuit against **Hennessee Group LLC** over its advice regarding investments in **Bayou Management LLC**'s now-shuttered hedge funds. ... U.S. District Judge Colleen McMahon granted a motion to dismiss the case against Hennessee Group, hedge fund consultant **E. Lee Hennessee** and her husband, **Charles A. Gradante**. 'Given that (ex-Bayou executives Samuel) Israel and (Daniel) Marino managed to deceive the entire investing community for nearly a decade, South Cherry's allegation that Hennessee Group would necessarily have uncovered the fraud had it conducted the due diligence it promised is far from compelling,' the judge said in a 30-page opinion. **South Cherry Street LLC**., a Denver investment firm, sued Hennessee Group last year, alleging the company failed to perform extensive due diligence of Bayou Management and its funds before recommending to customers that they invest in the Bayou Management family of funds." (AP, 8/3/07, "Judge Dismisses Suit Vs. Hennessee Group") Dismissed with prejudice or is there a chance to re-plead? How does anyone know that "entire investing community" was "deceived" by Bayou? Even if that were true, the "entire investing community" did not hold itself out as possessing expertise in hedge fund due diligence! Hennessee was paid a fee and tasked to vet hedge fund investments. The standard of care is a comparison with others in that same field and the specific activities Hennessee contracted to provide. One might wonder whether Hennessee was tasked to assess all hedge funds and pick the best for its clients vis-à-vis the client selected Bayou and Hennessee was used to validate that decision. If it were the former, then what criteria, if any, did Hennessee employ to select Bayou over other hedge funds?

"Is a Hedge Fund Shakeout Coming Soon? This Insider Thinks So"

"[L]ots of hedge funds were posting returns that were just too smooth to be realistic … with hard-to-appraise, illiquid investments - like real estate or esoteric interest rate swaps - showed returns that were particularly even. … [M]anagers had no way to measure their fluctuations, and simply assumed that their value was going up steadily. The problem, unfortunately, is that those are exactly the kinds of investments that can be subject to big losses in a crisis. In 1998, investors retreated en masse from such investments. Now … a disturbing conclusion: that smooth returns, far from proving that hedge funds are safe, may be a warning sign for the industry. (The paper is at http://web.mit.edu/alo/www/Papers/systemic2.pdf.) … [M]easuring the smoothness of returns gives economists a good way to estimate the level of relatively illiquid investments in the hedge fund world. The approach lets economists measure industry-wide liquidity risks without knowing the details of the investments - information that hedge funds just don't give out. … [H]edge fund investments are less liquid now than they have been in 20 years. … [T]he same pattern of investing preceded the 1998 global hedge fund meltdown and the 1987 stock market crash.… [T]he catastrophic losses of 1998 were preceded by a noticeable series of months of mediocre performance. …

[W]hile a hedge fund crisis appears to be sudden and to be caused by unforeseen events, the breakdown is only the late stage of the problem. As more hedge funds compete for the same slice of the pie, … their managers feel that they have no choice but to 'leverage up,' juicing their returns by borrowing more money to make bigger investments. That, in turn, makes the investments more prone to a sudden credit crisis. Hedge funds that are highly leveraged are vulnerable to having their lenders - banks and big brokerage firms - cut off credit when they think that their money may be at risk. And … lenders would do exactly that in an industry-wide downturn. That would force hedge funds to close out their positions at the worst possible time - the kind of cycle that brought down Long Term Capital Management. … [T]he industry may have already entered a period of lower returns that signal a prelude to crisis. … [A] downturn in April that hit virtually every category of hedge fund pursuing every kind of strategy. … What might set off a crash is a matter of guesswork… an oil-price increase to $100 a barrel … a tightening of lending rules…. The nightmare script … would be a series of collapses of highly leveraged hedge funds that bring down the major banks or brokerage firms that lend to them." (New York Times, 9/4/05, "Is a Hedge Fund Shakeout Coming Soon? This Insider Thinks So")

"Connect the Dots. Find the Fees."

"[T]he mess at **Bayou** (**Group** - a hedge fund company and brokerage firm run by **Samuel Israel III**), which federal prosecutors are now calling a $300 million fraud, should be a clarion call for caution among the many investors who have been throwing money at hedge funds recently. This is especially true for institutions - endowments and public pension plans - that have flocked to hedge funds with the hope of increasing their returns. Because many of these institutions are having financial difficulties - low interest rates are cutting deeply into their returns - they are too often captivated by investments that seem to promise outsized gains with little risk. 'Our unique multifactor risk model acts as a road map for navigating risk and provides investors with alternative routes to reach their investment summit,' **Steve Henderlite**, a co-founder and principal of **Trail Ridge Capital L.L.C.**, said in a press release from October 2003. Trail Ridge Capital is a hedge fund and fund-of-funds company that had clients in Bayou. … Central to the Bayou story, and to almost every other financial disaster of recent years, are conflicts of interest. At Bayou, these conflicts began in its brokerage unit, which executed trades for the hedge funds. Because the brokerage unit, Bayou Securities, was wholly owned by Mr. Israel, he was able to profit personally from the rapid-fire trading conducted by the funds he oversaw. But some Bayou investors who got into the funds on the recommendation of investment consultants were confronted with another layer of conflicts. That is, the consultants who recommended the hedge funds to their clients and the funds of funds that bought Bayou shares for their investors often received compensation from Bayou for sending assets its way. While some investors may not find fault with such an arrangement, institutional investors who have a fiduciary duty to their beneficiaries should definitely steer clear of the deals. … Unfortunately, not all fiduciaries know where these conflicts lie. They are often well hidden. … Sometimes the payments come in the form of commissions on trades steered by a hedge fund to a brokerage firm that is affiliated with the consultant; in other cases the payments are fees paid by the fund based on the assets the consultant brings in. In one case … a pension

consultant received a partnership interest in the hedge fund to which it was steering clients. Such payments were a part of the picture at Bayou. According to materials provided by the fund to a prospective investor in 2003, Bayou had several outside marketers that it paid either as a percentage of assets raised or through commissions to the promoters' 'designated broker/dealer.' One of the firms that Bayou listed as an external promoter at that time was the **Consulting Services Group of Memphis**. Bayou also gave prospective investors the name of **E. Lee Giovannetti**, chief executive of Consulting Services, as a reference and as an institutional investor in Bayou. … [T]he firm did act as a reference for Bayou in 2003 and that it had recommended Bayou funds to clients. … Consulting Services did the right thing in advising its clients to exit Bayou before the debacle. Others weren't so lucky. … Because Bayou's minimum-investment requirement of $250,000 was smaller than that of most hedge funds, the firm unfortunately attracted a lot of individual investors. ... Larger investors, especially those who are fiduciaries, should take a lesson from the losses at Bayou. <u>Conflicts of interest in the financial world are often hard to uncover.</u> But refusing to do the necessary digging is downright irresponsible." (NYT, 9/4/05, "Connect the Dots. Find the Fees.")

<u>"Want a Hedge Fund? Here's Your Homework"</u>

"IF you're thinking about investing in a hedge fund, how can you steer clear of the likes of the **Bayou Group**, the recently imploded hedge fund company and brokerage firm run by Samuel Israel III? Unfortunately, getting information about individual hedge funds isn't easy. … **Randy Shain**, the co-founder of **BackTrack Reports**, which researches hedge funds for institutions and some wealthy individuals, says that in the Bayou case, several red flags - including questions about Mr. Israel's character - would not have been evident to people contemplating an investment in the fund. … In promotional material for the Bayou funds, Mr. Israel told investors that he had worked as the head trader at Omega Advisors, a hedge fund run by Leon Cooperman, a former Goldman Sachs partner. But Mr. Israel had misrepresented the length of his employment at Omega as well as his position there, Mr. Cooperman said in an interview. Mr. Israel had worked there as a trader for 18 months, but had not been there for four years as the head trader as he had claimed, Mr. Cooperman said. … Would Mr. Cooperman have taken a call about Mr. Israel's credentials from a prospective investor in the Bayou funds? 'I can't answer that,' Mr. Cooperman said. 'If somebody calls me for a reference check, I will respond factually and appropriately. But certain firms are very cautious about talking about former employees.' Another cautionary piece of news for Bayou investors should have been that while Omega oversees two funds of hedge funds that invest money with 25 different managers, Mr. Israel's group wasn't among them. 'We never invested in Sam Israel's hedge fund nor did one trade with his securities company,' Mr. Cooperman said. Promotional materials also stated that Mr. Israel began his career at F. J. Graber & Company, a money management firm geared 'toward high-velocity trading' and run by its founder, Fredric Graber. One person who knew both men, but requested anonymity, recalled that Mr. Israel had worked for Mr. Graber as a summer intern, a position arranged through a family friend.… Potential investors might also have been concerned if they had learned other information. Mr. Israel had been arrested in New York State in 1999 and accused of 'driving under the influence' and charged with criminal possession of

a 'controlled substance,' Mr. Shain of BackTrack Reports said; the case was discontinued a year later. That case was reported without elaboration on **LexisNexis**, a subscription data base, where Mr. Shain's firm found it while researching Bayou for a potential investor. In order to get details about the case, Mr. Shain had to send a researcher to State Supreme Court in Manhattan. Sometimes red flags are more immediately visible. The documents that Bayou made available to its investors say that Richmond-Fairfield Associates was Bayou's accounting firm. **Charles Levenberg**, a private investigator who researches hedge funds, said that lack of information about the accounting firm was a warning sign. 'If they are not using somebody you have heard of, that is a big red flag,' he said. 'You have to wonder why.' The government has contended that Richmond-Fairfield was controlled by Bayou. … For investors who are intent on picking hedge funds themselves, despite the risks, experts say that it may pay to subscribe to services that track lawsuits. For example, an investor can subscribe to Pacer, an online index to federal civil, criminal and bankruptcy cases nationwide. A **Pacer** subscriber could have found that a suit was filed against Bayou in 2003 in Federal District Court for the Eastern District of Louisiana by a former employee, Paul T. Westervelt Jr., and his son. The plaintiffs contended that Bayou had failed to provide them with necessary business documents and that Mr. Westervelt discovered 'possible violations of the S.E.C. regulations governing the operating of hedge funds.' … To winnow out potential problems, investors may want to look for some common-sense warning signs. In addition to checking for evidence of possible deception or illegality, some analysts say they try to check whether the manager is in the midst of a difficult divorce, as Mr. Israel was, which can add psychological and financial pressures." (NYT, 9/11/05, "Want a Hedge Fund? Here's Your Homework")

"At Wood River, Tide of Red Flags Went Unnoticed"

"As investors and securities firms assess possible losses related to the ailing hedge fund **Wood River Partners LP**, questions are growing about how sophisticated market participants overlooked a series of red flags surrounding the firm. The Wood River episode is the latest in which a hedge fund finds itself facing accusations of improprieties, leaving big-name investors wondering what happened to the money they put in these lightly regulated investing pools. … Amid a sluggish stock market, some investors have become more willing to sign up with hedge-fund managers with seemingly stellar performances, without thoroughly checking out the funds before investing their money. … The episodes also come as securities firms fight to get a piece of the lucrative business of catering to the hedge funds, increasing the temptation to overlook potential problems. … Wood River executives didn't return calls for comment, nor did an attorney representing the firm. Mr. Whittier wasn't at his Ketchum, Idaho, home yesterday. One reason many sophisticated investors liked Wood River was the firm's apparent big returns. … Despite all the interest from big-name firms in Wood River, the warning signs were many: Firms holding more than $100 million of exchange-traded shares are required to make an annual securities filing called a 13F that lists virtually all of the firm's holdings. … [E]ven though Wood River claimed to manage more than $275 million of assets…. It isn't clear if Wood River ever filed a 13F form. That means Wood River either didn't manage as much money as Mr. Whittier suggested, the firm bought

investments other than public shares despite how Mr. Whittier described the firm to investors, or that he never made the required filings when he should have. A search of state law dockets shows that in April 2002, Credit Suisse Group's Credit Suisse First Boston securities firm sued Mr. Whittier and Wood River in New York state court for allegedly not settling purchases of certain shares… CSFB's earlier suit accuses Mr. Whittier of causing $1.6 million of losses for CSFB. … Mr. Whittier accumulated about $265,000 of tax liens, or tax obligations not fully met, between 2002 and 2004, according to lien records. … Wood River Capital Management, the entity formed by Mr. Whittier to run a family office that preceded the hedge fund, was alleged in August 2002 to have failed to pay rent on its offices for three months of that year, according to court records. … Three financial advisers to wealthy prospective clients who met with Mr. Whittier in recent months said they were troubled by the fact that they couldn't seem to pin him down on his strategy. … Still another bad sign: Some marketing materials recently circulated by Wood River named Morgan Stanley, among others, as a prime broker for the hedge fund. But Morgan Stanley has told certain people that the materials were inaccurate and the firm doesn't do work for the hedge fund. … At one point, Wood River told investors that Citigroup was one of its prime brokers. A spokeswoman for Citigroup Inc. said it hasn't served as a prime broker since July 2004. Citigroup let Wood River go as a client after becoming suspicious over certain trading activity…. NAV Consulting, which was listed in Wood River's 2004 marketing materials as a service provider for Wood River, never did any work for the hedge fund… NAV Consulting … performs daily accounting and administration for about 250 hedge funds. Some said securities firms are in danger of compromising on their standards to get hedge fund business. … Still, some firms avoided bigger involvement with Wood River. UBS, for example, had qualms about doing capital introduction for the hedge fund, a relationship that could have brought liability for UBS…." (WSJ, 10/12/05, "At Wood River, Tide of Red Flags Went Unnoticed")

"S.E.C. Accuses Hedge Fund of Deceiving Its Investors"

"Federal regulators filed suit against a hedge fund yesterday, claiming that its manager deceived his investors by not disclosing his high concentration in a rapidly sinking stock. The suit was filed against **Wood River Capital Management** and its manager, John H. Whittier. … Mr. Whittier did not disclose to investors that he had at one point as much as 98 percent of one of his funds invested in a speculative stock with no recent history of profitability. … Mr. Whittier raised millions of dollars from individuals to invest in his hedge funds, which at one point had $265 million under management. Despite promises in his marketing material that he would invest no more than 10 percent of his portfolio in any one position, last June he had as much as 68 percent of one of his funds, Wood River Partners, invested in **Endwave**, a manufacturer of radio frequency modules for the telecommunications and defense industries. Peaking at $54 in June, the stock closed at $12.69 yesterday. In addition to not disclosing the size of his stake, Mr. Whittier incorrectly informed his investors in his marketing materials that his funds were audited by a company called American Express Tax and Business Services…. The firm does not itself perform audits, and it never delivered independent audits of Wood River's financial statements…. According to the complaint, Mr. Whittier,

a former media and communications analyst, repeatedly told investors that he would invest in popular names like Time Warner and Comcast. Instead, he seemed to have a peculiar interest in Endwave, a little known company that has reported losses for the last three years. Mr. Whittier's stake was so large that it made up as much as 45 percent of Endwave's shares outstanding, surpassing the 5 percent threshold that requires the fund to notify regulators, which it did not do. 'There was no effective oversight of the investment manager and no effective control or checks on his actions,' said Peter Bresnan, associate director in the enforcement division at the Securities and Exchange Commission. … Mr. Whittier tried to keep his head above water, promising one client to repay him with new investments." (NYT, 10/14/05, "S.E.C. Accuses Hedge Fund of Deceiving Its Investors")

"Hedge Fund Manager May Face SEC Penalties"

"**Charles Harris**, a former hedge fund manager fined almost $13.9 million and sentenced to 14 years in prison… Harris, of Winnetka, Ill., was sentenced Oct. 6 for lying to investors about the performance of **Tradewinds International II**. … Harris misrepresented the funds' value and rate of return. About 25% of the $10 million he raised to invest for clients in 2003 and 2004 was used 'for Harris' personal and business expenses,' … The hedge fund manager sent e-mails and a DVD to some investors in July 2004, confessing that he had lied about the 12% annual returns in Tradewinds II,…. had fled the country and taken the investors' assets offshore." (Bloomberg, 10/14/05, "Hedge Fund Manager May Face SEC Penalties")

"In Connecticut, A New Cop Walks Hedge-Fund Beat State Attorney General Assails Pending SEC Rule Changes And Seeks Tougher Oversight"

"Connecticut, within commuting distance of Wall Street, is home to perhaps more than a third of the nation's 8,000 hedge funds -- the lightly regulated investment pools that have grown in popularity despite a small number of spectacular stumbles. … Mr. (**Richard**) **Blumenthal** (attorney general of Connecticut) is putting together a task force of regulators and hedge-fund executives to jump-start changes. He says he will move to impose his recommendations on any hedge fund with operations in Connecticut or pursue necessary legislation to allow him to put the new rules in place. Among the changes he says he could pursue: forcing funds to disclose much more about who audits their holdings and whether they have conflicts of interest with the fund's management; changing current civil and criminal penalties for hedge-fund fraud; and requiring funds to tell prospective investors whether other investors received preferential terms. He also would like to force funds to disclose any fees paid by brokers or other parties. … Mr. Blumenthal hopes to announce his group's recommendations ahead of previously announced changes from the SEC, slated to take effect in February. Many funds are already grumbling about those pending SEC changes. Starting in February, most hedge-fund firms will have to register with the agency, providing more information about their operations and letting the SEC conduct audits. Some say the changes will boost costs without providing investors much extra protection. … Mr. Blumenthal stresses that he has yet to determine the degree to which the hedge-fund industry needs additional changes and that he will be consulting with members of the business. And he

acknowledges that his ideas are unlikely to shake up the business. Rather, they could add more regulatory oversight to an industry that has relished its freewheeling ways. … Mr. Blumenthal says he and the state's banking commissioner, John Burke, may have to persuade the Connecticut state legislature to pass stricter rules governing the hedge-fund business. He says that some recent scandals in the business, including the alleged fraud at Connecticut-based Bayou Management LLC, a hedge-fund-management firm, involved hedge funds dealing with broker-dealers and auditors that they had an ownership stake in, raising questions of potential conflict." (WSJ, 11/5/05, "In Connecticut, A New Cop Walks Hedge-Fund Beat State Attorney General Assails Pending SEC Rule Changes And Seeks Tougher Oversight")

"Has Eight Ball Slipped Into the 'Side Pocket'? --- More Hedge Funds Use Accounts That Restrict Access of Clients, Provoking Concerns Over Returns"

"Hedge funds … are adding extra layers of secrecy to their operations by putting some investments in separate accounts that restrict clients' access to their money and may be susceptible to chicanery. Known as 'side pockets,' the accounts are meant to address a glaring conflict. To boost returns, more and more hedge funds are delving into private-equity investments -- shares of nonpublic companies, real estate and the like. Unlike stocks, these investments don't trade continuously on public exchanges, so it is hard to estimate their true value from month to month, quarter to quarter or even year to year, the cycles that hedge funds use to calculate gains. Managers generally get a cut of a fund's reported gains, making it tempting to inflate the value of these holdings. … To mitigate such problems, more hedge funds -- lightly regulated investing pools for wealthy individuals, pension funds and other institutions -- are putting such investments into side pockets excluded from the periodic value calculations. … Under your investment agreement, you can't withdraw any of that money until Big Bucks cashes out some or all of the side pocket's investments, which can take years. … But restricted access to the money is just one downside. Side pockets give hedge funds other ways to cheat, in part because managers often don't tell investors how those holdings are doing on a regular basis. … The biggest risk: A hedge fund could exile poor investments into a side pocket, allowing the fund to post jazzy returns on its stronger-performing investments, while keeping sour deals in a black hole. If the side-pocket investments later are sold at a loss, investors take the hit -- without dinging managers' performance fees. … Hedge funds use other methods to address the conflict involved in valuing private investments, but these aren't perfect either. Some hire an independent valuation firm to make estimates, but that can be cost-prohibitive for smaller funds. Others establish internal audit committees to double-check estimates, but those committees depend on information from fund managers. … Some hedge-fund agreements allow money to be put into side pockets at any time, and managers use that power to block investors from withdrawing money from funds that hit rocky patches. … Hedge funds with side pockets typically agree to limit how much the fund can divert into them to between 10% and 30% of their holdings. … Unless hedge-fund agreements have strict continuing limits, investors risk having disproportionately big shares of their investments tied up in private equities that can't be easily cashed out. Investors who agree to have a relatively small percentage of their

initial investment in side-pocket investments would see that percentage balloon over time if those investments grow while the other investments do poorly. Side pockets aren't used only for private investments. Activist hedge funds that specialize in taking large positions in public companies to pressure management for shareholder-friendly changes use side pockets to prevent withdrawals that would cause them to diminish their stake in -- and influence over -- a target company." (WSJ, 11/7/05, "Has Eight Ball Slipped Into the 'Side Pocket'? --- More Hedge Funds Use Accounts That Restrict Access of Clients, Provoking Concerns Over Returns")

"Hedge Fraud Is Alleged by SEC"

"The founder of a $43 million hedge fund, **Groundswell Partners LLC**, hid losses by altering financial statements and misleading his investors, according to a complaint from the Securities and Exchange Commission. For years, the Waltham, Mass., hedge fund, founded by **Mark Conway**, turned heads with what appeared to be stellar returns using a mathematical-based trading strategy that attracted investments from other hedge-fund professionals and wealthy institutions and individuals. But late last month, Mr. Conway's partner, **Aaron Behle**, wrote to fellow investors that Mr. Conway, an author of number of books and newsletters about investing, confessed to Mr. Behle that he had created 'fictitious brokerage statements, fictitious accounting reports, fictitious audit reports, a fictitious auditor, and fund performance information,' according to Mr. Behle's letter." (WSJ, 11/10/05, "Hedge Fraud Is Alleged by SEC")

"Commentary: Hedge Funds Today --- Fortunes Favor the Brave"

"What are the red flags? First, if the bulk of the manager's personal financial net worth is not invested alongside yours, his interests will not be aligned with yours. In a pinch, he may serve himself at your expense. Second, if the manager's compensation is heavily weighted toward asset-based fees, he may focus more on asset gathering than investment performance. Third, beware heavily promoted hedge funds run by untested general partners managing billions of dollars; they will likely disappoint. This description unfortunately applies to many newly minted hedge funds sponsored by some of the biggest investment banks on Wall Street." (WSJ, 11/22/05, "Commentary: Hedge Funds Today --- Fortunes Favor the Brave")

"**Hedge Funds Work for Yale, but Will They Work for You?"**

"A fund of hedge funds - which contains investments in at least several individual hedge funds - may seem to be the solution. Not only do funds of funds offer some diversification, but they also generally require a lower initial investment than individual hedge funds, and they can be bought by people whose bank accounts are merely large, not colossal. … Well, as it usually turns out in investing, finding the right fund of hedge funds isn't all that easy. Comparable data for different funds of funds is not readily available. What's more, **David F. Swensen**, the chief investment officer of the Yale endowment, says that most investors shouldn't even bother to look for one. 'Funds of hedge funds generally aren't a good investment for the unsophisticated investor,' he said.

'The best hedge funds aren't included in them, and the fees are too high.' One fundamental problem is that hedge funds, by their very nature, can be difficult for outsiders to evaluate and understand. Many hedge fund managers like it that way because they generally want to keep their strategies to themselves. And those strategies tend to be complex. … [W]hile investors in mutual funds can turn to many services to rate and compare funds, there is no corresponding service that tracks and compares the performance of registered funds of hedge funds, partly because hedge fund trackers tend to cater to the very rich. … Registered funds of hedge funds tend to be assembled by banks and money management firms. Some are managed by one firm and then marketed by another. Each layer, starting with the underlying hedge funds, can tack on fees. … Consider the **DB Hedged Strategies** fund, started by Deutsche Bank in 2002. Smith Barney has been marketing the fund to clients who can put up as little as $50,000. … If you pore through the figures for the DB fund's overall performance, you will find that it has been disappointing, lagging behind the S.& P. 500-stock index from 2002 through 2004. Deutsche Bank plans to close the fund in 2007, citing 'relative performance and dwindling interest in the fund.' What, exactly, were the fund's returns? That depends on how you look at them. The fund generated returns of 0.22 percent in 2002 and 10.71 percent in 2003, and declined 0.12 percent in 2004, if you include two layers of fees. Those are the fees of the underlying funds, typically a 1 percent management fee and 20 percent of the profits, as well as Deutsche Bank's charges - an additional 1.95 percent in investment management fees and 0.25 percent in administrative fees. But Smith Barney can also tack on a one-time sales charge of as much as 3.5 percent - a fee that is negotiable and whose impact on performance is not shown in the documents. Investors who paid the entire 3.5 percent up front would have earned a cumulative 6.9 percent return over three years; without the Smith Barney fee, they would have earned 10.8 percent. No matter how you slice it, though, the fund didn't match the S.& P., which posted a cumulative 11.1 percent return over the period. Mr. Swensen of the Yale endowment says the high fees on funds of funds are a big problem. Speaking of the entire class of funds, he said, 'The fee structure, particularly when one adds the fees for the fund of funds, goes from unfair to ridiculously unfair.' How did the Deutsche Bank fund compare with other registered funds of hedge funds? It's hard to say, because there is no readily available source of data on them. … Smith Barney would not provide comparable data on the returns of the registered funds of hedge funds that it markets. Mr. Swensen saw another fundamental problem: many of the best hedge funds are not available through any fund of funds. The most successful hedge funds, he said, often prefer to court only institutional investors who have longer time horizons. … His skepticism comes despite the S.E.C. rule changes, which will require hedge fund advisers who manage more than $25 million and have more than 15 investors to register with the S.E.C. … But hedge funds that want to avoid government scrutiny can make use of a big loophole in the regulations. If a fund insists that investors lock up their money for two years, the hedge fund does not have to register." (NYT, 11/27/05, "Hedge Funds Work for Yale, but Will They Work for You?")

"Pension Officers Putting Billions Into Hedge Funds"

"Faced with growing numbers of retirees, pension plans are pouring billions into hedge funds…. Pension funds account for roughly 40 percent of all institutional money. … While most pension plans have modest stakes in hedge funds, others have invested more than 20 percent of their assets. … In Congress, there has been a push for amendments that would make it easier for hedge funds to manage even more pension money, without having to comply with the federal law that governs company pensions. Pension officials who have been shaken by market downturns and persistent deficits are attracted by hedge funds' promise of richer, or more consistent, returns. But the trend has caused some consultants and academics to voice cautions. They question whether hedge funds, with risks that are hard to measure, are appropriate for pension funds, whose sole purpose, by law, is to pay out predetermined benefits to retired workers. … Given that the benefits are paid out on a set schedule, critics wonder whether it makes sense to rely on investments whose returns are hard to predict, managed by private partnerships that disclose little about their operations and charge some of the highest fees on Wall Street. … Accounting rules let companies factor expected pension returns into their operating income; Weyerhaeuser's hedge-fund-laden portfolio allows it to claim expected annual returns of 9.5 percent. By comparison, the 100 largest companies that sponsor pension funds predicted last year that their average long-term returns would be 8.5 percent.… For Weyerhaeuser, each 0.5 percent increase in the expected rate of return is worth an additional $21 million to the company's pretax income this year…. Employees of G.M., Verizon or International Paper, who are involuntary hedge-fund investors through their participation in pension plans, will not find any reference to the funds in those companies' annual reports. In their footnotes, these and other companies drop hints that a sophisticated investor might recognize as a reference to hedge funds, but they do not give the particulars. International Paper's description of its pension asset allocation, for example, breaks it down into 'equity securities,' 'debt securities,' 'real estate' and 'other.' Some companies and governments, like Pennsylvania, make the argument that hedge funds are not really an asset class at all, but an 'asset management tool' that does not have to be disclosed as part of the fund's allocation to stocks or bonds. That lack of disclosure has some regulators and pension specialists worried. … **Susan M. Mangiero**, author of 'Risk Management,' a textbook for pension officials, said she had come across pension executives who had not done that level of analysis. Some did not even know they had derivatives in their portfolios, she said. … In Washington, despite concerns over the health of the nation's pension system, there has been little discussion of pension plans' growing use of nontraditional investments. … But the surge of pension money is coming at a time when the returns of many hedge funds have not been as strong as in past years, raising questions about whether pensions are arriving at the party late." (NYT, 11/27/05, "Pension Officers Putting Billions Into Hedge Funds")

"Ex-Hedge Fund Manager Fined by NASD"

"NASD … fined **John Mangan Jr.** $125,000 to resolve charges that included improper trades of restricted, unregistered shares. Mr. Mangan, a hedge fund manager formerly registered as a broker with Friedman, Billings, Ramsey & Company, was also

permanently barred from associating with a NASD-registered firm…. The charges against Mr. Mangan included 'deceptively obtaining' the restricted shares - known as PIPE's, for private investments in public equity - and improperly selling them short without obtaining permission from Friedman, Billings. In a short sale, traders sell borrowed shares in hopes of buying them back at a cheaper price. PIPE's are securities that can help companies raise money quickly by selling shares at a discount to a targeted group of investors. The market for the securities was active in 2000, but when the dot-com stock bubble burst, they were shunned by investors as a last-ditch attempt by companies to raise cash. … Mr. Mangan neither admitted nor denied the charges." (Reuters, 12/21/05, "Ex-Hedge Fund Manager Fined by NASD") Funny, NASD managed to acquire jurisdiction over Mangan.

"SEC Charges Hedge-Fund HMC Principals of Fraud"

"The Securities and Exchange Commission accused hedge-fund trader **Bret Grebow** and manager **Robert Massimi** of operating a 'Ponzi scheme' that bilked investors without actually trading on their behalf. In a complaint filed in federal court in the Southern District of New York, the SEC charged Mr. Grebow, 29 years old, and Mr. Massimi, 45, with securities fraud, alleging they 'misappropriated more than $5.2 million' from about 80 investors in their **HMC International LLC** fund. A judge granted the SEC's request to freeze the fund's remaining assets, whose value couldn't immediately be determined. The SEC alleged that the Montvale, N.J., hedge fund used money from new investors to pay investors who were leaving the fund and also sent out false monthly statements as Mr. Grebow, who worked out of a Florida office, 'was systematically looting the fund's trading account.' The fund told investors it was trading daily, but it hadn't made any trades for some time, according to the complaint. … Mr. Grebow was featured in a page-one article in The Wall Street Journal last year about financial professionals living the high life again. In that article, Mr. Grebow said he was so confident in stocks he was comfortable spending $160,000 on a Lamborghini and flying friends on privately chartered jets stocked with his favorite treats, including Cookie Crisp cereal and Jack Daniel's." (WSJ, 12/22/05, "SEC Charges Hedge-Fund HMC Principals of Fraud") What kind of "favorite treat" were they smoking?

"S.E.C. Accuses a New Jersey Hedge Fund"

"The Securities and Exchange Commission has sued **HMC International**, a small New Jersey hedge fund company, and its two principals, accusing them of misappropriating $5.2 million of the firm's $12.9 million to pay for their lavish lifestyles. An emergency enforcement action, intended to freeze all remaining assets, accused **Robert A. Massimi**, who managed the fund and was its head, and only, trader; and **Bret A. Grebow** of misrepresenting the fund's performance for 2001 and 2002 by more than 50 percent and of publishing false returns for 2003 and 2004. … The two men were said to have paid themselves profit distributions from investor deposits that were based on the false statements. On Oct. 2, shortly after the S.E.C. started investigating, Mr. Massimi's wife opened a brokerage account in her maiden name, and Mr. Massimi transferred $1.5 million into the new account, according to the complaint. The fund represented itself as a

low-risk 'day trading' fund, which is similar to how Bayou, the $400 million hedge fund that collapsed this summer, characterized itself to investors. Mr. Massimi assured investors that he was a hands-on manager who diligently oversaw the fund's trading, the complaint said." (NYT, 12/22/05, December 22, 2005, "S.E.C. Accuses a New Jersey Hedge Fund") Did HMC provide prospective investors with audited reports of its purported investment results?

"Fund Manager Pleads Guilty"

"The Securities and Exchange Commission said Thursday that a hedge fund manager, **Scott Sacane**, had pleaded guilty to investment adviser fraud in a case prosecuted by the United States attorney's office in New Haven. The S.E.C. said that it sued Mr. Sacane, 39, in October over related civil accusations that he had manipulated the stocks of Aksys, a medical products maker, and Esperion Therapeutics, a cholesterol drug therapy company that has since been acquired by Pfizer. Mr. Sacane was an investment adviser to the **Durus Life Sciences Fund**, the **Durus Life Sciences International Fund** and the **Durus Life Sciences Master Fund**…. The S.E.C. said Mr. Sacane 'knowingly and willfully inflated the value of the Durus Funds, thereby garnering increased management fees and performance incentive fees to which he was not entitled.' … Sentencing has been scheduled for April 28. Mr. Sacane faces a maximum sentence of five years in prison and a $250,000 fine, the S.E.C. said. In September, the Federal Trade Commission fined him $350,000. In a separate action, two Texas hedge funds, their investment adviser and two executives agreed to pay $37.7 million to settle charges of fraudulent market timing and late trading in mutual funds, federal and state regulators said. The funds, **Veras Capital Master Fund** and **VEY Partners Master Fund**; their investment adviser, Veras Investment Partners; and its managing members, Kevin D. Larson and James R. McBride, agreed to settle without admitting or denying wrongdoing. The case was brought by the S.E.C., the Commodities Futures Trading Commission and Eliot Spitzer, the New York attorney general. The S.E.C. said Veras used 'deceptive techniques' when conducting inappropriate mutual fund trades from January 2002 through September 2003, including attempts to hide its identity from mutual funds." (Reuters, 12/23/05, "Fund Manager Pleads Guilty")

"Citadel Pulls Up Its Withdrawal Bridge, As Hedge Funds Aim to Block the Exits"

"Hedge funds are cracking the whip to keep investors in the fold. Facing a spate of possible withdrawals by investors disappointed by recent poor returns, **Citadel Investment Group** imposed penalties on at least one investor who insisted on getting money back, prompting others to keep their funds in the $12 billion hedge fund…. Under longstanding Citadel rules, when investors try to withdraw more than 3% of its money under management, the fund can charge penalty fees on those seeking to withdraw more than a specified amount of their investment. … The unusual activity at Chicago-based Citadel, one of the investment world's most prominent hedge-fund operators, demonstrates investors' frustration with recent performance. … [M]any hedge funds are

imposing increasingly stiff terms on their newly restless clients. In some cases, in addition to penalties and prohibitions, investors are receiving payment in kind or the promise of payment in the future, rather than 100 cents on the dollar in cash, according to managers of funds that invest in multiple hedge funds. Because any hedge fund is vulnerable to a so-called run for the exit, investor restrictions have become more common in recent years. But these restrictions remain a hotly debated topic. The justification is that … a hedge fund would typically sell its best investments first, because they are the easiest to sell. As soon as there is a whiff of trouble around a fund, many investors will rush out. They fear that if they stay, they will be left with the holdings that are too difficult to sell." (WSJ, 1/13/06, "Citadel Pulls Up Its Withdrawal Bridge, As Hedge Funds Aim to Block the Exits")

"By the Numbers: Hedge Funds and Half-Truths"

"[P]erformance statistics for 2005 might seem to be a great way to measure whether hedge funds, the $1 trillion asset class of the moment, are worth the astronomical fees that their investors must pay. … But gauging 2005 performance for the sector is no simple task. …[D]ifferent indexes include different funds. … The discrepancy among those figures presents a number of issues. First and foremost, investable indexes do not attract rock star performers. By contrast, noninvestable returns are better, but you can't get into them, so what's the point? As with all indexes, there are concentration issues. The Credit Suisse/Tremont investable index is smaller - it includes 60 funds - compared with its noninvestable index, which includes 413 funds. Wild outperformance or underperformance of one fund will more likely skew the results in the smaller universe. … Each index also includes different funds. The Hedge Fund Research composite hedge fund index is an average of about 2,000 funds. That makes it broadly representative of the sector, which is estimated to have about 8,000 funds. But it does not have a minimum track record requirement. The S.& P. hedge fund index includes only 42 funds, but the stringent reporting requirements for those funds have probably dissuaded many fund managers from revealing much. Many of the best-performing funds, like Renaissance, don't report to any database. Perhaps most troubling is the general upward bias that appears to exist in all the indexes. According to research by Burton G. Malkiel and Atanu Saha, both of Princeton, and the Analysis Group, an economic consulting group, the TASS database acquired by Tremont has overstated hedge fund returns by more than 4 percent a year from 1996 to 2003. The inflation is a result of various factors including survivorship and a lack of uniform reporting standards. The performance of hedge funds that fail are erased from the database. That's a big deal considering their research showed that of the 331 funds that reported returns in 1996, only 58, or fewer than 25 percent, still existed in 2004. … 'The bottom line is, there is a lot of survivorship bias in many of the hedge fund indices that are used to sell hedge funds,' Dr. Malkiel said in an interview. Since there are no requirements that all data since inception be included in any performance database, hedge funds can choose to report to a database when their returns start to look good, creating a natural upward bias. … Many sophisticated investors develop their own benchmarks, or they set an absolute return objective. Not all hedge fund investors are so sophisticated. For those who are not, and who happen to be piling

into hedge funds, it is worth finding a reliable benchmark. (NYT, 1/20/06, "By the Numbers: Hedge Funds and Half-Truths")

"Making Hedge Funds Less Secret"

"With 934 hedge-fund advisers registering with the Securities and Exchange Commission since the passage of a new rule, potential investors have a chance to lift the veil and review registration forms of some of the most private hedge-fund managers. … And here is the unexpected part. As some registrants are discovering, past skirmishes with government authorities will also be aired for all the world to see, on http://www.adviserinfo.sec.gov. The disclosures can include run-ins with the law that are unrelated to the securities industry, such as drunken-driving or domestic-abuse charges. … While the registration shines a spotlight on a secretive industry, it hardly completes the picture. Lawyers estimate that information won't be available for the 15% to 20% of hedge-fund advisers who are exempt from registration, either because they aren't soliciting funds from new investors or investors' money is locked up for two years. That includes some of the biggest funds, such as **SAC Capital Management LLC, Kingdon Capital Management LLC, GLG Partners LP and Lone Pine Capital LLC.** … Other information that potential investors and competitors may be examining is also more readily available than before, such as assets under management, beneficial ownership interests, names of principal investors and their ownership stakes, and how the adviser is paid." (WSJ, 2/3/06, "Making Hedge Funds Less Secret")

"NASD Issues Second Set of Queries About Sales of Hedge-Fund Pools"

"Securities regulators have sent a new round of questions to Wall Street brokerage firms about whether they have been selling risky pools of hedge-fund investments that are unsuitable for some of their customers. The National Association of Securities Dealers, which sent initial general questions to the brokerage firms last summer, has sent out more-specific questions, according to people at some of the firms. Fewer than a dozen firms have received the current series of follow-up questions, according to people familiar with the inquiry. The questions encompass procedures the firms have to make sure the investments are suitable, as well as sales material and training received by brokers who sell the funds. The hedge-fund pools, known on Wall Street as funds-of-funds, are offered in vehicles that carry a minimum investment of as low as $25,000 to $50,000. … [F]unds-of-funds can be sold to investors who wouldn't qualify for hedge funds. … The questions also include how brokers assess clients' ability to sustain losses…. The agency is seeking information about funds that appear to include a disproportionate amount of small-denomination investments." (WSJ, 2/3/06, "NASD Issues Second Set of Queries About Sales of Hedge-Fund Pools")

"NFL Players Sue A Hedge Fund For Fraud, Theft"

"A group of current and former professional football players filed a civil lawsuit in Georgia state court against an Atlanta hedge-fund firm in which they had invested millions of dollars, accusing its principals of theft, forgery and fraud. In their suit, the

investors say they put a total of about $15 million into funds managed by **International Management Associates LLC**, its affiliates and principal Kirk S. Wright. They allege that Mr. Wright, other principals and the firm have failed to honor withdrawal requests made Dec. 5, misled investors as to the funds' investment style and forged their names on checks that bounced when deposited in the investors' bank accounts. The judge said he would freeze all of the assets of International Management, said to be about $150 million, according to Mr. Wright. Plaintiffs Terrell Davis, Steve Atwater, Rod Smith, Ray Crockett, Blaine Bishop and Al Smith currently or formerly played in the National Football League, for the Denver Broncos. The other plaintiff, Clyde Simmons, also played in the NFL. … Mr. Wright, who founded the firm in 1996, acknowledged that the fund and its returns hadn't been verified or audited in more than two years. … In court, Judge T. Jackson Bedford, a Fulton County Superior Court justice, said he would grant the investors' request to freeze all assets of International Management, its affiliates and its three principals: Mr. Wright, the chief executive, Chief Operating Officer Nelson Keith Bond and Chief Financial Officer Fitz N. Harper, Jr. Drs. Bond and Harper are anesthesiologists, according to the International Management Web site. … The judge also ruled that the court would take the principals' passports. … No one representing the defense attended the hearing. … 'A fund managed by anesthesiologists?' Judge Bedford quipped. 'I apologize to all anesthesiologists, but they ought to stick to being anesthesiologists.' … Mr. Wright said the redemptions were the result of poaching by Drs. Bond and Harper, whom he said recently left to start a rival firm. … The firm's flagship **Taurus fund** reported a nearly 25% annualized gain in the five years ended Dec. 31, 2004, according to its marketing materials. That compares with a loss for the Standard & Poor's 500-stock index. According to the marketing materials and during the interview last week, International Management and Mr. Wright claimed the firm followed a diversified strategy to moderate risk. Court documents indicate, however, that recently, 67% of the assets of the firm's **Platinum I** and **Platinum II** funds were invested in a short position -- a bet on a decline in a stock price -- in Time Warner Inc." (WSJ, 2/18/06, "NFL Players Sue A Hedge Fund For Fraud, Theft")

"Claiming Stock Manipulation, Biovail Sues Hedge Fund"

"The Biovail Corporation, a Canadian pharmaceutical company, has sued **SAC Capital Management**, one of the most powerful hedge funds on Wall Street, accusing it of colluding with independent research providers to issue misleading reports to drive down the price of Biovail's stock. The lawsuit, filed yesterday in New Jersey Superior Court in Newark, lays out a scheme by several hedge funds to send 'ghost written' research reports — all negative — to Camelback, an independent investment research firm based in Arizona now known as Gradient Analytics. Camelback would wait for the hedge funds to accumulate a short position on the stock — a technique that allows traders to make money if the stock price falls — and then Camelback would release the report, the suit says. As a result of the reports of Camelback, as well as subsequent reports by David W. Maris, an analyst with Banc of America Securities, shares of Biovail stock fell more than 50 percent between 2003 and the spring of 2004, resulting in its business reputation being "devastated" and curtailing its ability to access capital, the lawsuit says. …The litigation is another battle in a larger war that is often waged between companies

and short sellers. … Yet in cases when a company has problems — and when short sellers aggressively highlight those problems — it may be unclear whether the stock price is falling because of fundamental problems with a company or because short sellers have simply persuaded other investors that the price is headed down. … The complaint, which seeks damages of $4.6 billion, lists 22 defendants, including Steven A. Cohen, the founder of SAC (the initials are his); various of his affiliate funds and their employees; Gradient, which was formerly Camelback; James Carr Bettis, founder and chief executive of Gradient and Donn Vickrey, founder and co-owner of Gradient, Mr. Maris of Banc of America Securities, the investment banking arm of Bank of America; and the Gerson Lehrman Group, a company based in New York that connects investors with experts in fields like pharmaceuticals. … Biovail also accuses Camelback of holding up the release of its reports to allow clients to build meaningful positions in stocks to maximize the benefit of the negative impact from the report and contends that the research firm misrepresented to clients that it did not manage money. Mr. Bettis and Mr. Vickrey managed various hedge funds including Pinnacle, Helios and Hallmark from the same office where the independent research was being conducted, according to the lawsuit. … The lawsuit accuses the Gerson Lehrman Group and other defendants of paying two doctors in 2003 to give false information to reporters suggesting Biovail had set up a program to bribe them to prescribe a Biovail drug. Camelback issued another negative report on Biovail with details of the bribes in late July." (NYT, 2/23/06, "Claiming Stock Manipulation, Biovail Sues Hedge Fund")

"GMM hedge-fund head pleads guilty"

"The head of a San Diego hedge-fund partnership that lost up to $60 million of investor funds pleaded guilty yesterday to tax evasion and conspiracy to commit mail fraud in federal court in San Diego. **Marvin Irwin Friedman** entered his plea … in the March 2004 collapse of **Global Money Management**, a $116 million hedge fund. … He could receive a maximum of eight years in prison…. Two other people – GMM fund co-manager **Paul Henrie Levy** and bookkeeper **Alice Mae Swiderski** – previously pleaded innocent and await trial. …The three operators of the hedge fund were charged last June in a 36-count indictment on charges including conspiracy, perjury, mail and wire fraud, money laundering and tax fraud. According to the plea agreement, Friedman admitted to conspiring with Levy to divert investor funds from the GMM hedge fund for their personal benefit or to entities they controlled. Friedman admitted that he and Levy disseminated false and misleading account statements and partnership tax returns that claimed investors were earning up to 25 percent annually on their investments. … Prosecutors alleged that the two men used new investor funds to pay off longer-term investors in the GMM fund in an attempt to induce those individuals to invest more in the hedge fund. Court-appointed receiver Charles LaBella said he believes the partnership took in an estimated $116 million from 210 investors during the fund's 11-year lifespan. … Eventually, investors are expected to get back about 25 percent to 30 percent of their investments…." (San Diego Union-Tribune, 2/28/06, "GMM hedge-fund head pleads guilty")

"Hedgebay looks to match hedge fund buyers, sellers"

"Hedge fund investors can sometimes face daunting challenges, both getting into attractive funds or exiting funds with long 'lock up' provisions in an industry that continues to grow rapidly. But an increased number of restrictions is benefiting **Hedgebay Trading Corp.**, a firm that seeks to match investors who want to bail out of certain hedge funds with those that may want to get into them. … But so far, experts say a secondary market for hedge fund assets is still in its infancy.… But investors will still face hurdles, since hedge funds typically have the final say in whether investors can enter or leave their funds. … [M]anagers in most cases … let an investor exit and, for a fee of up to 1 percent of assets [if they] can arrange to have the exiting investor replaced by another one. The usual arrangement … is that an investor agrees to a discount of up to 5 percent to the existing net asset value of their investment. … Hedgebay is far from developing a full-fledged market for hedge fund investors, where assets are traded through an exchange. But the company says it brokers up to a dozen transactions a month, with an average asset value of $4 million per transaction. The service, which was founded in 1999, has grown some 46 percent per year over the last five years…. The service comes at a time when new hedge funds started by successful traders often require investors to keep money in a fund for two years or more…. In previous years, when the hedge fund market was smaller, investors could often bail out monthly or quarterly. Now many top funds, such as Chicago-based **Ritchie Capital Management**, will bar investors from pulling most of their money altogether if their strategies are threatened by excessive 'redemptions,' which can hurt the fund's strategy." (Reuters, 3/2/06, "Hedgebay looks to match hedge fund buyers, sellers")

"SEC lawsuit accuses hedge fund investors of fraud "

"The SEC filed the lawsuit against **Sharon E. Vaughn** and her investment advisory company, **Directors Financial Group Ltd.** The suit claims Vaughn and her group founded and managed a private hedge fund called **Directors Performance Fund LLC** and told investors in a memo that the fund would be managed to maximize returns using an approved system of trading and investment management. But Vaughn and her group really took the funds received by investors and placed them in a fraudulent trading program in which exorbitant returns were promised, but in which funds were really transferred between accounts and ended up in the pocket of those running the trading program, the suit claims." (The Sun-Times, 3/2/06, "SEC lawsuit accuses hedge fund investors of fraud ")

"A look at long-short mutuals"

"Long-short funds are the poor man's hedge fund. Both buy securities they think will go up (called going long) and bet against securities they think will fall, usually by selling them short or using more esoteric strategies. The main differences: Hedge funds are lightly regulated investment vehicles that require large minimum investments, often $250,000 to $1 million. They are open to a limited number of qualified -- meaning wealthy -- investors. The manager collects an annual fee -- usually 1 to 2 percent of

assets -- plus a fat slice, typically 20 percent, of profits, if any. There are usually limits on when investors can withdraw their money. Long-short funds are regulated by the Securities and Exchange Commission and are subject to the same rules as other public mutual funds. They are open to anyone who can come up with the initial investment, usually a few grand. The manager charges an annual fee, typically 1 to 2 percent of assets, but does not share in any profits. Investors can sell their shares any business day. … The main thing they have in common is that they have at least 20 percent of their assets sold short. … The new category also excludes funds that are entirely short or close to it. They are in a separate category called bear market funds. The funds in the new long-short category pursue a variety of strategies. They can be grouped into three major subgroups. -- Long-short funds: These funds adjust their ratio of long and short positions to take advantage of expected returns in the overall market. … -- Market-neutral funds: These funds seek to offset every $1 in long positions with $1 in short positions, thus having zero exposure to the overall market. … -- Merger arbitrage funds: Two funds in this category, the Merger fund and the Arbitrage fund, invest in companies involved in acquisitions. After a deal has been announced, they typically buy stock in the target company, whose share price runs up close to the acquisition price, and short stock in the acquiring company, whose stock often falls due to concerns about the merger. When the merger happens, they collect the acquisition price. … Although Morningstar provides extensive information on a fund's long position, it does not show how much a long-short fund has sold short, nor does it show individual short positions. … Information on short positions is sometimes available from the funds themselves." (San Francisco Chronicle, 3/5/06, "A look at long-short mutuals")

"PlusFunds seeks bankruptcy protection, cites Refco"

"**PlusFunds Group Inc.**, a New York provider of hedge fund products, on Monday filed for bankruptcy protection, after some of its assets were tied up because of Refco Inc.'s own Chapter 11 filing. Upon court approval, PlusFunds intends to sell its business to **FTVentures**, a private equity firm that invests in companies providing technology and services to financial institutions. It has $623 million of assets under management, and offices in New York and San Francisco. … PlusFunds offers private investment vehicles to investors seeking exposure to hedge funds, and receives fees tied to assets under management. …[A]n affidavit filed with the U.S. bankruptcy court … said that before Refco's bankruptcy, $312 million of customer assets at PlusFunds' SPhinX Managed Futures Fund were transferred to Refco from Refco Capital Markets, an unregulated broker-dealer unit. … A committee of unsecured Refco creditors, however, opposed the transfer, and the money has now been frozen.… As PlusFunds' assets under management tumbled to $1.24 billion in January from $2.52 billion in September, related fees also fell by more than half, with most of the decline in January…. The firm listed $7.8 million of assets and $3.5 million of liabilities." (Reuters, 3/6/06, "PlusFunds seeks bankruptcy protection, cites Refco")

"Troubles at Atlanta Hedge Fund Snare Doctors, Football Players"

"Kirk S. Wright, a 35-year-old hedge-fund manager, celebrated his second marriage last October with a lavish reception at his sprawling brick-and-stucco home in this city's northern suburbs. Former professional football players, joined by many of Atlanta's top African-American doctors and entrepreneurs, crowded his home…. Many of Mr. Wright's guests had an extra reason to be impressed. Along with other investors, they had allocated at least $115 million to Mr. Wright's hedge-fund firm, **International Management Associates LLC**. Over the prior seven years, which included the worst bear market since the Great Depression, Mr. Wright had reported average annual returns of more than 27%. … The SEC estimates that Mr. Wright, who handled International Management's investments, managed somewhere between $115 million and $185 million of client money. After more than two weeks of searching, the hedge fund's court-appointed receiver and the SEC have found only about $150,000 of it…. About 500 investors fear they have lost everything. … Some of Atlanta's African-American business leaders express anger that the city's biggest black-owned hedge fund may have taken advantage of the city's black professionals to gain legitimacy early on, letting the fund build a broad client base later. … International Management first focused on attracting money from doctors, then on retired professional athletes, Mr. Wright says. The former anesthesiologists who are his partners, Nelson Keith Bond and Fitz Harper Jr., are African-American. They marketed first to their peers, including many black doctors, Mr. Wright says. Most of the firm's clients, he says, aren't African-American. … **In hindsight, there were many red flags at International Management: unusually consistent high returns, vague descriptions of investment strategies, aggressive marketing, no auditing, and secretive behavior by the manager.** … Mr. Wright, a Bronx, N.Y., native, opened International Management in his house in Manassas, Va., in 1996, after earning a bachelor's degree from Binghamton University, State University of New York, and a master's degree in public administration from Harvard University. … Mr. Wright says he met Drs. Bond and Harper through a mutual acquaintance in 1998. … They invested with him in 1999, and soon began setting up meetings where Mr. Wright would solicit business from doctors in the Atlanta area, who were viewed as wealthy but with little time to manage their portfolios, Mr. Wright says. … Mr. Wright made presentations to groups of doctors rounded up by Drs. Bond and Harper, clients of the firm recall. Descriptions of his investment strategy were vague and jargon-filled, clients say. Marketing materials for the flagship **Taurus fund** said its 'objectives are achieved through a top-down, bottom-up process that identifies disparities in the economy or security sectors creating +/- changes in market perception.' Investors say they were attracted by the fund's reported high returns and low volatility. The Taurus fund reported a 27% average annual gain from 1998 through the end of 2004, compared with less than 5% for the Standard & Poor's 500-stock index, according to marketing materials. … The firm's rise coincided with a blossoming of black affluence in Atlanta. … Mr. Wright entertained investors in corporate suites he rented at Atlanta Falcon football games, Atlanta Hawk basketball games, and concerts. Neighbors say Mr. Wright doubled the size of his house. He bought a Bentley, a Jaguar, an Aston Martin, a BMW and a Lamborghini. … Some in Atlanta were skeptical. … Mr. Wright had no business cards, and as proof of his investment returns, presented only photocopied spreadsheets….

Between 2000 and 2004, the firm opened offices in Las Vegas, Los Angeles and New York, and began drawing substantial money from outside of Atlanta. In 2004, it hired **Thomas H. Birk**, a Los Angeles-based salesman who previously raised money for several major brokerage firms. Mr. Birk, who is white, would troll Western golf courses talking up Mr. Wright's investment record, according to clients who invested through him. Mr. Birk eventually raised more than $10 million, his lawyer says. … In October, Dr. Harper, the salesman Mr. Birk, and the two former players … met with Mr. Wright. Mr. Wright showed them a handful of account statements from Ameritrade, an online brokerage service owned by TD Ameritrade Holding Corp., which listed total assets of roughly $155 million, but he wouldn't let anyone touch them, according to Mr. Harper's declaration. … The statements with the Ameritrade logo were fake, according to a sworn statement by an SEC investigator. … In early February, Mr. Wright removed several files from his office between 4 a.m. and 6 a.m…. At the same time, some bank records were deleted, though back-ups were recovered, according to this employee. … The $150,000 discovered thus far was held in two Ameritrade accounts, according to court declarations in the SEC's suit against Mr. Wright and his firm. The suit says regulators believe 'virtually all of the assets of the funds have been dissipated,' although it offers no explanation of what happened to them. … (Mr. Wright's) mother, Joyce Wright, is concerned about her son's safety, as well as the retirement money she invested with him. … Asked in a telephone interview whether he had funded his lifestyle with client money, Mr. Wright responded: 'I challenge you to find where I spent $185 million.' Mr. Wright said that if required to answer questions from the SEC, he is considering exercising his Fifth Amendment rights." (WSJ, 3/9/06, "Troubles at Atlanta Hedge Fund Snare Doctors, Football Players")

"Hedge fund blowups not scaring investors yet-study"

"Hedge fund blowups make for scary headlines but so far they have not frightened investors into looking more closely at how these slightly regulated funds operate before putting money in, new research shows. … [I]n New York, investors last week sued the attorneys, auditors and advisors who introduced them to a now collapsed hedge fund to recoup the roughly $200 million they are owed. …[I]ndustry consultants at **Carbon360** found that only about one in three investors is concerned with a hedge fund's infrastructure and risk management systems. And only about one in eight double checks how a manager makes the money he said he earned. … Mistakes in the back office, even if committed by well-intentioned but poorly trained staffers, can quickly sink even the savviest hedge fund trader and his clients…. But now that federal regulators have accused several hedge funds of having fabricated their numbers… there is no excuse for not checking out a fund's accounting system. … (There were) situations where managers ran the numbers on a Microsoft spreadsheet while lying to clients about using sophisticated accounting software. Similarly, investors should investigate how a fund processes trades and how often it has to cancel or correct orders in the wake of mistakes…. But these tedious tasks are often ignored by investors and their consultants who appear far more interested in reviewing a manager's resume and meeting them at their offices." (Reuters, 3/9/06, "Hedge fund blowups not scaring investors yet-study")

"Treasury to Hedge Funds: Let's Have a Little Chat About the Risks of Your Game For Everyone Else?"

"The Treasury Department, concerned that complex investments favored by wealth managers could pose broad financial-market risks, is summoning hedge-fund executives and other market participants to discuss the issue. The plan was … to address questions about how financial institutions value, measure and disclose their exposure to credit derivatives, which are investment contracts tied to various forms of debt. … The Treasury efforts follow similar preventive steps by the Federal Reserve, Securities and Exchange Commission, and the British Financial Services Authority." (WSJ, 3/11/06, "Treasury to Hedge Funds: Let's Have a Little Chat About the Risks of Your Game For Everyone Else?")

"Hedge fund operator gets prison"

"**Ricky Dale Fenney**, a hedge fund operator who defrauded investors of more than $2 million, was sentenced to three years, one month in federal prison. He pleaded guilty to wire fraud Dec. 20. Between 2001 and 2004, Fenney set up hedge funds and signed up 17 clients whose money he used to day-trade on the Nasdaq Stock Market, according to his plea bargain. When he began losing money, in the first month, he didn't tell investors, but instead sent out e-mail claiming extraordinary returns, and in the style of a Ponzi scheme, paid out early investors with money from other investors, according to court documents." (San Diego Union-Tribune, 3/11/06, "Hedge fund operator gets prison")

"Do You Really Need a Hedge Fund?"

"Today, performance is hardly spectacular. Since the stock market bottomed in 2002, hedge funds, as measured by the Credit Suisse/Tremont Hedge Fund Index, underperformed the S&P 500 two out of three years. … How is it possible then that new assets into hedge funds increased approximately 36% to $1.5 trillion in 2005 from $1.1 trillion in 2004? Clearly, institutions crave the high returns historically associated with hedge funds. Furthermore, large investment firms and financial advisers are increasingly marketing hedge funds to a less sophisticated audience, which is a troubling trend. There can only be so much smart money. Identifying the managers who can deliver consistently superior returns is no easy task. Even the most sophisticated investors will be challenged, confirming once again that hedge funds are not designed for the masses. Eventually, investors will refuse to pay high fees for average performance especially when so many better alternatives exist, including 'passive investing' strategies. The growing gulf between compensation and performance is an aberration that I don't see lasting -- even if so many have so much invested in seeing that it does." (WSJ, 4/14/04, Commentary "Do You Really Need a Hedge Fund?")

"Are These Hedge Fund Results Real?"

"For those who favor open markets and open investment management, it may look like the best of times. But it may really be the worst -- and we may not learn just how bad it is until something horrible happens. … Hedge funds trade with virtually no disclosure of what they are doing. And both they and others trade -- without disclosure -- derivatives that had not been dreamed of when the regulatory structure was established more than half a century ago. This has happened in the last two decades with little notice. **Alan Greenspan**, as Federal Reserve chairman, and the derivatives industry won the argument that regulation of new instruments would just drive them offshore. In any case, they argued, the players in the derivatives markets -- the big banks and institutional investors -- were regulated, so why worry? The market in credit default swaps means that holders of General Motors bonds may not be in danger if that company defaults. But how much risk has been passed off in that market, and to whom? Has some of it landed with players who might not be able to meet their obligations? … But months before Sarbanes-Oxley was passed, no one would have thought that such a law was possible. Then came Enron and WorldCom. Let us hope that no similar alarm and outrage come up when we do learn more about how -- and how safely -- hedge funds are secretly trading all those secret derivatives. (NYT, 4/21/06, "Are These Hedge Fund Results Real?")

"Worried About Noisy Children, and Hedge Funds, Too"

"What I really wanted to say was that hedge funds are largely, but not always, a snare and a delusion. … But the long-term record of most hedge funds is not at all impressive. Research by **Burton G. Malkiel**, a professor at Princeton, and **Atanu Saha**, a principal at the Analysis Group, found that over long periods hedge funds significantly underperform index funds, like those based on the Standard & Poor's 500-stock index. For openers, the hedge funds they looked at — starting with 604 in 1996 and rising to 2,700 in 2003 as the funds proliferated — earned less than an S.& P. index fund in the period he studied, 1996 to 2003: an annual average return of 9.3 percent, compared with 9.4 percent for the index fund (and 10.1 percent for a simple stock-and-bond portfolio). But hedge funds also create much more tax liability because they trade so often and have so much short-term taxable income, compared with a tax-efficient index fund. And, as is well documented, they have far higher fees than index funds. It is easy to buy an index fund that charges a management fee of only about 20 basis points — two-tenths of a percentage point — of the amount invested. A hedge fund takes an astounding fee of one to two full percentage points of net assets off the top, and then 20 percent of any profits. This cuts hedge fund returns to significantly less than those of broad-based index funds.
Dr. Malkiel and Dr. Saha calculated that even if hedge funds earned almost 50 percent more than market returns, the higher taxes and fees that hedge funds pay would whittle away their net return to investors to 20 percent less than index funds. Other commentators, including … **Phil DeMuth**, say that even these results overstate hedge fund results. For one thing, there is survivorship bias — always a problem in the back alleys of finance — because only the hedge funds that survive report at all. If you take into account the ones that fail, the results would be worse. Then there are problems of self-selection, in which only the funds that feel like it report at all, and instant-history

bias, in which hedge funds that are brand new and have just had one good spurt can skew all the results. And because many assets of hedge funds are illiquid, the managers can put any price they want on them for any period until they sell them (and maybe even after that). This can be used to greatly underreport volatility because the assets in question can be reported at any price the managers wish, even while comparable liquid assets are gyrating wildly. To be sure, some hedge funds do well. Some do incredibly well, but rarely do any of them do incredibly well for a long time." (NYT, 4/23/06, "Worried About Noisy Children, and Hedge Funds, Too")

"Fort Worth invested $6 million in failed hedge fund, records show"

"Everything seemed to be going great for an innovative investment made by the city's retirement fund in early 2004. In fact, after just four months, the pension fund was told that it had earned more than $230,000 on its $6 million investment. By 2005, though, that investment - **Bayou Management** hedge funds of Stamford, Conn. - had collapsed in a $450 million fraud. To the city's relief, the Fort Worth pension fund had pulled out in time to avoid any losses. … [F]ormer Executive Director James Newgard, … who left in February for another job, … credited the pension's consultant, **Consulting Services Group**, for spotting signs of trouble at Bayou and pulling out before the collapse. … Records show that ultimately a company hired by **CSG** apparently alerted the Fort Worth fund to concerns about Bayou and prompted the withdrawal of its investment. … Consulting Services Group jumped into a hedge-fund program for Fort Worth shortly after Newgard brought it on board, and Bayou was one of its earliest investments. A key question is how thoroughly CSG checked into Bayou and its founder. … It's not clear whether CSG did other checks the Fort Worth fund requires in choosing hedge-fund managers. Those include checks on the background and experience of managers and key employees. … If it did, CSG would have known that Bayou had compliance issues with regulators. Bayou was fined in 2003 by Connecticut for lacking required records and separately by the National Association of Securities Dealers for using some unregistered traders. NASD records also show that a client of Bayou's broker-dealer firm complained in late 2002 about fraud, unauthorized transactions and excessive trading; the matter was settled in arbitration in April 2004. CSG also could have learned about a 2003 lawsuit by a former Bayou executive, who said he had discovered possible securities law violations and that more than $7 million was apparently missing from a trading account. That case was later ordered to arbitration. A copy of the lawsuit was available on the Internet. … CSG asked **BackTrack Reports**, which specializes in investigating the personal backgrounds of hedge-fund managers, to follow up. … BackTrack's co-founder, **Randy Shain**, said the company had first spotted red flags with Bayou in the fall of 2001. It discovered that Israel's résumé falsely stated that he had been a head trader at another firm for four years. 'The issue there was dual: Both that he did not have the experience he suggested he did, which is bad enough, and he was a liar,' Shain said. … BackTrack, now **First Advantage Corp.**, also became concerned about Bayou's auditor. Bayou used an auditing firm that had no track record. The auditor is supposed to offer an independent assessment of the accuracy of financial information. … Later, it was revealed that Israel's partner, Daniel Marino, created the auditing firm, **Richmond-Fairfield Associates**, to make up rosy returns. **…** Also

troubling to some fiduciary experts were CSG's arrangements with Bayou. CSG at one time was a reference for Bayou, helping to promote the fund. … Although it's not illegal to run trades through a consultant's brokerage, or pay a fee to a money manager in exchange for references, some are concerned that it can create conflicts of interest. … CSG did not file a written disclosure of its past relationship with Bayou to the Fort Worth fund. … The extent of Fort Worth's reliance on CSG for its alternative investments also troubles some experts. … The experts say Fort Worth dropped the ball by not having board members on the hedge-fund committee that evaluates and chooses money managers and selects the auditing firm to review the hedge-fund program. Its hedge-fund committee is composed of officials of CSG and its affiliates. The committee selects the auditor. The consultant also interprets all financial data for the fund." (Fort Worth Star-Telegram, 4/24/06, "Fort Worth invested $6 million in failed hedge fund, records show")

"Hedge Fund Chief to Plead Guilty"

"The founder of a Valencia-based investment firm has agreed to plead guilty to criminal conspiracy charges in connection with a securities fraud that may have cost investors as much as $14 million. **Keith G. Gilabert**, 35, whose **Capital Management Group** operated a hedge fund called **GLT Venture**…. Gilabert, who was touting 27% returns at GLT in late 2004…. Far from earning such returns, the fund lost more than $7 million and distributed to investors some $4.6 million in money falsely labeled as profits…. Capital Management Group turned into a classic Ponzi scheme…. Gilabert stole at least $2.5 million of investor money for his own use. And he continued marketing his fund throughout 2004, officials said, even though Capital Management's investment advisor registration had been revoked by the California Department of Corporations in 2003. … More than 40 investors poured money into Capital Management from September 2000 to January 2005, when the company was abruptly closed… Gilabert worked with a co-conspirator at a major brokerage house to lull investors into a false sense of security. … [I]n a civil lawsuit filed in August 2005, an investor said he had been persuaded to invest $4 million in Capital Management by a broker at **UBS Financial Services Inc.** The investor, **Rabbi Sam Bronstein** of Los Angeles, said in his complaint that the broker came to his home with Gilabert to tout a 'special investment program' that they said was backed by UBS. The two also sent Bronstein fictitious account statements, purporting to show how his money was allocated and performing…." (LAT, 4/29/06, "Hedge Fund Chief to Plead Guilty") One might wonder whether the unnamed UBS broker made other house calls with Gilabert.

"Student Charged In Hedge-Fund Scam To Remain In Prison"

"The former New York University student (**Hakan Yalincak**) accused of running a $7 million hedge-fund scam will remain in prison while he awaits his fraud trial. … Defense attorneys said Yalincak was just a naive kid who was left holding the bag when more experienced investors bailed out of the scam. They acknowledge that the fund was a fraud but said Yalincak's not to blame. Prosecutors said Yalincak charmed investors from an office in Greenwich. They said he's so good at counterfeiting checks and committing

bank frauds, all he needs is a computer and a telephone." (NBC 30 Connecticut News, 5/30/06, "Student Charged In Hedge-Fund Scam To Remain In Prison")

"Hedge Fund Industry's Dirty Little Secret"

"As the pools of capital attracted to the hedge fund business multiplied geometrically, the industry morphed away from stock-picking and became a leveraged pool of capital. (**Long-Term Capital** begot others.) After all, funding a longer-term asset yielding 5% with shorter-term liabilities costing 3% was a no-brainer, and so was funding a market rising exponentially, vis-a-vis cheap debt. The only question was how that spread would be multiplied by additional debt/leverage. … A vicious cycle was created as the appetite for risk turned into its own bubble. Generally speaking, investors (especially of the fund-of-funds kind) cared little about how returns were generated. Rather, they focused solely on the level of the returns that were generated. And hedge funds complied by stacking cheap debt upon their equity bases in all sorts of carry trades (funding longer-dated assets with shorter-term liabilities). … Then, almost overnight, return on capital (appetite for risk) was replaced by concerns regarding return of capital (risk aversion), as uncertainty relating to the Federal Reserve's actions, coupled with tightening around the world, created a panic in the hedge fund's crowded carry trade and the bubble was pricked. Once the weakest investors starting selling -- at the margin -- similarly correlated asset classes began to drop. It is noteworthy that the May panic was not accompanied by any fundamental change or, as in the past, a financial crisis, but by the perception of a change in liquidity. Many (myself included) have cautioned that the growth and size of the hedge fund industry represents a significant bubble-like market risk. I have repeatedly written that bubbles are almost always based on the same set of conditions: **1.** Debt is plentiful. **2.** Debt is cheap. **3.** The egregious use of leverage becomes commonplace and accepted. **4.** A new and growing asset class raises asset prices. The above circumstances led to the Internet stock bubble in the late 1990s, to the real-estate bubble in 2003-2005 -- and, as we shall soon find out -- the bubble in hedge funds (and their appetite for risk). … *Caveat emptor.*" (TheStreet.com, 6/1/06, "Hedge Fund Industry's Dirty Little Secret")

Hedge Fund Conflicts Still Largely Kept Secret

"When an adviser, consultant or broker recommends a hedge fund or fund of funds, he or she may not be pitching the best investment for you because there's a commission at stake. …[C]onflicts of interest can lead to losses. **Portus Alternative Investment Management Inc.** was one of Canada's fastest-growing hedge fund companies until the Ontario Securities Commission sued the firm over questionable transactions last year. A judge forced the firm into receivership and ordered Portus's assets seized to repay investors. The fund obtained clients through 1,000 financial advisers, who steered 26,000 investors to Portus for a 5 percent referral fee. While using commissioned advisers, brokers and consultants to land clients for hedge funds is a common practice, it's not known how much investors are being informed about hedge fund risks or if the sales pitches gloss over money-losing trading strategies. … Fund managers use a carrot-and-stick approach to attract clients. Performance and management

fees are already lucrative and fund promoters share in the bounty. … [P]lacement incentives range between 10 and 15 percent of the annual fees received by the manager. Alternatively, there are one-time fees of 1 percent to 2 percent of money placed with a fund manager. These payments go directly to brokers, promoters and consultants from fund managers. With a fund of funds, which combine multiple managers, there are two levels of fees. Managers of individual funds take as much as 2 percent of annual money under management plus 20 percent of profits. Then the packager of multiple funds also receives a fee of 1 percent to 2 percent of assets under management, plus 10 percent of any annual gain exceeding 8 percent." (Bloomberg, 6/26/06, "Hedge Fund Conflicts Still Largely Kept Secret") Hey, when did a little conflict of interest by a trusted advisor hurt anyone? It's called breach of fiduciary duty and results in legal consequences!

"'Side-Pocket' Accounts Of Hedge Funds Studied"

"A number of hedge-fund firms are setting up separate accounts to hold certain harder-to-value investments. Now regulators and investors are becoming concerned about whether these accounts, known as "side pockets," are being handled properly and whether they might help some hedge funds to overstate performance. … An accurate value for these investments sometimes can be derived only when they are disposed of, so hedge funds often are slower to put up-to-date valuations on the accounts. Regulators say side pockets are appropriate for investments that are difficult to value or are illiquid, that is, hard to trade, noting that if a fund was forced to place an inappropriate value on these investments, it could penalize a fund's investors. … [R]egulators are expressing some concern that hedge funds might be tempted to store investments with less rosy prospects in these accounts, enabling firms to make their returns look better. … Investors are criticizing at least one large hedge fund. Last September, **Ritchie Capital Management LLC** of Geneva, Ill., which manages $2.8 billion, removed about 20 investments valued at $290 million from its largest hedge fund and put them in a side-pocket account, as part of its expansion into private equity. Some investors are unhappy over how the account is being operated, in part because they can't withdraw from the side pocket. … If these investments hadn't been placed in the side investments, their losses would have cut the gains on Ritchie's flagship fund to about 5%, reducing Ritchie's performance fees and hurting the track record used to attract new investors. … Ritchie executives say it doesn't give details about the side investments to its investors because that would put the firm at a competitive disadvantage." (WSJ, 8/4/06, "'Side-Pocket' Accounts Of Hedge Funds Studied")

"The Private Lives of Hedge Funds"

"Hedge fund managers, let us toast the triumphs and travails of your secretive world as the year draws to a close. Already I can hear some of you yelping. You hate being called secretive. You insist that it is federal laws that prohibit you from talking to the public, and in fact you would like the world to know more about you (except who you are, what you trade and what kind of returns you have generated). ... So let’s hand out the hedge fund awards for 2006. THE HOUDINI AWARD To **Amaranth Advisors** and its founder, **Nicholas Maounis**, for overseeing the evaporation of $6 billion in less than

one week at the hands of a 32-year-old Ferrari-driving energy trader. Amaranth had been a respectable fund; investors loved it for its high returns and energy exposure, until the high returns turned into epic losses and its energy 'exposure' turned out to be a bunch of concentrated bets on the direction of natural-gas prices (bets that did not work out well). Soon after $6 billion went poof, Mr. Maounis tried to pull a rabbit out of his hat. On a brief, carefully lawyered phone call with investors, Mr. Maounis suggested that he intended to win back the trust and faith of his investors. 'We have every intention of continuing in business generating for our investors the same consistently high risk-adjusted returns which have been our hallmark.' Right. THE BETTER-THAN-BARINGS BLOW-UP AWARD Amaranth's energy trader, **Brian Hunter**, blew through more cash in less time at Amaranth than, well, than anyone I can think of. When Nicholas Leeson, a young trader at Barings Bank in Singapore, blew up Barings, he burned through $1.3 billion. When Long Term Capital Management imploded in 1998, its $4.8 billion quickly shrank to $600 million (although enormous leverage magnified the losses and brought the financial system to its knees). Bayou lost $460 million, $100 million less than Amaranth lost on Sept. 14. ... THE BUYER BEWARE AWARD Shakespeare questioned the power of a name and so should investors. **Viper Capital Management**, a fund in San Francisco, has been sued by the Securities and Exchange Commission for fleecing investors out of $5 million. **Pirate Capital**, whose letters to investors discuss 'treasures' and 'shipwrecks' accompanied by matching pictures, suffered a mutiny of talent and disappointing returns (5 percent through November for the flagship Jolly Roger fund). Investors not tipped off by the name perhaps should have been warned by a New York magazine article that featured one of the fund's 27-year-old analysts, a former snowboarding champion, yelling at a chief executive that he was the boss. Capt. Jack Sparrow take heed. ... THE HYPOCRITE'S AWARD For all the talk about wanting to be more open, a lot of you are still secretive. One of you stopped me on my way into your Greenwich, Conn., offices and insisted: 'You were never here, right?' I joked that such metaphysical requests were beyond my abilities. Upon gaining entry into your secret kingdom, you suggested the press was unfair, perhaps even inaccurate, for calling hedge funds secretive. And for that, I award you the hypocrite's award for 2006." (NYT, 12/29/06, "The Private Lives of Hedge Funds")

"Amid Amaranth's Crisis, Other Players Profited"

"When **Amaranth LLC** collapsed in the fall, after swiftly losing more than $6 billion, it was the biggest hedge-fund failure ever. ... Amaranth's case also reflects an incentive structure in the world of hedge funds that can tempt some to assume heavy risk. Typical of hedge funds -- private investment pools for the wealthy and institutions -- Amaranth took 1.5% of investors' assets as a management fee each year, plus 20% of investment gains. This 20% fee is calculated on gains recorded at year end, including gains not nailed down by closed trades. From this take, traders at many firms, such as Amaranth, are given bonuses that are largely theirs to keep, even if the paper gains later shrink or vanish. 'This results in a huge incentive for taking risk,' says **Luis Garicano**, a University of Chicago business school professor. 'When the bet goes well, the hedge-fund manager collects a lot, while when it goes badly the worst that can happen to the loser is he gets zero.' At Amaranth, star energy trader Brian Hunter won an estimated $75 million

bonus after his team produced a $1.26 billion profit in 2005. Like many others at the fund, he had to keep about 30% of his pay in the fund. The fund's chief risk officer, Robert Jones, got a bonus of at least $5 million for 2005, say people familiar with the bonuses. Nicholas Maounis -- founder, majority owner and chief executive of the Amaranth management firm -- got an estimated $70 million cut of 2005 management fees, plus some of Amaranth's $200 million-plus in performance fees. He kept much of his compensation in the fund. ... The 32-year-old Mr. Hunter's specialty was natural-gas futures -- contracts for delivery on a future date -- and options. This is a highly volatile market, where the price can move swiftly on changes in gas available in storage and shifts in the weather --- or weather forecast. ... His business in tatters, Amaranth's Mr. Maounis, 43 ... stepped down as the firm's chief. ... Mr. Hunter ... is now talking about launching a hedge fund of his own. Mr. Maounis also is exploring starting a new hedge-fund business. ... How much the investors in Amaranth will lose depends on when they got in. They've gotten back about $1.6 billion to date. For one investor that came in in mid-2005, money returned so far comes to 27% of what it put in and about 18% of what its stake was worth at the peak." (WSJ, 1/30/07, "Amid Amaranth's Crisis, Other Players Profited")

"Amaranth investors suggest dropping legal claims"

"Some investors in **Amaranth Advisors** LLC have proposed dropping legal claims against the collapsed hedge fund firm, arguing that the move would help them get what's left of their money back more quickly. Meanwhile, **Brian Hunter**, the former Amaranth trader who lost billions of dollars trading natural gas, is trying to start a new hedge fund firm called **Solengo Capital**.... Investors could either relinquish potential litigation claims against the firm's funds, which would free up more cash to return to investors. Or they could maintain their right to pursue litigation, which would require Amaranth to maintain "significant" reserves to pay future legal expenses.... Amaranth, a multistrategy hedge fund with $9.2 billion in assets at the end of August, lost more than $6 billion in September after massive natural-gas bets went awry. The collapse is now considered the largest in the history of the hedge fund business and the firm has been sued by several investors. ... **Karl Koster**, another former Amaranth employee, will design and run Solengo's risk management software.... [S]olengo plans to charge a 2% annual management fee and take 20% of annual profits." (3/23/07, MarketWatch, "Amaranth investors suggest dropping legal claims") One might take interest in the part of Solengo's selling memorandum that describes the principals' working histories.

"San Diego pension fund sues Amaranth"

"A San Diego County pension fund overseeing the retirement benefits of roughly 35,000 people sued Amaranth Advisors LLC, accusing the collapsed hedge fund of securities fraud. ... The $7 billion **San Diego County Employees Retirement Association** (SDCERA) invested $175 million in Amaranth. ... SDCERA filed the complain on Thursday against Amaranth Advisors, (Amaranth Founder Nick) Maounis, former trader Brian Hunter, Chief Operating Officer **Charles Winkler**, and Chief Risk Officer **Robert Jones**. The pension fund alleged securities fraud and argued that

Amaranth collapsed because of 'unbridled speculation in natural gas futures that was directly contrary to statements made to SDCERA that Amaranth would be diversified and risk controlled,' according to a statement on its Web site. ... SDCERA's complaint centers on whether Amaranth informed investors properly that it was taking such big bets and if the firm took enough steps to control risk. 'We invested in Amaranth because Mr. Maounis and the other officers of Amaranth told us that a team of highly experienced professionals would carefully manage our pension funds,' David Myers, chairman of SDCERA's Board of Trustees, said in a statement. 'Instead, as we state in the suit, they turned our money over to Mr. Hunter, who in my opinion was an absentee rookie trader located thousands of miles from Amaranth's office,' he added, referring to Hunter's move from Amaranth's Greenwich, Conn. headquarters to Calgary in Canada before the collapse. SDCERA's suit alleges that Hunter made 'bet-the-fund' natural gas investments that were more concentrated, volatile, leveraged, and illiquid than represented, the pension fund explained. ... Amaranth has hired David Boies to help defend the suit. Boies is a famous trial lawyer...." (3/30/07, MarketWatch, "San Diego pension fund sues Amaranth") SDCERA members might wish to inquire in to the due diligence exercised by the Board of Trustees upon making a $175 million investment of their funds in Amaranth. What are the duties of a "Chief Risk Officer" at a hedge fund?

"Hedge fund asset pricing is a crucial issue"

"The valuation of hedge fund assets has risen from nowhere to become a hot-button issue. How to value illiquid instruments is occupying minds inside and outside the industry. ... This sudden focus is recognition that valuation of the increasingly complex assets used by hedge funds is a big issue for investors. Incorrect valuations can mean investors pay too much for units in a fund, lose out when they sell, or pay too much to managers in performance fees. ...[T]here has been a proliferation of sophisticated strategies in recent years that have required advanced valuation techniques. These techniques are required primarily for over-the-counter derivatives, which are illiquid and therefore not easily priced. Instruments include collateralised debt obligations, credit default swaps, total return swaps and mortgage derivatives, all of which have grown enormously in popularity. ...[V]aluation is not an exact science. The vast majority of bonds and derivatives do not trade on exchanges. Therefore, data vendors have developed and refined complex computer models to generate artificial best estimates, or fair values, of bond prices. Vendors' techniques vary depending on the type of security being priced. Commoditised pricing, including investment grade corporate, municipal and government bond prices, is generally calculated using a computer model with little or no manual intervention. Complex and illiquid issues are typically hand-priced, involving an evaluator calling the desk of a broker-dealer that makes a market in the security (ideally the primary dealer). Mortgage-related products are often priced using models with analytical data and dealer quotes as inputs. Vendors will often incorporate actual trade data into the models and adjust the model prices in line with any visible trades in the market. This process is clearly far from straightforward. ... It is easy to imagine a situation where a valuation problem remains undiscovered for years, substantially affecting net asset value." (FT, 5/28/07, "Hedge fund asset pricing is a crucial issue")

"In Canada, a Fund's Messy Downfall"

"For thousands of average investors lured by the sizable returns on hedge funds, **Boaz Manor** and his colleagues seemed to offer a chance to enter a world normally open only to the rich. The outcome now looks like a cautionary tale for small investors seeking to tap hedge-fund riches. According to Canadian authorities, the 33-year-old Mr. Manor was a founder and principal of the **Portus Group**, a Toronto-based collection of investment entities that offered an appealing product. For as little as $5,000, a person could buy into an investment vehicle that supposedly guaranteed the investor's principal while putting some of the money into a collection of hedge funds that could provide a healthy return. Between 2003 and 2005, Portus attracted about $700 million from roughly 26,000 individuals, mostly Canadians. ... In early 2005, however, Portus collapsed.... [D]uring court-ordered questioning in Israel by the receiver, Mr. Manor denied wrongdoing, saying he merely worked at Portus and didn't control the operation. ... But with all the news coverage given hedge funds and their sometimes outsized returns, regulators worry that average investors might be lured in by unscrupulous operators. Last year, for instance, **Keith Gilabert**, a Valencia, Calif., hedge-fund operator, pleaded guilty in Los Angeles federal court to conspiracy to commit fraud in connection with raising some $7 million from more than 40 investors. Federal prosecutors said Mr. Gilabert stole funds and lied about his investment track record. He is awaiting sentencing. Mr. Gilabert's lawyer declined to comment. ... The Portus arrangement in Canada was similar in some respects to a fund of hedge funds. Mr. Manor and a colleague formed Portus in 2003 and registered with Canadian regulators. Portus offered an investment package that included a complex combination of bank notes, stocks and options with returns tied to a group of hedge funds.... Portus paid referral fees of 4% or more to agents who sent it customers, the commission said. ... [A]bout $150 million of client funds were 'diverted' for improper purposes, such as running Portus and paying referral fees to agents who brought in customers, the receiver's report said. ... In the Portus case, the search for funds continues, including the $8.8 million the receiver says went to buy diamonds. The recent receiver's report said that the stones were supposedly kept for a time in a safe-deposit box in a Hong Kong bank. Everyone questioned, including Mr. Manor, denies knowing where the diamonds are." (WSJ, 6/11/07, "In Canada, a Fund's Messy Downfall") Investors might seek recovery from a fiduciary that received 4% for a referral, if there was a failure to disclose the payment.

"Bear's Fund Is Facing Mortgage Losses"

"A hedge fund (**High-Grade Structured Credit Strategies Enhanced Leverage Fund**, together with a sister fund) managed by Bear Stearns Cos. is scrambling to sell large amounts of mortgage securities, a setback for a Wall Street firm known for its savvy debt-market trading. The fund makes bets on bonds backed by mortgages, many of which are subprime, meaning they go to especially risky borrowers. ... The Bear fund, which was down 23% in value in the year through April, has more than $6 billion in assets. ... Bear isn't alone. Early last month, the Swiss bank UBS AG shut down **Dillon Read Capital Management**, an internal hedge fund, after bad trades in mortgages led to a $124 million loss. **...** The Bear fund, only 10 months old, is highly levered.... [T]he fund

quickly raised more than $600 million in investments, much of which was put toward the purchase of mortgage-backed securities. Combined with around $6 billion in borrowing from a dozen major Wall Street players ... it has assets in excess of $6 billion. ... The sister fund, which uses less leverage, was launched four years ago and goes by a similar name, **High-Grade Structured Credit Strategies Fund**. A person familiar with the situation said the fund is liquidating positions to free up cash for redemptions and to prepare for likely margin calls. A margin call is when a bank asks for repayment of its loans or more collateral as its borrowers' investments fall in value. Last month, Bear blocked some investors from taking money out of the fund. ... The latest mortgage woes seem to be hitting the broader market. ... 'There are concerns about investment vehicles that are seeing negative returns because of their subprime exposure,' said Alex Pritchartt, a mortgage-derivatives trader at UBS Securities. 'If some funds try to liquidate their portfolios and sell large blocks of securities, it could cause a backup in prices and spreads.'"(WSJ, 6/14/07, "Bear's Fund Is Facing Mortgage Losses")

"A 'Subprime' Fund Is on the Brink"

"Concerned that an internal hedge fund at **Bear Stearns** Cos. wouldn't be able to meet a margin call, **Merrill Lynch & Co**., one of the fund's biggest lenders, seized $400 million of its assets and is preparing to auction them off. The auction, in the coming week, could trigger the fund's dissolution -- the second blowup in recent months of a hedge fund that made dicey bets on the market for risky home loans, known as subprime mortgages. ... [T]he Bear fund's managers, led by bond-sales veteran Ralph Cioffi, scrambled Thursday and Friday to sell hundreds of millions of dollars in bonds to satisfy demands for cash and assets from creditors and stave off liquidation. ... Merrill opted not to wait ... circulating a list of securities that had served as collateral, or security, for the credit it had extended to ... **High-Grade Structured Credit Strategies Enhanced Leverage Fund**. ... The seizure by Merrill -- which could spur other lenders to seize fund assets -- may well mean the end of Mr. Cioffi's two funds. ... In the earlier blowup, in May, **UBS** AG shut down **Dillon Read Capital Management** after bad trades in subprime-mortgage loans led to a $124 million loss. The latest auctions have been watched closely by Wall Street. Especially concerned are other hedge funds that may be forced to lower the value of their own assets if the Bear sale fetches bids that are well below what the fund says they are worth. ... Built on about $600 million in investor capital, $40 million of which came from Bear and a group of firm executives, the fund had borrowed at least $6 billion in additional capital from a dozen Wall Street lenders, say people familiar with the matter, including Merrill, **Goldman Sachs Group** Inc., **Bank of America** Corp. and **Deutsche Bank** AG. ... During April, the leveraged fund began falling sharply. Its bearish bets on subprime securities had created paper losses, and some investors were getting antsy and asking to redeem their cash.... After getting wind of the redemption requests, some of the firms that had sold subprime securities to the fund asked to revalue them at a lower level.... By the end of the month, the leveraged fund had fallen 23% for the year. Mr. Cioffi's team froze the redemption requests, hoping to stabilize the fund, and began selling off billions of dollars in its most valuable assets from both the leveraged and the less-risky funds." (WSJ, 7/16/07, "A 'Subprime' Fund Is on the Brink")

"County Retirement Fund Knew the Risks, Says Hedge Fund Executive"

"In March, the **San Diego County Employees Retirement Association** filed legal action against Amaranth seeking $150 million to cover the lost funds plus damages. Earlier this month, Connecticut-based **Amaranth Advisors** filed a motion to dismiss the county fund's lawsuit, stating the hedge fund's disclosure documents clearly state the risks involved and stating that county officials signed documents acknowledging those risks. ... Brian White, chief executive officer for the retirement association, said the disclosure documents do not absolve Amaranth from outright lies about how the hedge was managed. ... In its motion to dismiss, Amaranth refers to many examples in its agreement with the retirement association that the investment carries significant risks. The agreement signed by the county fund states, 'The fund is a speculative investment that involves risk, including the risk of losing all or substantially all of the amount invested.'" (San Diego Business Journal, 6/18/07, "County Retirement Fund Knew the Risks, Says Hedge Fund Executive")

"Two Big Funds At Bear Stearns Face Shutdown"

"Unlike stocks and Treasury bonds, whose prices are continually quoted and easily obtained, many of these derivative instruments trade infrequently and don't have clear market prices. To come up with market values for these investments -- a process known as 'marking' their positions to market -- investment funds often rely on their own valuation models. ... There is no indication that Bear Stearns's fund managers sought to mislead lenders or investors about the value of the funds. Indeed, the firm's approach to valuing its securities seems to be in line with guidelines set up by Moody's Investors Service, which evaluates hedge-fund practices. But the crisis does point to the kinds of valuation problems hedge funds and their investors or lenders can run into, even when they follow sound practices. ... The issue of pricing has plagued the hedge-fund industry for several years. In 2004, the Securities and Exchange Commission accused four men involved in running Beacon Hill Asset Management LLC of intentionally shading the value of their own investment in mortgage backed bonds to inflate the value of their portfolio when reporting returns to investors. ... For hedge funds, the incentives to abuse the murkiness of the market can be huge, because they are compensated by fees based on the values of their portfolios. 'Hedge funds have the incentive to mark their positions more favorably because their compensation is tied to those marks,' says one senior Federal Reserve official. 'No one in the subprime business wants to ask the question of whether they need to re-mark all the assets. That would open the floodgates,' said Janet Tavakoli, president of Tavakoli Structured Finance, a consulting firm in Chicago. 'Everyone is trying to stop the problem, but they should face up to it. The assets may all be mispriced.'" (WSJ, 6/20/07, "Two Big Funds At Bear Stearns Face Shutdown")

"Bear Stearns Bails Out Fund With Big Loan"

"Bear Stearns Cos.'s dramatic decision to lend as much as $3.2 billion to one of its two troubled hedge funds staves off the risk of a fund collapse that could have damaged its position as a major Wall Street bond player -- and had the potential to ripple

through a jittery subprime-mortgage market. ... [T]hey worried as well that a liquidation of the funds -- which invested heavily in subprime-mortgage assets -- risked igniting a broader panic in the mortgage-bond market. ... [A] lot of firms are deeply invested in the subprime sector.... Bear may have prevented a wider meltdown -- and kept many of the subprime bonds from plunging in value in a fire sale. ... Firms that loaned money to the hedge funds to make additional investments ... spent much of the week testing the market's appetite for the mortgaged-backed assets in the fund, which they held as collateral. The results were mixed. Some assets were scooped up at or near asking prices, but others received offers of 50 cents on the dollar or less, which left some of Bear's lenders holding hard-to-sell assets. Bear's rescue attempt might not end the turmoil in the market. The future of both funds remains in some doubt. ... Though subprime mortgages are highly risky, Wall Street carves CDOs into pieces so that some investors can take on more risk than others. The Bear hedge funds took on many less-risky pieces. They also borrowed heavily, which helped to enhance their returns on those less-risky pieces. ... Merrill put up its $850 million in collateral for sale, seeking bids from a wide range of investors. When the bids came in late Wednesday, many of them were significantly below prices that Merrill was willing to sell the securities at. The bank ended up offloading only a fraction of the assets.... With the funds' standing deteriorating, Bear also saw an opportunity: come in with a larger loan to prevent a fire sale of their assets. Such a move could help stabilize the assets' perceived value and prevent widespread markdowns of similar securities that would hurt Bear and others." (WSJ, 6/23/07, "Bear Stearns Bails Out Fund With Big Loan") How owns the non-"less-risky pieces"? What impact will this all have upon marketing-to-market CDOs in all hedge funds?

"When Models Misbehave"

"Although Bear Stearns announced on Friday that it would shore up one of its two faltering hedge funds that are heavily exposed to the subprime mortgage mess, the move did little to instill confidence in an already fearful market. ...[Q]uestions continue to swirl around the implosion of the funds, how they could have lost so much value in such a short time and why the firm's risk management professionals seem to have been AWOL in recent months as subprime mortgage loans plummeted in value. ... [T]he **Bear Stearns High Grade Structured Credit Enhanced Leveraged** fund ... was a sort of steroid-laced version of its sister fund because it used considerably more leverage. Bear Stearns has decided to abandon that fund for dead. There are a couple of lessons in this. ... First, marking illiquid securities to a model that makes certain assumptions about their future behavior is not the same thing as marking to an honest-to-goodness market of buyers and sellers. ... In worst-case scenarios, such models may reflect the fantasy that a firm's principals prefer, not the reality of a security's likely value. And yet, investors and financial firms everywhere are relying heavily on these models and building their balance sheets accordingly.... What does this mean in cold, hard cash? ... [A] Credit Suisse analyst estimated that the markdowns would likely be in the billions of dollars. That brings us to our second lesson ... the rating agencies, which investors rely on to be prescient cops on the beat, are stunningly behind on downgrading mortgage-backed securities and the pools that own them. ... 90 percent of the fund consisted of securities with AA or AAA ratings, according to the investor. Officials at ratings agencies have said

in the past that their ratings reflect their estimates of future performance, not market pricing. So the agencies are also marking to model. ... Another bit of reality is setting in ...values of securities higher up in the capital structure of these asset pools will likely take a hit. The Bear funds unwound as quickly as they did partly because of a surprisingly close correlation between lower-rated slices of these pools and higher-rated ones, according to people who have seen the portfolio. The bad performance is bleeding upward." (NYT, 6/24/07, "When Models Misbehave")

"Everyone a loser in hedge fund saga"

"About 175 investors and seven creditors have claimed $137 million in losses from West Palm Beach hedge fund **KL Group,** whose partners face civil and criminal charges ranging from fraud to money laundering. A court-appointed receiver, who is trying to track down the tens of millions still unaccounted for, has recovered about $4 million. ... So far investors have been paid just one cent for each dollar of losses. ... KL, a group of hedge funds that attracted investments through sales pitches made at fancy Palm Beach social events, was raided by Securities and Exchange Commission examiners in February 2005. ... The SEC, in a civil suit, alleged that **John Kim**, his brother **Yung Bae Kim** and **Won Sok Lee** engaged in a 'massive' fraud. Yung Bae Kim and Lee disappeared right after the raid. ... KL allegedly bragged about triple-digit annual investment returns while suffering big losses. ... KL operated like a Ponzi scheme, in which money to pay some investors comes from other investors' accounts." (South Florida Sun-Sentinel, 6/24/07, "Everyone a loser in hedge fund saga") Willie "the actor" Sutton said that a thief has to go where the money is --- Palm Beach.

"Wall Street Fears Bear Stearns Is Tip of an Iceberg"

"The near-meltdown of two hedge funds at investment bank **Bear Stearns** Cos. last week underscored -- and in some ways aggravated -- a growing fear on Wall Street: that hard-to-trade investments may suddenly turn south and set off a broader market downturn. ... Fund managers have broad discretion in attaching a value to these assets, and often don't reveal many details of their trades. ... Many hedge funds and other institutions are paid in part on performance, so it is often in their interest to price, or 'mark,' their assets aggressively, attaching the highest possible value to them. The higher the value, the more compensation the fund manager receives from the fund's investors. ... [B]ecause illiquid assets don't trade regularly, marking to market -- or using recent sales prices to determine an asset's value -- may not be possible. In these cases, a fund manager may instead use a mathematical model to value an asset, a practice called marking to model. ... The Bear Stearns funds' situation demonstrates the considerable leeway funds have in valuing illiquid assets. The Enhanced Leverage Fund reported last month that it lost 6.75% of its value in April, but later put that loss at a far steeper 18%. One reason the Bear Stearns funds' troubles worry Wall Street is the fear that other players own similar securities that have similarly been mispriced." (WSJ, 6/25/07, "Wall Street Fears Bear Stearns Is Tip of an Iceberg") There are "mathematical models" and there are mathematical models." Could those models become the legal Achilles heal of hedge funds? Did hedge funds make the kinds of disclosures necessary to explain the process

fully? How did a hedge fund's models differ from those of other hedge funds for the same type of investments? How would BS and others explain rapid reporting corrections? Would access to initially correct data have made a difference since investors were locked-in to investments for lengthy periods?

"A Stock Filing Gone Awry for Bear Stearns"

"Early in May, as Bear Stearns executives scrambled to meet redemption requests from clients in two troubled hedge funds, a money management company affiliated with the Wall Street firm filed its intention to sell $100 million worth of shares to public investors. Among the assets of the management company, Everquest Financial, were $550 million of debt securities.... substantially all the assets in its $700 million portfolio had been bought from the **Bear Stearns High-Grade Structured Credit Enhanced Strategies Fund** and the **High-Grade Structured Credit Strategies Enhanced Leveraged Fund**. ... Yesterday afternoon, Everquest withdrew its offering, which was in the earliest stages. ... Had the filing gone through, Bear Stearns could eventually have sold its $400 million stake in Everquest.... (and) would have allowed the Bear Stearns funds to eliminate some of their exposure to the high-risk mortgages. ... Wall Street has been buzzing about the timing of the Everquest equity offering in particular because the Bear Stearns funds had encountered losses and redemption requests well before the filing appeared. ... An analyst at Portales Partners, Charles Peabody, said in a note to clients last week that Everquest appeared to be an investment vehicle used in part 'as a way for Bear Stearns to offload some of its own mortgage exposure.' ... [I]n the bull market for risky-debt investing, potential conflicts of interest on Wall Street were presented as beneficial to investors. Bear Stearns was central to the creation of Everquest... In addition to selling securities to Everquest, Bear Stearns was to serve as lead underwriter of the stock offering, collecting lucrative fees. ... The new company was to be run by ... **Ralph R. Cioffi**, a senior managing director at Bear Stearns who also oversaw the troubled hedge funds. ... [E]verquest began operation in September and paid almost $548.8 million to buy 10 collateralized debt obligations from the Bear Stearns hedge funds. ... When Everquest acquired collateralized debt securities, the filing said, the assumptions it used for the performance of the assets were based on projections made by the organizations that put the debt pools together. ... The relationship between Bear Stearns and Everquest did raise questions about whether the new company overpaid for the securities it purchased from the Bear Stearns hedge funds, the prospectus noted. 'The consideration given by us in exchange for these assets was not negotiated at arms-length and may exceed the values that could be achieved upon the sale or other disposition of these assets to third parties,' it said." (NYT, 6/26/07, "A Stock Filing Gone Awry for Bear Stearns") Who were the "organizations that put the debt pools together" and did they have an incentive to enhance the "projections"?

"Galvin slams UBS for hedge perks"

"**UBS Securities LLC**, the investment banking unit of Swiss banking giant UBS AG, was today accused by Massachusetts regulators of 'dishonest and unethical' practices in dealings with hedge fund advisers. The firm allegedly gave hedge fund advisers

below-market rent, low-interest personal loans, tickets to sporting events, meals and other gifts to induce and maintain business, **William Galvin**, the secretary of the commonwealth and the state's top securities regulator, said in a statement. ... The complaint, filed with the Massachusetts Securities Division, seeks a censure, cease and desist order and an undisclosed administrative fine, the statement said." (InvestmentNews, 6/27/07, "Galvin slams UBS for hedge perks")

"A Mortgage-Securities Hedge Fund Suspends Payouts"

"In another sign that troubles in the mortgage market are spreading, a prominent hedge fund that specializes in bonds backed by home loans has suspended redemption requests by investors. The **Horizon ABS Fund** managed by **John Devaney**, a well-known trader of asset-backed securities who is based in Florida, said yesterday that it made the decision to block withdrawals after one investor who accounted for about a quarter of its $650 million in assets sought to leave the fund. ... The fund's borrowings stand at about one and half times its assets, considerably below the 10 times leverage used by one of the two Bear Stearns funds.... The Horizon fund allows investors to redeem their stakes in the fund once a quarter with 90 days' notice, a common practice among hedge funds. ... United Capital said it suspended redemptions because it did not want to be forced to liquidate its holdings at a time when the market for such securities was depressed. ... At 37, Mr. Devaney has established a reputation as a shrewd buyer of distressed bonds. His lavish parties at industry conferences have earned him a measure of celebrity in the world of structured finance. At an industry conference early this year, he seemed to predict a collapse in the market for securities backed by mortgages to people with weak, or subprime, credit." (NYT, 7/4/07, "A Mortgage-Securities Hedge Fund Suspends Payouts") And, how are the "assets" valued in determining the leverage ratio? "Seemed to predict" means what?

"Funds Accelerate Subprime Exit Strategy"

"Two hedge funds that invest in subprime mortgages have run into trouble, with one shutting down and a second stopping investors from withdrawing their cash. Investors received a letter earlier this week from **Braddock Financial Corp**. of Denver. It said it was closing its **Galena Street Fund**, which mainly invests in bonds backed by subprime mortgages extended to borrowers with poor credit, and suspending redemptions until it can sell assets in the roughly $300 million fund. ... More hedge-fund troubles are expected to surface in the coming weeks as funds report their second-quarter performance to investors. Some firms may feel additional pressure from lenders to provide more collateral to back the leverage, or borrowings they've taken on, as the value of existing collateral falls in value. ... Prices have been depressed by investors 'flooding the market' with asset-backed securities, the Galena letter said. 'In addition to technical weakening in the market, many [asset-backed] securities continue to perform poorly. As a result, Wall Street has taken what we believe to be a very conservative approach to pricing and leveraging of securities, further dampening liquidity.' Galena had barely any leverage, according to the letter. It had also begun accumulating significant 'short' positions -- betting that its own investments would decline. So, if an investment moved in one

direction, it would be hedged in the other direction. 'Thus, we're not forced to involuntarily sell securities to meet margin calls,' the letter said. At first, the hedging strategy paid off. Last year, Galena posted about 7% in profits. This year, losses were probably mitigated by the hedging, investors say. But it still lost about 3%. In June alone, it lost from 4% to 8%. (WSJ, 7/5/07, "Funds Accelerate Subprime Exit Strategy")

"Fugitive Banker Caught in Austria"

"The five-year manhunt for a banker whose U.S. fund lost $400 million when he bet against the Internet stock-market bubble in the late 1990s ended Friday when he was caught in Austria, police said Monday. **Michael Berger**, an Austrian citizen who pleaded guilty to charges of securities fraud in a Manhattan court in 2000 and then became a fugitive in March 2002, was arrested while driving toward Salzburg. ... Mr. Berger, who is now 35 years old, launched his **Manhattan Investment Fund** hedge fund in 1996. The fund suffered enormous losses when Mr. Berger bet against technology and Internet stocks between 1996 and 1999 as their prices were skyrocketing. His fund went bust in January 2000, just two months before the Internet stock-market bubble burst in March 2000. In the 1990s, Mr. Berger raised more than $575 million from investors by overstating the performance and market value of the hedge fund's holdings.... Mr. Berger admitted in his guilty plea that he sent out misleading statements to investors in his fund between 1996 and 2000 when the market turned against him. He tried to withdraw his plea a year later, alleging he had been mentally incompetent at the time he admitted guilt. A judge dismissed his motion and ruled there was no evidence he was incompetent to plead guilty. Mr. Berger was free on bail pending his sentencing but failed to show up at a court hearing on March 1, 2002. He has been on the run since then. As an Austrian citizen, Mr. Berger can't be extradited to the U.S., where he would face as much as 10 years in jail and fines of at least $1.25 million plus restitution." (Reuters, 7/10/07, "Fugitive Banker Caught in Austria")

"Subprime Uncertainty Fans Out"

"Wall Street firms yesterday circulated at least a dozen lists of subprime-related bonds they planned to hastily sell to investors. Some of the assets were from a fund managed by **Basis Capital**, a large hedge-fund manager based in Australia, and were put on the block by Citigroup Inc. and J.P. Morgan Chase & Co., according to people familiar with the matter. **Basis Yield Alpha Fund** last week informed its investors it had lost around 14% in June. Another fund, called Basis Pac-Rim Fund, was down 9.2% that month. Basis said the declines came after bond dealers abruptly marked down the value of the securities, which it said were 'otherwise fundamentally sound.' ... 'Right now things are starting to come unglued,' said Charles Gradante, co-founder of hedge-fund consultant **Hennessee Group**. The net value of assets in Bear's highly indebted fund, High-Grade Structured Credit Strategies Enhanced Leverage Fund, is wiped out.... The net value of assets in its other, larger, less-leveraged fund is roughly 9% of the value at the end of March.... In March, before their sharp losses, the enhanced-leverage fund had $638 million in investor money, while the other fund had $925 million. The funds' net values, which took more than two weeks to calculate because of the fluctuating values in

the market for risky, or subprime, mortgage securities, came amid another tumultuous day for the broader mortgage market. The ABX index, which tracks the performance of various classes of subprime-related bonds, hit new lows yesterday. In the past few months, the portions of the index that tracked especially risky mortgage bonds with junk-grade ratings had been falling. But now, the portions of the index that track safer mortgage bonds, with ratings of triple-A or double-A, are also falling sharply." (WSJ, 7/18/07, "Subprime Uncertainty Fans Out")

"Bruised Bear hedge fund investors mull legal action"

"Some aggrieved investors are turning to lawyers to pursue possible legal claims stemming from losses at two Bear Stearns Cos. hedge funds that were virtually wiped out from large, illiquid bets on risky mortgages. ... Bear Stearns said in a letter to clients on Tuesday that there was 'effectively no value' left for investors in its High-Grade Structured Credit Strategies Enhanced Leverage Fund and 'very little value' remaining in the High-Grade Structured Credit Strategies Fund. ... CNBC reported on Wednesday that Bear Stearns had hired several outside law firms as it braces for investor litigation. It said the Wall Street firm had hired WilmerHale to represent it before the U.S. Securities and Exchange Commission and shareholders, another to represent the board of directors and audit committee and another to represent the funds themselves. ... Legal experts say ... plaintiffs could have a tough time proving their case. Because the funds were aimed at sophisticated investors such as institutions and wealthy clients, it could be hard to argue that the risks were not properly defined." (Reuters, 7/18/07, "Bruised Bear hedge fund investors mull legal action") There are some interesting trial techniques that might be used. An investor's attorney might obtain actual documentation on one of the subprime loans in the package, show it to the hedge fund's manager and ask him/her to explain how packages of such garbage was foisted upon investors. An investor might be asked what risks he/she was assuming to achieve such high interest yields when federal funds were paying around 5% per annum. The judges/arbitrators may resolve the issue with a pox upon all houses.

"Australian Fund Catches U.S.'s Subprime Flu"

"For a sign of how far Wall Street's subprime problems have spread, you can't get much further than Sydney, where one of Australia's largest and most prominent hedge funds is in crisis after its investments related to U.S. mortgages went sour. **Basis Capital Funds Management Ltd.**, which had nearly $950 million in assets under management as of May, was founded in 1999 by two veterans of Asian finance. Basis is one of the leaders of the hedge-fund boom sweeping Australia, which has become the biggest center for such funds in Asia. Two Basis funds invested in instruments related to U.S. subprime mortgages posted steep losses last month, prompting Basis to restrict investor withdrawals. The firm has appointed accounting firm Grant Thornton LLP to help it restructure as creditors press for repayment of loans. Citigroup Inc. and J.P. Morgan Chase & Co. earlier this week moved to sell some Basis assets, including subprime-related bonds used as collateral for loans, according to people familiar with the matter. ... When Basis investors sought to withdraw their funds, the firm was unable to quickly sell

enough assets, some of which were illiquid or trading at big discounts, to cover those redemption demands.... In the past few years, the ranks of Australian hedge funds and assets under management have rocketed. ... Australia allows retail investors to invest in the funds, which in many other places are restricted to wealthy individuals or institutional investors. ... About 60% of Basis Capital's investors were from overseas and about 40% were domestic investors, including Australian pension funds...." (WSJ, 7/20/07, "Australian Fund Catches U.S.'s Subprime Flu")

"Barclays Spars Over Its Losses at Bear Stearns"

"Signaling the frustration among investors who were hurt by bad bets on the risky subprime-mortgage market, **Barclays** PLC is sparring with **Bear Stearns** Cos. over a loss that could be as high as $400 million, according to people familiar with the matter. ... London-based Barclays, one of the world's biggest banks, wore several hats in its dealings with Bear Stearns Asset Management's High-Grade Structured Credit Strategies Enhanced Leverage Fund.... Firms like Barclays and Bear not only compete for some of the same business, but behind the scenes they also extend one another credit, team up for private-equity investments, and, in the case of Barclays, put its own money -- or that of investors using Barclays' products -- into a Bear hedge fund. ... Barclays is reviewing its options for recovering $400 million that it invested in the fund separately from the loan... The possibilities: arbitration, or a negotiated settlement, or litigation. ... [B]ear's hedge funds weren't the only ones looking for outsize returns. Outside investors in the more-leveraged fund were also trying to juice returns, in some cases by adding leverage to their Bear fund investments. For instance, an investor might have liked Bear's pitch but wanted even higher returns than the ones that were promised. To increase the potential upside, that investor could pair his or her $50 million with $50 million from a bank. The investor would pay the bank a fee, and the bank, in turn, would invest the $100 million in the fund, allowing the investor to benefit as if he or she had initially put in $100 million. To protect investors who used such a strategy, Barclays imposed certain investment restrictions on Bear. The restrictions ranged from limiting the number of noninvestment grade holdings that the fund could buy, to curbing the fund's exposure to collateralized debt obligations, securities backed by pools of mortgage loans, and asset-backed securities. But according to people familiar with the situation, some of those restrictions were breached by the Bear fund." (WSJ, 7/21/07, "Barclays Spars Over Its Losses at Bear Stearns") Some investors will claim that they were not fully informed as to the investments or that the information with which they were provided was false. They will have to show actual "reliance" and that their reliance, if any, was "reasonable." Many have advisors, who advised them to invest. Did they actually rely upon their advisors and not the information, if any, provided by the hedge funds? Did those advisors have undisclosed conflicts of interest?

"Subprime Woes Push Up Bonds, Clip Hedge Funds"

"Fallout from the turmoil in subprime mortgages caused investors to sell off risky bonds, shun some new junk offerings and drive up Treasury prices Friday. Several hedge funds got caught in the downdraft, reporting losses. **Y2K Finance Inc.**, a $2 billion

London-based hedge fund, said its investments dropped 7.3% in June, according to a letter it sent investors. The fund blamed price drops on its holdings of U.S. subprime assets. ... **[O]ld Hill Partners Inc.**, a $700 million Darien, Conn., hedge fund, was down 8.2% this year through May, according to people close to the matter. ... The hedge-fund troubles follow difficulties in markets for all kinds of risky debt, from subprime mortgages to junk bonds. ... Shares in **TRIO Finance Ltd.**, a London-listed fund managed by Wharton, lost 20% of their value on the week. ... TRIO, at its last portfolio update in May, said about 22% of its holdings were in U.S. residential mortgage-backed securities as of March 31." (WSJ, 7/21/07, "Subprime Woes Push Up Bonds, Clip Hedge Funds") Of course, sophisticated, non-greedy, investors would only reward the brightest of the bright with that 20%. To what level of risk would more than 6,000 of the smartest guys in the room have to take to obtain returns that justified a reward of 20% of the "profits"?

<u>"Hedge fund burns Vic teachers' superannuation"</u>

"In the coming days the full-scale crisis at **Basis Capital's Yield Fund** will become clear. Already most people know the $1 billion Sydney-based group is in deep trouble and unable to repay many investors their full funds. What most people have not twigged is whose money these guys were playing with. A quick look at the register of the top 20 shareholders at the Basis Capital Yield Fund throws up not investment banks or high-rollers but funds linked with schools and hospitals. High on the list of casualties is the Combined Fund, the superannuation fund for teachers in private schools in Victoria which has $21 million in the fund. ... It's difficult to believe these definitive "long-term" funds have money in hedge funds. ... The CEO of the Princess Margaret Children's Hospital Foundation, Vern Reid, said he was reviewing the decision process that led to his relatively small fund — $17 million against the Combined Fund's $430 million — placing money into hedge funds. Mr Reid says the charter of his hospital foundation is to invest in 'blue chip, conservative investments'. Well, it might just be time for superannuation funds and every other fund that manages other people's money to sober up and stop fooling themselves that any fund which uses 'hedge fund' investing is a blue-chip investment. Hedge funds gamble on derivative markets that future prices will align with their bets. It's gambling. Westscheme, a superannuation fund that came first place in the entire superannuation industry in 2006, says it has hedge funds 'as a defensive mechanism'. Get serious: a good defensive mechanism is to take no risk — put some money into cash. ... There's nothing wrong with hedge funds per se. Just like there's nothing wrong with chainsaws or V8 sports cars — you just don't give them to the wrong people. Basis Capital were the wrong people to be managing fund money for schools and hospitals. But then again the ratings agency Standard and Poor's had voted Basis Capital one of its fund managers of the year for 2007. You can't be too careful." (The Age, 7/22/07, "Hedge fund burns Vic teachers' superannuation") There may be lawsuits brewing against those holding fiduciary positions! However, their individual pockets may not be deep.

"Mr. Vranos Has a Deal for You"

"Hedge fund managers are not short on chutzpah, as a rule. But it takes a special kind of cheek to ask investors at this very tender moment in the housing market for $750 million to fund a new company specializing in subprime residential mortgage loans. **Michael W. Vranos**, celebrity bond trader and founder of **Ellington Management**, has that audacity. .... Mr. Vranos oversees $5.4 billion in hedge funds and private accounts, and an additional $1.2 billion in a managed account, while also managing almost $23 billion in collateralized debt obligations (pools of loans backed by assets like home loans or credit card debt). ... [M]r. Vranos is also peddling shares in a new entity called **Ellington Financial LLC**. ...[I]t is a private placement aimed solely at institutional investors, like pension funds and insurance companies. ... On its face, it may sound like a promising deal for speculators. ... But is now the time to raise $750 million in permanent capital on a subprime spending spree? ... Yet the timing of Ellington Financial's hoped-for debut is intriguing because it appears to be a way for Mr. Vranos to unload subprime assets (the riskiest portions of mortgage pools, known as equity residuals, issued by the New Century Financial Corporation, a subprime lender that declared bankruptcy in April) he bought a few months ago at higher prices than they would likely fetch today on investors. ... But what inquiring Ellington investors should want to know is exactly how those New Century residuals are being valued and whether that amount reflects reality or fantasy. .... The problem, traders say, is that residual interests in New Century mortgage securities are not trading, so any valuation ... will likely be based on a model, not a true market. ... So in addition to jettisoning some of the New Century residuals, the transaction with Ellington Financial may allow Mr. Vranos to value those that he owns elsewhere in his financial empire at a higher price than he otherwise could." (NYT, 7/22/07, "Mr. Vranos Has a Deal for You") Do "institutional investor" read the NYT? If so, they might have some questions to ask. And, if they do not get and memorialize satisfactory answers, they may have some future liabilities of their own.

"Sowood chief explains hedge collapse"

The founder of **Sowood Capital Management LP** was remorseful as he tried to explain to his clients how more than $3 billion in hedge fund assets were wiped out. 'You entrusted us with the management of your money, and we lost a lot of it, to say the least,' Mr. Larson said, according to published reports. 'No apology is sufficient.' ... Mr. Larson said that Sowood borrowed heavily to make investments that the company believed were low risk and backed them up with a hedging strategy intended to act as insurance in case anything went wrong. However, markets reacted differently than Sowood had expected, driving down the price of its securities and rendering its hedges ineffective." (InvestmentNews, 8/6/07, "Sowood chief explains hedge collapse") How did Sowood initially define "low risk"? What was the alleged "hedging strategy"? How and why did the "hedging strategy" not work as "expected"?

"How Street Rode The Risk Ledge And Fell Over"

"A recurring characteristic of the recent trouble in financial markets is that ...funds ... were following statistical models that grossly underestimated how risky the market environment had become. The term for this is 'model error.' The genesis of the problem begins in subprime mortgages, or loans to risky borrowers. Wall Street had limited experience with subprime, which until the late 1990s was a much smaller fraction of the mortgage market. With the development late in the housing boom of subprime mortgages where borrowers needed to provide little or no documentation, and no money down, the market entered uncharted territory. The models ... used to determine the likelihood of default, which depend on standard credit ratings known as FICO scores, didn't adequately distinguish between loans where borrowers had put money down and those with no down payment. Nor did the models take into account what would happen if housing prices fell to the point where the amount owed on some mortgages exceeded the value of the homes they covered. ... Making matters worse, value-at-risk, or VAR, models that Wall Street firms use to determine how much they could safely lend to investors had assumed that financial markets would remain quiescent. When volatility picked up, firms found that they had extended more credit than they should have. They demanded more collateral for their loans, forcing even more selling." (WSJ, 8/7/07, "How Street Rode The Risk Ledge And Fell Over") Did different hedge funds use different models? Could some models have been so recklessly constructed and updated and/or employed to incur legal liability? Were risks not considered in the models, also, not revealed in offering materials? How specific need risk disclosures be when an investor knows that the product is leveraged and expects to earn such a high return to pay 20% of the profits to a manager and still do well? Would any further disclosure dissuaded a greedy investor?

"Escaping the lock-up"

"If you invest in a hedge fund, you are usually subject to what is known as a lock-up period; it's a certain amount of time -- a year, two, or even 10 -- when you are barred from liquidating your money. Yet now, lots of people are trying to get out from behind those bars. ... [T]hey can turn to secondary markets and sell their shares to an investor who wants in. ...[T]he investor coming in stands to profit by bottom feeding. Still, new investors can get burned, too. Many Bear Stearns buyers found this out when they believed they were buying the firm's battered hedge-fund shares at the bottom, and there was lower still to go. ... That action is increasingly being taken by Bahamas-based **Hedgebay Trading Corp.**, which is an agent for secondary-market hedge-fund shares. There, investors selling their shares take a hair cut between 1% and 5% of the current value -- that is, if there are any takers for their positions." (MarketWatch, 8/7/07, "Escaping the lock-up") How does one determine "current value"?

"Blind to Trend, 'Quant' Funds Pay Heavy Price"

"That was the lesson so far this month for many so-called quant hedge funds, whose trading is dictated by complex computer programs. The markets' volatility of the past few weeks has taken a toll on many widely known funds for sophisticated investors.... Quant funds -- 'quant' stands for quantitative -- generally operate by building computer models of market behavior and then allowing the computer programs to dictate trading. A recurring characteristic of the recent trouble in financial markets is that many lenders, funds and brokerages were following statistical models that grossly underestimated how risky the market environment had become. 'Our risk models failed to pick up the fact that we were due for a correction,' says **Keith Campbell**, founder of **Campbell & Co.** ... Campbell's losses occurred because of wrong bets on interest rates, currencies and stocks... Mr. Campbell declined to disclose just how much leverage was behind his trades.... Mr. Campbell called the recent market turmoil 'very unusual.' Critics say that is one of the drawbacks of the investing style. Much of the time, the market can be accurately modeled by computer programs. The times when they don't work are treacherous. ... The reliance on models can be especially problematic because many quant hedge funds have very similar models. That means they are often doing the same trades and buying the same shares. Moreover, because the strategies are supposed to be market-neutral, with no net positive or negative bent, the funds often borrow large sums so they can bet more and achieve better returns when things go their way. That massive borrowing adds to the pressure when markets reverse course several times in the course of a single day, as the stock market has done repeatedly in recent weeks, or when tried-and-true relationships between different markets suddenly break down." (WSJ, 8/9/07, "Blind to Trend, 'Quant' Funds Pay Heavy Price") This sounds a little bit like herd mentality. Do the sponsors charge 20% of the profits to run the model? Would it be less expensive for serious players to buy a model and operate it for themselves?

"Bear Stearns Sued Over Collapse of Fund"

A limited partner in a failed hedge fund run by Bear Stearns has sued the investment bank, saying it took only 'meager steps' to prevent the fund's recent collapse. The limited partner, **Navigator Capital Partners**, made the accusation this week in a lawsuit filed in New York State Supreme Court in Manhattan. ... 'The plaintiff is an experienced investment firm and, as described in the fund's materials, this was a high-risk, speculative investment vehicle,' Bear Stearns said in a statement. Navigator Capital, run by **Steven Resnick**, invested more than $700,000 in the hedge fund from August 2004 to mid-April 2005. The firm and other investors lost nearly the entire value of their investments... 'Defendants failed to disclose to investors the significant challenges facing the partnership, and the meager steps they were taking to face those challenges, while at the same time reaping substantial fees,' the suit said." (Reuters, 8/10/07, "Bear Stearns Sued Over Collapse of Fund") Fraud must be pleaded with particularity. What were the supposedly undisclosed "challenges"? What "steps" were taken? In what manner were they "meager"? Would the fund have collapsed anyway had the Bear taken other than "meager steps"? How does one prove what appears to be pure speculation as to what

might have happened? One might wonder how the Navigator would describe its "due diligence" in selecting the investment.

"Bayou Investors Who Got Out Early Lose Their Bid for Pretrial Victory"

"Investors who got their money out of **Bayou Group LLC** before it collapsed in 2005, after officers pleaded guilty to fraud charges, have lost a bid to quash lawsuits seeking to make them return the cash to the hedge fund. U.S. Bankruptcy Judge Adlai S. Hardin said last month that he wouldn't grant a pretrial victory to two dozen former Bayou backers who are being sued in an attempt to recover the money. ... Hedge-fund investors are worried the case could set a precedent that exposes them to liability to other investors, if they learn of a fund's troubles in time and pull their money out, while others don't. Bayou's managers in Chapter 11 say 110 Bayou investors who redeemed their investments before the fund failed need to give the money back so the pain of Bayou's collapse can be spread evenly among all investors. ... The investors who got burned by Bayou were creditors, the judge said Thursday, not equity holders. As such, they are entitled to the protection of bankruptcy laws meant to prevent them from being taken advantage of by creditors who are in the know about a company's pending collapse." (WSJ, 8/11/07, "Bayou Investors Who Got Out Early Lose Their Bid for Pretrial Victory") Will discovery now commence against the departing "creditors" to determine whether they anticipated Bayou's "pending collapse"? Do they need to get their insider trading defenses ready? The experience will be time consuming and expensive whether or not funds need to be returned.

"Behind the Stock Market's Zigzag"

"The stock market in the past few days has looked like it has gone haywire. Shares that would have been expected to fall have risen, and shares that might be considered safe have taken big hits. ... Behind the bizarre behavior: quantitative hedge funds. These funds rely on computer models to pick which stocks to bet on and which to bet against. They've been liquidating positions to raise cash. They sold stocks they liked, forcing prices lower. For the stocks they sold short, the opposite occurred; to exit from those positions, they were forced to buy. 'A massive unwind is occurring,' says **Tim Krochuk**, managing director of **GRT Capital Partners**, a Boston investment manager. Buying and selling by hedge funds are 'pushing those crummy names higher, and pushing names you like lower.' ... Even before the selloff, it was becoming difficult to make money using quantitative methods to go long some stocks, short others, and pocket the difference. ... Some quant funds have tried to amplify returns by using more borrowed money, or leverage, to invest. But using leverage also amplifies losses, opening up the risk that lenders will demand more collateral for loans. Such margin calls can force funds to liquidate positions. ... 'Can the market really continue to favor companies that are doing worse? It's just not sustainable,' says Mr. Krochuk. 'A lack of leverage and patience are going to be very well rewarded.' ... One of the central tenets of quantitative investing is 'mean reversion' -- a fancy way of saying that things will eventually get back to normal. But one of the reasons that quant funds may have gotten into trouble is that the market, rather than returning to what their models defined as 'normal,' behaved more abnormally.

At a time of lingering worries about prospects for a full-fledged credit crunch, normal may still be some distance away." (WSJ, 8/11/07, "Behind the Stock Market's Zigzag") How much "quant" was involved in the decisions to amplify results by the use of margin and the amount of margin to use? The computer did not make them do it.

"Hedge fund flop hits Huizengas"

"The wealth manager for the Huizengas, among Chicago's most prominent families, says it got a reassuring update from one of the biggest local hedge funds in June of last year. The update included a chart showing that the fund, in which the family invested $10.6 million, was well-diversified, according to a lawsuit the Huizengas filed against ... **Ritchie Capital Management LLC**. Turns out, the lawsuit claims, it wasn't. The fund was devoted almost entirely to a controversial vehicle known as death bonds. Now the Huizengas, whose fortune was made in trash hauler Waste Management Inc., allege they were defrauded... Ritchie Capital says it made no promises to diversify. ... The complaint alleges Ritchie Capital provided false and misleading materials, failed to disclose important facts and had discrepancies in its books. ... The fund in which the Huizengas invested bet virtually all its money on death bonds.... Seniors who want quick cash can sell their life insurance policies to an investor who collects the benefit when the policyholder dies. ... Ritchie ... had assembled hundreds of policies, which they planned to tie to death bonds to sell to other investors. ... In 2005, Mr. Ritchie invited the Huizengas to invest in a new fund targeting a 'wide range' of strategies in the insurance business.... The new fund appeared profitable, based on updates provided to the Huizengas in 2006 that described 'home runs' in a diversified portfolio.... Ritchie Capital's July 30 court filing describes the Huizengas' wealth manager, **Huizenga Managers Fund LLC**, as 'a sophisticated investor that made a high-risk investment' with the full understanding it could lose its money." (Crain's Chicago Business, 8/12/07, "Hedge fund flop hits Huizengas") What caused the fund to fail? Will the Seniors live forever? Could the investment be considered "well-diversified" as there were many insureds? Further, there was no reliance upon the "update" as the investment had previously been made. No reliance means no liability! Ritchie's attorneys will be interested in the Huizengas' other investments, their due diligence and the risks that they were willing to assume.

"Investors Mull How to Get Out Of Hedge Funds"

"With a number of hedge funds hammered by market turmoil, the question some hedge-fund investors are now dealing with is: Should I be heading for the exit? ... Exiting from a hedge fund can be far more complex than selling a stock or a mutual fund. Redemption policies vary widely. Most funds will redeem your money only at the end of a calendar month, or the end of a quarter. And you generally must provide written notice in advance that you intend to redeem money. The notice period is often 30 days to 60 days, but some funds require as many as 90 days or more. Rules for redeeming money from a hedge fund are generally laid out in the limited-partnership agreement. The long notice period means that investors might not see their money for weeks, or even months, in which time markets might shift dramatically. ... For investors trying to gauge their own situation, the key challenge is knowing what your hedge fund owns.... Still, investor

nervousness goes beyond the hardest-hit funds that invest in subprime mortgages and make use of quantitative trading strategies. ... Investors who successfully withdraw money from a struggling hedge fund may still be at risk. If a hedge fund fails, in some cases a bankruptcy trustee or other investors may sue investors who have already redeemed money and try to force them to pay that money back into the fund.... The trustee could argue that the hedge fund didn't value its assets correctly and that investors withdrew more money than they were entitled to.... Investors need to read hedge-fund offering documents and limited-partnership agreements carefully to understand redemption rules. In some cases, funds may impose a penalty on investors who try to withdraw money without giving proper notice or require longer redemption notice periods for investors who want to take out money at year end.... In some cases, investors have negotiated in advance special agreements with hedge-fund managers known as a 'side letter,' which may allow the investor to redeem money more quickly than other investors in the fund. Often, however, such agreements are reserved for very large investors like institutions." (WSJ, 8/15/07, "Investors Mull How to Get Out Of Hedge Funds") Who would invest where the sponsor would not inform you of the details of the underlying investments or strategy, where the investor has no real assurance of when he/she will be able obtain a return of funds and where the sponsor is rewarded with 20% of the profits and suffers none of the losses? Don't regulate it, but bail it out --- one way or another. It's the new American capitalism!

"Dear Investors, We're..."

"Running a hedge fund means never having to say you're sorry, at least not in so many words. ... None of these highly paid managers are prostrating themselves before their clients, begging forgiveness, however. Instead, in letters to clients, they point fingers at other hedge funds, once-in-a-lifetime events and their own computer programs. **Black Mesa Capital**, a Santa Fe, N.M., hedge fund captured the "don't blame us" spirit with its letter last week, blaming "unprecedented market events," including "a very large or several very large trading entities, possibly very large hedge funds...liquidating massive" portfolios. The managers, **Dave DeMers** and **Jonathan Spring**, said they are taking "unprecedented actions" to fix its problems, a response to the "unprecedented market events." ... Goldman's letter portrayed the firm's money-losing hedge funds as innocent bystanders, caught up in a violent market. ... A simple mea culpa would be more satisfying for many investors. ... The recent pain has largely centered on quantitative hedge funds, which rely on computer models of the sort more often developed by math whizzes than English majors. So, some of the explanations are heavy on the jargon. "The culprit is not the Basic System but our predictive overlay," said Jim Simons, who runs Renaissance Technologies.... Lawyers say they advise hedge managers to detail losses quickly, but restrict their explanations to the facts. Owning up to mistakes or apologies could give an opening to investors to level lawsuits.... One major hedge-fund manager admits to using the word 'sorry' in his letter to investors, but striking it at the last moment, arguing that he had nothing to apologize for." (WSJ, 8/15/07, "Dear Investors, We're...")

"How a hedge fund star lost it all"

"When **Jeffrey Larson**, a Boston hedge fund millionaire, visited a classroom of economics students at his alma mater last year, he picked up a marker and diagrammed a low-risk strategy for maximizing profits when investing in company stocks and bonds. ... Friends and colleagues said Larson, 49, never fit the stereotype of a swaggering hedge fund cowboy. ... Sowood's strategies involved exploiting differences in prices between a company's bonds, notes and other loans and its stock. Larson would buy these debt securities of a company in the hope that those values would rise, then hedge that bet by short-selling its stock, which would pay off if share prices fell. That way, if he gambled wrong on the bond position, Larson would be able to recover or limit those losses if and when its stock price also fell. ... [S]owood's investment strategy was neither uncommon on Wall Street nor excessively risky. Rather, where Larson stumbled was how he financed that strategy. Like many other hedge funds, Sowood borrowed heavily to finance its investments.... [I]t appeared that Larson's fundamental problem was not having enough cash or liquid assets in case his bets went wrong and his lenders, as they ultimately did, demanded their money back. ... In late spring of this year, the market for bonds and other debts issued by corporations was rocked by the crisis in U.S. subprime mortgages. As happens in routs, the market deteriorated in ways Larson failed to anticipate: investors abandoned many forms of corporate debt, not just those related to the mortgage markets, and did so without regard to the underlying fundamentals of specific companies. The careful research that Larson and his managers performed to pick strong companies did not matter once investors made a mass exodus. As a result, Sowood's bond-related holdings plunged in value. Meanwhile, stocks that were supposed to fall - the hedge - did not fall enough. The lenders who provided Larson with credit to place his heavily leveraged bets wanted their money back. Scrambling to raise money during the week of July 23, Larson could not sell his devalued holdings fast enough. The more demand for these holdings dropped and they declined in value, the more he had to sell to raise cash, which in turn pushed their prices down even further. Within a week, this classic death spiral had claimed Larson's company." (Boston Globe, 8/16/07, "How a hedge fund star lost it all") Investments on mega-steroid leverage come easy to managers playing with other people's money with the hope of taking 20% of the profit and sharing none of the loss.

"Art Loans Get Hung Up"

"For years, art loans -- ones with a borrower's Raphael or Rothko as collateral -- were the purview of large banks serving wealthy clients. ... Today, hedge funds ... offer rival services. Often they cater to less wealthy borrowers dabbling in the big leagues. Some loans are like reverse mortgages, letting borrowers receive monthly payments against the value of their art, rather than selling it outright and taking a capital-gains tax hit. Other lenders essentially act as high-end pawnbrokers, taking possession of the artwork itself during the loan period.... [C]oncerns are rising in the art world that some borrowers could default or find themselves in over their heads. Art is notoriously tough to value, so if prices fall sharply, lenders could find that they're holding collateral worth less than the loan it is backing. ... Terms on these loans vary widely, based on the quality of

the art, the lender's policies and the borrower's financial condition. Generally, interest rates range from 8% to as high as 18% -- making it a lucrative, if risky, game for lenders. The potential for outsize returns like that is one reason hedge funds have pushed into the business in recent years. To protect themselves, some lenders require what are essentially margin-call provisions: The lender reserves the right to reappraise the collateral, and if there's a drop in value, to ask for more collateral or partial payback of the loan. ... The perils to lenders of art-backed loans are many. For one thing, by the time a lender forecloses on such a loan, the borrower has usually tried aggressively to sell the art. ... In the notoriously murky art market, the prospect of defaults is particularly unnerving. Fears were renewed in 2003 with an incident involving **SageCrest**, a hedge fund that loaned $37 million to Art Capital Group, which in turn lent $20 million to Berry-Hill Galleries, a New York art gallery. Berry-Hill filed for Chapter 11 bankruptcy protection in 2005, triggering a wave of alleged loan defaults, followed by several suits and countersuits in New York State Supreme Court. SageCrest's attorney, Robert Friedman, says the hedge fund sued Art Capital Group after it failed to meet its obligations under the loan, including payments due late last year.... [A]rt Capital Group's president, says SageCrest's claim is 'total nonsense.'" (WSJ, 9/1/07, "Art Loans Get Hung Up")

"Hedge Funds and the Little People"

"Burton R. Lifland, a United States bankruptcy judge in Lower Manhattan, said last week that he needed more time to decide whether the liquidation of two failed **Bear Stearns** mortgage securities funds could proceed in the Cayman Islands, where they are incorporated, or in this country, where most of their assets and many of their investors reside. Although there is little left in the funds to divvy up among investors and creditors, how Judge Lifland rules will be closely watched. That's because most hedge funds are domiciled in faraway places where the courts may be, ahem, less friendly to investors than they are to the managers who park billions there. If the Bear Stearns funds are liquidated in the Cayman Islands, they will be shielded from investors' suits.... Ronald L. Greene, 79, a retiree in Northern California ... lost $280,000 in the Bear Stearns High Grade Structured Credit Strategies Fund.... He contends that Bear Stearns duped him with assurances that the fund's high-quality investments would protect holders against market and credit risks. ... On July 20, 2005, he received an e-mail message from his broker at a small regional firm, with the following header: 'Bear Stearns High-Grade Structured Credit Strategies Fund will accept smaller investments this month on a limited basis.' ... The message went on to note the fund's stellar performance: up a cumulative 29.4 percent since its October 2003 inception, and no down months. Mr. Greene, a former engineer, said he invested in several hedge funds in recent years, aiming to preserve his principal. Most of the funds have worked out well, he said, producing slightly better-than-market returns with little volatility. ... He invested in the Bear Stearns fund in October 2005, and he said the fund appealed to him because its returns of about 1 percent a month did not seem to fall into the too-good-to-be-true category. ... 'Everything went fine until last June,' Mr. Greene said; that was when he learned from his broker that the funds were having difficulties. 'I asked him how they could be in trouble if they were high-grade securities. He said they were bundled high grade but not really high grade. If you're going to be dealing with a high-grade securities dealer, I didn't understand how that was an

excuse of any kind.' ... 'We believe that Bear Stearns misrepresented the risk to investors in the hedge fund, misrepresented the extent of risk controls that were in place to cut losses and misrepresented performance on conference calls to avoid a run on the bank,' he (one of Mr. Greene's attorneys) said. ... 'The accredited, high-net-worth investors in the fund,' he (a Bear Stearns' spokesman) added, 'were made very aware that this was a high-risk speculative investment vehicle.'" (NYT, 9/2/07, "Hedge Funds and the Little People") Are the "small regional firm" and its "broker," who got Mr. Greene into his situation, still financially viable? At least he won't have to go to the Cayman Islands, but will probably have to seek justice before an arbitration panel sponsored by the securities industry.

"Prosecutors Begin a Probe Of Bear Funds"

"Federal prosecutors have launched a criminal investigation into two mortgage-related hedge funds at Wall Street firm **Bear Stearns** Cos. that collapsed during the summer.... The U.S. attorney in Brooklyn made a request to Bear Stearns for information related to the hedge funds, whose failure cost investors $1.6 billion, said these people. ... Bear is already under the microscope by the Securities and Exchange Commission. ... It has been a rough few months for Bear, which has been stung by bad bets on the market for risky or subprime mortgages." (WSJ, 10/4/07, "Prosecutors Begin a Probe Of Bear Funds")

"Craving the excitement of a hedge fund?"

"While the hedge fund industry touts its performance record, academic studies have discovered that there are many biases in the reported data. Once the biases are accounted for, returns investors have earned have been well below the returns of equities — even before accounting for the incremental risks of hedge-fund investments. Burton Malkiel and Atanu Saha, in their paper "Hedge Funds: Risk and Return,' (2005) used Lipper's TASS database of hedge funds and concluded that previous research, using the same information, had underestimated biases in the data:
• There is a substantial attrition rate — less than 25 percent of the funds in existence in 1996 were still alive in 2004. ... • Survivorship bias led to returns being overstated by 4.4 percent per annum.... Investors should note that academic research also has found that past performance of hedge funds is not a good predictor of future performance. ... Yet the average investor likely did even worse, because investors tend to pile in after funds produce great returns and exit only after they experience poor returns. The result is that investors tend to underperform the very investment vehicles in which they invest. ... Investors need to understand this about hedge funds: While hedge funds charge large annual fees (typically 2 percent), and they typically earn 20 percent of the profit in good years, they don't return the performance-based fees when investors experience losses. That's another reason why hedge funds should be thought of as compensation schemes rather than investment vehicles." (St. Louis Post-Dispatch: Commentary, 10/7/07, "Craving the excitement of a hedge fund?")

"Pricing Tactics Of Hedge Funds Under Spotlight"

"New academic research suggests that some hedge-fund managers may cherry-pick flattering prices when valuing securities that don't actively trade in an effort to improve the performance of their funds. ... How to price hard-to-value securities has become a hot-button topic on Wall Street in recent months as debt markets froze up. ... So far, investors, auditors and regulators have focused on the way banks and brokers value these securities. But the new research suggests hedge funds may be an even bigger area of concern. The academic research found a significant difference in the number of funds reporting a slight gain compared with a slight loss in any given month. That difference was most pronounced for funds that trade illiquid securities; it didn't show up in funds that primarily trade stocks or futures contracts, which have active markets and easily obtained prices. This suggests that some funds could be fudging results. 'Hedge-fund managers purposefully avoid reporting losses by marking up the value of their portfolios,' according to the authors of the study, Nicolas P.B. Bollen, an associate finance professor at Vanderbilt University, and Veronika K. Pool, an assistant finance professor at Indiana University. If that is the case, the authors wrote, investors may 'underestimate the potential for losses in the future and may overestimate the ability of hedge-fund managers.' The study used a hedge-fund database from the University of Massachusetts to analyze monthly returns from 4,268 hedge funds with varying investment styles from 1994 to 2005. ... Fund managers can have a lot of leeway in determining whether such securities have lost or gained money. As long as they remain consistent, they can, for example, choose whether to use the bid or offer price of a security, which can sometimes vary widely, or pick among different quotes offered by competing brokers. So if a hedge fund is looking at a possible loss for a month, a manager could pick the more optimistic prices for some securities to push the fund into positive territory while ignoring those that could exacerbate losses. ... Previous academic research has found that a variety of hedge-fund strategies generate smoother returns than the underlying economics might justify. The recent paper by Mr. Bollen and Ms. Pool builds on this work but is different in that it suggests a manager 'is going to round up returns to make sure they're slightly positive' rather than smoothing out both gains and losses, Mr. Bollen said. Typically, hedge-fund returns should fall along a familiar bell-curve pattern with a peak that is likely to be in slightly positive territory. That is how the returns play out for equity-neutral strategies, which bet on stocks either rising or falling in value. But that doesn't happen for strategies that deal with illiquid securities. 'This is perhaps no surprise: Distorting returns is more feasible when the opportunity for exerting managerial discretion is higher,' the paper said." (WSJ, 10/9/07, "Pricing Tactics Of Hedge Funds Under Spotlight")

"Bear Stearns Draws Probe On Fund Trades"

"Massachusetts securities regulators are investigating whether **Bear Stearns** Cos. improperly traded with two in-house hedge funds that collapsed this summer, saddling investors with added losses. ... Investigators are attempting to determine whether the trades were priced fairly and whether troubled securities positions were offloaded onto investors in the two funds, among other things.... Such mortgage securities are priced by

dealers who do not publish quotes; it's often difficult to determine their market values. ... The case underscores the myriad conflicts facing diversified Wall Street securities firms that sponsor their own hedge funds. When acting for the firm's own account, for example, Bear Stearns traders have a primary responsibility to make money for Bear Stearns, not for the mostly investor-owned hedge funds, and they routinely seek the best prices for the firm. The Bear Stearns funds' offering memorandums listed 12 other types of arrangements that could lead to conflicts, including handling brokerage business for the funds, allocating positions between the funds and other entities managed by Bear Stearns, valuing the assets of the partnerships, and lending to the funds. .... As previously reported, Massachusetts regulators are looking at why Bear Stearns research analysts upgraded subprime lender **New Century Financial** Corp., a real-estate investment trust based in Irvine, Calif., from 'sell' to 'neutral' on March 1, just before New Century filed for bankruptcy proceedings. The state is examining whether Bear Stearns made loans to New Century that may have affected the stock recommendation, people familiar with the inquiry said. A subpoena in that inquiry elicited responses that led investigators to the area of principal transactions, these people said." (WSJ, 10/19/07, "Bear Stearns Draws Probe On Fund Trades") Will investors ever understand the significance of potential conflicts of interest? At the end of the day, we'll probably see another regulatory slap-on-the-hand settlement --- a cost of doing business --- and BS will continue to flow to the next sure-fire investment product.

"Investors in Bear Funds To Vote on Control Change"

"Investors in two Bear Stearns Cos. hedge funds that flamed out this past summer are looking into whether to install a forensic accounting and restructuring firm in place of Bear as controlling party.... The investors, who lost about $650 million in the two funds, will vote on the matter at the Wall Street firm's headquarters in New York on Nov. 7 and in London on Nov. 14. More than 10% of investors in the two funds have petitioned for the change, setting up the vote, the person said. If more than 50% of investors, as measured by capital invested, approve, Bear will be replaced as controlling party by FTI Capital Advisors LLC, a broker-dealer subsidiary of FTI Consulting Inc. of Baltimore. Lawyers at Reed Smith LLP and some other firms representing institutional and retail investors in the funds have complained that Bear isn't cooperating in providing information on the names of all investors or on the activities that led to the funds' demise. FTI would be charged with conducting an investigation to see if there is cause to sue. ... By ousting Bear, investors hope for quicker access to information than if they were forced to litigate.... Bear Stearns -- under fund guidelines -- is charged with coordinating the vote." (WSJ, 10/30/07, "Investors in Bear Funds To Vote on Control Change") Perhaps, by-laws should state that an independent third-party should arrange and conduct hedge fund votes.

"Hedge Fund Manager Convicted In Ohio Fraud Case"

"A Pittsburgh hedge fund manager was convicted today of defrauding Ohio's workers' compensation system. **Mark Lay** had been charged with losing $216 million he

invested for the **Ohio Bureau of Workers' Compensation** in a highly-levered hedge fund without authorization. Lay, the CEO of **MDL Capital Management** ... faces up to 20 years in prison for investment advisory fraud, mail fraud and conspiracy to commit mail and wire fraud.... Prosecutors are also seeking to recoup $1.7 million in fees BWC paid to MDL. ... Lay was accused of exceeding a strict limit on leverage.... The daughter of the BWC oversight board member **George Forbes** also worked at MDL Capital. (FIN*alternatives*, 10/30/07, "Hedge Fund Manager Convicted In Ohio Fraud Case") Nothing like keeping it in the family. Anyone smell some *quid pro quo* here?

"Did Authorities Miss a Chance To Ease Crunch?"

"Federal and state authorities may have missed an opportunity two years ago to get ahead of the mortgage-securities-pricing crisis now gripping Wall Street. In 2005, the Securities and Exchange Commission and New York state's attorney general's office launched separate investigations into whether Wall Street securities firm **Bear Stearns Cos.** harmed investors by improperly valuing complex mortgage securities. Determining the prices of these securities, often based on mathematical models, involves some guesswork, particularly in distressed markets. An SEC branch office said it intended to recommend that Bear Stearns be charged for improperly pricing about $63 million of mortgage securities it sold to a bank; the New York attorney general's office, headed at the time by **Eliot Spitzer**, had sought information about how Bear priced $16 million of mortgage securities it sold to an institutional client. In each case, government authorities dropped the enforcement cases, according to regulatory filings and people familiar with the matter. The two aborted cases have new resonance amid the credit crunch and resulting crisis engulfing the financial world. It was Bear Stearns's disclosure of badly priced mortgage securities in two of its internal funds that helped spark this year's mortgage-market and credit convulsions. High-profile enforcement cases could have sent a message to Bear Stearns and other Wall Street firms to attempt to more accurately price mortgage securities. Such a message could have helped blunt the impact of the current crisis, which has led to investor uncertainty over how firms price these mortgage-related instruments. .... Unlike stocks or bonds traded on exchanges, these securities are traded privately between dealers. Values often are based on mathematical pricing models. Wall Street traders long have had a motive to inflate the value of securities because their bonuses often are tied to them. The problem is exacerbated when market trading dries up, as it has in recent months in the mortgage area. ... In mid-2005, the SEC's Miami office planned to recommend that Bear Stearns be civilly charged for the way it priced and valued $62.9 million of collateralized debt obligations it sold to **W Holding Co.'s Westernbank Puerto Rico** bank unit. The probe involved whether Bear Stearns had committed fraud, a person familiar with the matter says. In a regulatory disclosure at the time, Bear Stearns said the SEC staff 'intends to recommend that the Commission bring a civil enforcement action' involving the firm's 'pricing, valuation, and analysis' of the CDOs, or investments that package pools of loans. The SEC subsequently informed Bear Stearns it had closed the investigation, a separate regulatory filing shows. ... W Holding ... ultimately took a $20 million loss after selling its $63 million CDO portfolio. ... In a separate 2005 probe, the New York attorney general's office subpoenaed Bear, seeking information tied to some $16 million of such CDOs, a regulatory filing shows. In that

case, Bear Stearns was valuing CDOs for an institutional client at more than 90 cents on the dollar, say people familiar with the matter. But when the client wanted to sell the securities back to Bear, the firm priced the CDOs in the high-30s, the people say. .... In June, two of its internal hedge funds holding mortgage securities began imploding, costing investors more than $1 billion. ... It isn't just regulators who may have missed a chance in 2005 to get ahead of a big problem. Before the attorney general's office dropped its case, it held talks with Bear Stearns about its CDO pricing procedures and staffing levels for valuing the securities." (WSJ, 12/10/07, "Did Authorities Miss a Chance To Ease Crunch?") After losing $20 million, did Westernbank or that "institutional client" commence a civil action against Bear Stearns and/or others? If not, why not? Did they continue dealing with the Bear or investing in CDOs? If continued dealings resulted in additional loses, the investors who employed them may have a cause of action.

"Pricing Probes On Wall Street Gather Steam"

"[T]he Securities and Exchange Commission ... (is) delving into whether Wall Street firms placed higher values on their own securities than those they placed on customer holdings.... [T]he SEC is examining for their mortgage-securities valuations and disclosures are **UBS** and **Morgan Stanley**, in addition to previously reported investigations of Merrill and **Bear Stearns** Cos. regarding their valuation methods.... Financial firms often use mathematical models with built-in assumptions in determining value, or 'marks,' which might differ if they had to sell the securities. The SEC has set up a working group that also is looking at whether firms adequately disclosed the risks of these investments and were timely in announcing stresses on the firms' financial statements. The probes are in early stages. ... The SEC is asking questions specifically about whether financial firms were valuing mortgage-related securities differently on their own books compared to the valuations they applied to the holdings of customers such as hedge funds. The SEC also is asking why securities firms would price the same or similar mortgage securities at higher prices for their in-house trading desks than for their asset-management groups, for instance, or the repurchase desk, where large slugs of securities are sold on a short term basis. In one investigation, the SEC is examining a situation this year in which a trader at a now-defunct hedge fund of UBS's Dillon Read unit was confronted and then ousted after he valued mortgage securities at prices below the value assigned the same securities elsewhere at UBS. ... The SEC also contacted a trader from Royal Bank of Canada in recent weeks following assertions by the trader in the Journal that the bank had intentionally mis-marked government agency and corporate bonds. This week, the trader sought protection as a whistleblower under the Sarbanes-Oxley act.... Some observers have compared this SEC investigation to an investigation of analyst research after the technology bubble burst. In 2003, regulators sanctioned several financial firms after discovering incriminating emails showing that the analysts' public pronouncements about stocks differed from what they said to colleagues. In that investigation, the issues came down to what was said publicly versus what they were saying internally, regulators and lawyers say. In the current environment, investigators will be looking at whether a firm changed its valuation methodology to one that was

more favorable in order to avoid or forestall taking big losses. (WSJ, 12/21/07, "Pricing Probes On Wall Street Gather Steam")

"Ritchie Investors Take Legal Actions"

"Investors in a failed hedge fund run by **Ritchie Capital Management LLC** want to force the fund into bankruptcy and investigate possible mismanagement and fraud by Ritchie Capital. The investors, themselves hedge funds, filed an involuntary Chapter 11 petition with the U.S. Bankruptcy Court in Chicago, accusing Ritchie Capital of keeping them in the dark about the sale of the fund's portfolio and use of the proceeds. ... Ritichie fended off a revolt by investors who objected to its 2005 move to shift much of its holdings into so-called side-pocket accounts. Such accounts are used to hold hard-to-value assets, and they limit investors' ability to withdraw money. ... The investors hoping to put the fund into bankruptcy -- **Benchmark Plus Partners**, **Benchmark Plus Institutional Partners** and **Sterling Low Volatility Fund QP** -- said in court papers that they are owed $46 million and expect 'to lose millions.' ... Other investors are owed more than $100 million...." (WSJ, 12/28/07, "Ritchie Investors Take Legal Actions") One only wonders what the three hedge funds represented to their respective investors about their investment strategies and due diligence in selecting and monitoring investments.

"Bad Bets and Accounting Flaws Bring Staggering Losses"

"**Mark S. Fishman** was a modern prince of the markets — a pedigreed money manager who raised billions of dollars at the height of the hedge fund boom. But last week his dream collapsed. Hobbled by bad trades in the credit markets, Mr. Fishman began to shut the fund he helped found, **Sailfish Capital Partners**, which oversaw $2 billion just six months ago, investors said. ... So far few funds have suffered the same fate as Sailfish Capital. But the signs are troubling. The average stock-picking hedge fund sank 4.1 percent in January. While that tumble was not as steep as the one taken by the broad stock market — the Standard & Poor’s 500-stock index was down 6 percent — it nonetheless represented the hedge fund industry’s worst showing since November 2000. Few of the investment strategies employed by these funds made money. ... 'People who have been in business for 20 years are saying January was one of the most difficult and challenging times they have ever seen,' said a manager who oversees a fund of hedge funds, who asked not to be identified because he does business with many managers. ... Managing a hedge fund has become the running dream on Wall Street. Since 2000, the number of funds has more than doubled, to 10,000. These private pools of capital now sit atop almost $1.9 trillion in assets. ... But making money is getting tougher. Many hedge funds are products of a bull market. Many profited by making leveraged bets on what were, until recently, steadily rising markets. Some plowed into emerging markets while others dove into the loan market. But now, as the credit squeeze tightens and talk of recession grows louder, those same markets have collapsed. ... Many managers fear things will only get worse. ... Sailfish seemed like a hedge fund that might weather the storm. ... But July proved treacherous. As the credit markets seized up, Sailfish owned seemingly safe top-rated investments, including mortgage investments, that suddenly plummeted in value. ... Sailfish bounced back in September and October, but investors,

alarmed by the deteriorating markets, began to take their money out of the fund. By the end of the year, Sailfish was down more than 15 percent. In January, it fell an additional 7 percent. Last Thursday, Sailfish started to alert investors that the fund was likely to shut down...." (NYT, 2/12/08, "Bad Bets and Accounting Flaws Bring Staggering Losses")

"Citigroup Fund Bars Exit By Investors After Bad Bet"

"**Citigroup** suspended redemptions in **CSO Partners**, a fund specializing in corporate debt, after investors tried to yank more than 30% of the fund's roughly $500 million in assets. To stabilize the fund, which had an 11% loss last year, Citigroup last month injected $100 million. The fund's longtime manager, **John Pickett**, has left, following a bitter dispute with Citigroup executives and complaints from investors that he put too much money into a single investment that went bad. ... Citigroup's new chief executive, **Vikram Pandit**, briefly ran the alternative-investments group, and some of the funds he oversaw have been struggling. ... The CSO Partners fund ran into trouble last June when Mr. Pickett, the fund manager, placed an order for hundreds of millions of dollars in loans. The size of the order exceeded internal trading limits at Citigroup.... CSO, which stands for Corporate Special Opportunities, was started in 1999 with Citigroup's own capital. In 2004, it began accepting money from outside investors such as pension funds and wealthy individuals. Those investors now account for most of the fund's assets. ... Mr. Pickett's big order last June was for several hundred million dollars of leveraged loans that a group of banks was selling in a private auction on behalf of a German media company, according to people involved in the transaction. At the time, CSO had roughly $700 million in assets, meaning that Mr. Pickett wanted to commit more than half of the hedge fund's assets. Some investors in the fund contend that executives at Citigroup didn't supervise Mr. Pickett closely enough. ... The seven banks running the June auction allocated CSO a bundle of loans with a price tag of more than €500 million ($730 million), say the people involved in the transaction. Mr. Pickett tried to back out, saying the banks in the deal changed the loan terms after he submitted his bid. There was a lot riding on whether Mr. Pickett could cancel his order. The credit crisis roiling financial markets last summer was eroding the value of the loans. ... Mr. Pickett argued that it was his fiduciary duty to investors to cancel the order. He proposed to Citigroup executives that the fund sue the banks arranging the transaction. Executives at **Morgan Stanley**, a lead bank on the loan deal, cried foul. They called Mr. Havens, who was Mr. Pickett's superior and former head of global sales and distribution at Morgan Stanley. Mr. Havens essentially sided with Morgan Stanley. He and James O'Brien, another Morgan Stanley fixed-income veteran who joined Citigroup in October, instructed Mr. Pickett to not initiate any legal action. They also began trying to negotiate a settlement with Morgan Stanley over the deal. Mr. Pickett responded by accusing Messrs. Havens and O'Brien of ignoring the fund's fiduciary duty and having a potential conflict of interest given their ties to Morgan Stanley.... Negotiations between the banks and Mr. Pickett dragged on for months. ... In early December, Citigroup executives agreed to a settlement proposed by Morgan Stanley. Under the deal, CSO would purchase €512 million (about $746 million) of the loans at face value, even though they were trading for 86% to 93% of their face value, according to a letter that CSO sent to investors. The agreement also required CSO to pay the banks' legal expenses. ... On Dec.

12, the week after the settlement, Mr. Pickett handed in his resignation." (WSJ, 2/15/08, "Citigroup Fund Bars Exit By Investors After Bad Bet") What does the fund's literature say about concentration of investments? What procedures did Citigroup use to assure compliance? How difficult could it be to determine whether the seller changed the terms after the buyer submitted a bid? When/how did Pickett learn that the terms had allegedly been changed and when/how did he react? Exceeding any position limit would not be a defense on the contract issue, but might affect Citigroup's credibility. Did Citigroup instruct Pickett not to threaten to litigate? Did Morgan Stanley know, during the negotiations, that litigation was off-the-table?

"Bear Probe May Center on Investor Call"

"A developing criminal investigation into the collapse of two internal hedge funds at Wall Street firm **Bear Stearns** Cos. could hinge on whether the funds' managers misled investors during a conference call last spring about the desperate straits they faced.... In an investor call held April 25 ... Bear Stearns fund manager **Ralph Cioffi** told participants he was 'cautiously optimistic' about Bear's ability to hedge its holdings of securities tied to subprime, or low-end, home loans. The previous month, Mr. Cioffi had moved $2 million of his own money out of one of the two troubled funds into a newer, less risky internal fund.... At the same time ... Mr. Cioffi was holding continuing discussions in internal emails with colleagues about the worrisome state of the credit markets, and wondering aloud whether the declines in subprime securities would spell trouble for his funds. Prosecutors in the U.S. Attorney's office for the Eastern District of New York, based in Brooklyn, are examining whether any disparity between the public and private comments of Mr. Cioffi and others could constitute fraud.... Mr. Cioffi is likely to argue that his decision early last March to move the $2 million was approved by internal compliance officers as a way to show confidence in a new fund... He ... (is) likely to portray their discussions about the market turmoil and its potential impact on the funds as standard exchanges about events in the subprime arena that any two money managers holding mortgage securities would likely have had.... Also at issue for prosecutors in the April 25 investor call was Mr. Cioffi's response to a question about the High-Grade fund's exposure to subprime loans.... When a participant wondered whether packaged mortgage securities in the fund -- called collateralized debt obligations, or CDOs -- were tied to subprime assets, Mr. Cioffi replied that he didn't have time to teach 'CDO 101,' or answer basic questions about the securities...." (WSJ, 2/15/08, "Bear Probe May Center on Investor Call") After the call, what, if anything, was done to hedge the hedge fund's investments? Using internal compliance is an old game --- give the compliance officer half the facts, get his/her approval and, later, blame whatever happened on the compliance offer. Another lesson --- beware of persons who respond to direct questions that seek disclosure with demeaning responses and/or personal attacks.

"Troubled Firm to Close 2 Funds Worth $4 Billion"

"**D.B. Zwirn**, a New York hedge fund that has been plagued by accounting irregularities, is closing two of its largest funds after investors demanded the firm return $2 billion. The investors will not get their money any time soon, however. D.B. Zwirn

invests in illiquid assets like loans to companies around the world, including some in China. In a letter sent to investors on Thursday, **Daniel B. Zwirn**, the firm's founder, said it would take two to four years 'or longer' to sell the assets in an orderly fashion. ... In late 2006, the firm uncovered improper money transfers between its funds and improper charges to clients. ... The firm paid clients back, with interest. But investors were shaken.... Yet D.B. Zwirn delivered steady returns — 1 to 2 percent a month — without much volatility, making the firm a magnet for new money. It doubled in size from 2004 to 2006 and returned 11 percent in its onshore fund and 7 percent in its offshore fund in 2007. But investors say the fund did not invest enough in risk management and financial controls required to handle such a big fund, particularly one with investments that are difficult to value. ... Potential and actual investors disagreed. They said the reason that it took so long for D.B. Zwirn to close the funds was that the firm required clients to invest in its funds for at least three years before they could withdraw money. It also required investors to give 120 days notice for withdrawals. Investors seeking to pull out money have their funds placed in separate accounts to be liquidated when and if the loans are paid off, a process that could take years. ... Several high-ranking employees have left the firm, including the chief financial officer, chief operating officer and general counsel." (NYT, 2/23/08, "Troubled Firm to Close 2 Funds Worth $4 Billion") Is the phrase "accounting irregularities" a euphemism for something else? Have the rats, *e.g.*, CFO, left a sinking ship?

"Banks Seize Assets of Peloton Hedge-Fund Firm"

"In a move reflective of how banks are moving quickly to deal with troubled borrowers, lenders have seized assets held by troubled London hedge-fund manager **Peloton Partners LLP**.... The moves by the banks come as they try to recoup some of the money they lent the firm. ... Peloton told investors this week that it had liquidated a fund that specialized in mortgage securities after making a bad bet -- using borrowed money -- on the value of highly rated securities. Peloton is shutting down the fund, called the **ABS Fund**, and investors in a second, sister fund, the **Multi-Strategy Fund**, have been told redemptions have been suspended. The moves come after Peloton reported an 87% gain last year. As Peloton, founded in 2005 by two former Goldman Sachs Group Inc. partners, deals with its banks, those lenders ... will find it difficult to find buyers." (WSJ, 3/1/08, "Banks Seize Assets of Peloton Hedge-Fund Firm")

"Swap Skirmish: Risks Hidden, Says Hedge Fund"

"In separate lawsuits filed in a New York federal court, a $58-million-asset hedge fund alleges that **Citigroup** Inc. and **Wachovia** Corp., respectively, improperly required the fund to pay out more money from insurance derivatives contracts known as 'credit default swaps' amid a steep decline in the value of mortgage-backed bonds. The hedge-fund manager says he didn't view the insurance-related trades as particularly risky and now says he feels 'suckered.' ... The skirmishes signal cracks in the vast and unregulated market for such credit default swaps, where banks, hedge funds and others trade insurance against debt defaults. In these swaps, one party pays another to assume the risk that a bond or loan will go bad. ... Not everyone who buys these contracts has bonds to

insure; because the value of an insurance contract rises or falls with perceptions of risk, they are also bought as a speculation. If the value of the debt changes, parties in a swap may be required to make large payments to each other. Now it looks like reckoning day for some of the speculators. ... Hedge funds provided roughly one-third of trading volume in all credit derivatives in 2006.... During the credit bubble, even small hedge funds made speculative bets by selling big banks insurance protection on mortgage-backed bonds. Banks bought the protection, reckoning it wouldn't be needed. ... [H]edge funds aren't subject to heavy oversight by regulators or capital requirements. Financial firms usually guard against the risk of their hedge-fund trading partners being unable to pay by requiring they put up cash or collateral for their swap trades. ... **VCG Special Opportunities Master Fund Ltd.** ... alleges that Citigroup breached its contract after the bank demanded the fund post additional collateral. ... In the other suit, the hedge fund, which at that time was named **CDO Plus Master Fund Ltd.**, says it sold credit protection on a mortgage-related security to a unit of Wachovia last May, only to be asked to pony up millions of dollars of collateral in the ensuing weeks. ... The hedge fund refused to pay the final request for collateral of $1.49 million, and Wachovia foreclosed on the fund's nearly $9 million in collateral, meaning the hedge fund got stuck with the losses. ... **Donald Uderitz**, the hedge fund's manager, says he believed there was little likelihood of having to pay out insurance to cover losses from the CDO. In an interview, he says he bought the investment to earn the fees the banks would pay the hedge fund, equal to 5.5% of the $10 million notional amount of the swap from Citigroup and 2.75% from Wachovia. Mr. Uderitz says he feels "suckered." (WSJ, 3/4/08, "Swap Skirmish: Risks Hidden, Says Hedge Fund") Does anyone read the small print in the contracts they trade or realize that, in effect, they are assuming the same risks as one selling naked put or call options? Did the hedge funds consider the impact of a worse case scenario?

"Hedge Funds Squeezed As Lenders Get Tougher"

"The financial turmoil is taking on a new dimension: Banks that lent money to hedge funds and other big risk-takers are asking for some of it back. Loans from banks and brokerages had allowed hedge funds ... to amass many times that amount in investments. But as the value of mortgage-backed bonds and other investments has dropped in recent weeks, the lenders are demanding that borrowers put up more cash ... When investors rush to dump assets, prices fall and lenders feel compelled to make further demands, or 'margin calls,' which cause even more selling. ... In the early stages of the financial turmoil, the riskiest securities -- such as those backed by subprime mortgages to people with poor credit -- were hit by selling. Now, as margin calls intensify, hedge funds and others find they must unload even assets perceived as high-quality.... The issue came to the forefront yesterday as **Carlyle Capital Corp.** said it failed to meet margin calls on loans backing part of its $21.7 billion portfolio of highly rated securities issued by Fannie and Freddie. ... The Carlyle news comes a week after margin calls triggered the implosion of London hedge fund **Peloton Partners LLP**, which analysts estimate could leave the funds' 14 lenders ... holding as much as $17 billion in problematic mortgage securities. ... Typically banks and brokers provide financing to hedge funds through so-called repo transactions, in which a fund turns over securities as temporary collateral for a loan. The fund later buys back the securities at a

higher price that includes interest on the loan. ... Now, banks and brokers are scaling back their exposure both by tightening standards on repo loans and reacting quickly when clients run into trouble. A bank might lend 97 cents against the collateral of a high-quality mortgage security with a market value of $1 -- a difference known as a 'haircut' that insures the lender against losses. If the value of the collateral drops to 95 cents, the borrower faces a margin call. Because repo loans often last only one day, hedge funds can find themselves in trouble literally overnight. ... When hedge funds can't come up with cash to meet a margin call, they are at risk of losing all access to credit and shutting down immediately. In that case, banks and brokers are forced to seize the collateral, leaving them holding the troubled securities at the root of the hedge funds' problems. Analysts say banks may have to take billions of dollars in further write-downs. The funds facing the greatest pressure are those that are highly leveraged, meaning they have large borrowings relative to the money entrusted to them. Carlyle Capital managed only $670 million in client money, but used borrowing to boost its portfolio of bonds to $21.7 billion, meaning it was about 32 times leveraged. Peloton, the fund that imploded, used borrowings to boost its portfolio by four to five times and possibly more." (WSJ, 3/7/08, "Hedge Funds Squeezed As Lenders Get Tougher") "32 times leverage" is beyond speculation and verges on gambling. The use of margin can make many ordinary persons into financial heroes and, sometimes, turn them into bums.

"As Deals Crash, Investors Flee Hedge Funds"

"As takeovers around the world collapse, hedge funds that bet on deals are feeling the pain. So-called event-driven funds are seeing losses mounting and investors seeking to withdraw their money in one of the roughest patches they have experienced. ... The declines ... are enough in some cases to send investors to the exits, because they pay large fees to hedge funds to outperform the market. ... Funds have several ways of investing in a takeover. In a leveraged buyout, they can buy shares in the target after a deal has been announced, a bet that will pay off if the deal closes on the proposed terms. In the case of one corporation buying another, they can bet that the acquirer's share price will fall and the target's will rise as the deal nears completion. If deals fall apart, these investors stand to lose a lot as the shares go in the opposite directions." (WSJ, 3/29/08, "As Deals Crash, Investors Flee Hedge Funds")

"Pardus Freezes Redemptions As Its Holdings Sink in Value"

"New York activist hedge fund **Pardus Capital Management LP** is halting investor redemptions indefinitely at a time when many of its holdings are plummeting in value. Pardus, which manages more than $2 billion, is seeking changes at several companies whose stocks it holds, most notably Delta Air Lines Inc. and UAL Corp., the parent company of United Airlines. Pardus has been trying for months to get the two airlines to merge, and both investments have been significant losers. Pardus, which doesn't use leverage, is down 40% from its high-water mark in early 2007.... An investment in French car-parts maker Valeo SA has been particularly painful for Pardus. Through a second fund, Pardus Europe Special Opportunities Master Fund LP, Pardus owns 12 million shares -- or more than $450 million worth -- of Valeo, making it Pardus's

largest holding. Valeo, which has lost more than 40% of its value in the past year, takes up almost a quarter of Pardus's overall holdings." (WSJ, 4/1/08, "Pardus Freezes Redemptions As Its Holdings Sink in Value")

"Hedge Funds Make It Hard To Say Goodbye"

"If you thought getting into a hedge fund was tough, try getting out of one. With the markets sputtering, some high-profile hedge funds are rejecting withdrawal requests, with some telling investors that it could be years before they will see all their cash again.... To be sure, so-called lockup policies are standard fare among hedge funds, with many firms reserving the right to restrict redemptions for periods of one year or longer. But there is concern in the industry that some funds could be dragging their feet on returning money to keep their businesses going, enabling them to continue to charge often-hefty fees. Many hedge funds charge management fees of about 2% and take 20% or more of any gains. ... The moves by the funds are legal. When investors sign up, they usually give a hedge fund the right to bar the exits, or limit the amount that can be withdrawn. But the gates are still catching some people by surprise. ... It is a painful reminder of the dangers of investing in hedge funds, which are more lightly regulated than mutual funds and other investments. ... Yet many hedge funds have moved into real estate, private equity, hard-to-trade debt and other investments that are difficult to sell on a dime at a reasonable price, particularly in a jittery market. So when investors ask for their money back, it can create difficulties. ... As more funds block the door to investors, there seems to be less of a stigma attached to it, some say, potentially encouraging others to do the same." (WSJ, 4/10/08, "Hedge Funds Make It Hard To Say Goodbye")

"Citigroup Posts $5.1 Billion Loss: Ailing Hedge Funds Infect the Wealth Unit"

"When one Citigroup Inc. unit sneezes, another seems to catch a cold. The phenomenon was on display Friday, as Citigroup reported that first-quarter profit in its wealth-management division, long considered a crown jewel of the financial empire, fell 33%, dragged down by the poor performances of internal hedge funds that were ravaged by turmoil in the credit markets. The disappointing showing in the wealth-management ... group had been peddling the hedge funds, run by Citigroup's alternative-investments division, to their clients. When the funds incurred steep losses, the wealth-management group moved to help the investors exit their positions. ... In three families of hedge funds, Citigroup this year has either had to inject its own capital to stabilize the funds or barred investors from withdrawing their money. All three fund groups have struggled to stay afloat due to their overexposure to the credit markets. ... The wealth group also set aside $250 million in the first quarter to help clients liquidate their positions in Citigroup's Falcon fund group, which was burned by big bets on some of the hardest-hit areas of the credit markets." (WSJ, 4/19/08, "Citigroup Posts $5.1 Billion Loss: Ailing Hedge Funds Infect the Wealth Unit") Is cross-selling just a fancy way to ignore conflicts of interest?

"SEC Rebuffs Lawmakers Over Bear"

"Securities regulators refused a congressional request to disclose why they dropped an investigation into whether **Bear Stearns** Cos. harmed investors by improperly valuing complex debt securities. The Securities and Exchange Commission cited confidentiality in its decision involving the late-stage probe of the Wall Street firm. At issue is a move by the SEC to abort an enforcement case into activities at Bear Stearns several months before the firm imploded in March. ... The Wall Street Journal reported in December that investigators including the SEC had pulled back from bringing two cases begun in 2005 against Bear Stearns involving collateralized debt obligations, or thinly traded investments that package pools of loans. In an April 2 letter, Sen. Charles Grassley, an Iowa Republican, requested information from the SEC into the circumstances surrounding the dropped case. ... The move sets the stage for further wrangling. Legislators could argue that they previously have sought -- and received -- much more-sensitive-classified data, and that the SEC investigations wouldn't harm the parties involved because they had been dropped. ... Legislators also could argue that the SEC wouldn't be releasing data to the public, but rather to Congress. Meantime, the SEC's inspector general is investigating circumstances related to the dropped Bear Stearns case, following a request by Sen. Grassley. ... The SEC branch office in 2005 said it planned to recommend that Bear Stearns be charged for the way it priced and valued about $63 million of CDOs. (WSJ, 4/23/08, "SEC Rebuffs Lawmakers Over Bear")

"Peloton Flew High, Fell Fast"

"When hedge-fund chief **Ron Beller**'s investments in U.S. mortgages turned against him, he got a rude awakening to Wall Street's unsentimental ways. Bankers who had vied for his business reeled in credit lines and seized the fund's assets. In a matter of days, **Peloton Partners LLP**, once one of the world's best-performing hedge-fund operators, lost some $17 billion. ... In its sheer speed, Peloton's demise offers an illustration of the delicate relationships upon which the financial industry is built, and the breakneck pace at which they have been unraveling. ... Peloton was particularly susceptible because it borrowed heavily to boost returns. For every dollar of client money, Peloton had borrowed at least another nine dollars to buy some bonds. ... In mid-February ... investments took a hit when Swiss bank **UBS** AG said it had marked down the value of highly rated mortgage securities similar to those that Peloton held. ... When Peloton traders tried to sell securities to raise money, brokers were unwilling to bid....[L]enders seized Peloton's assets, bringing a chaotic end to the fund."(WSJ, 5/12/08, "Peloton Flew High, Fell Fast")

"Banks Fumble At Operating Hedge Funds"

"Getting into the hedge-fund business seemed like a no-brainer for big banks just a few years ago. ... [T]he foray is raising questions. **Citigroup** Inc., Bear Stearns (absorbed into **J.P. Morgan Chase** & Co.), **Goldman Sachs Group** Inc. and **UBS** AG have seen hedge funds that they started or invested in run into problems amid the credit crunch. ... At the same time, lawsuits leveled against banks such as Citigroup after

sudden hedge-fund losses raise the question about whether the downside to getting into the hedge-fund game is worth any potential gains. ... When hedge funds collapse, their investors grumble, but there usually isn't much they can do about it. But banks have much deeper pockets and are more likely to be the targets of messy lawsuits from investors -- legal action that can cost them money and hurt their reputations. ... [T]he track record so far isn't promising: Bear's mortgage funds lost almost $2 billion last year; Goldman Sachs's huge Global Alpha fund lost almost $4 billion in 2007; and UBS's high profile Dillon Reed fund was closed after losses in the summer. More recently, Citigroup's Falcon funds ran into losses of almost $2 billion." (WSJ, 5/31/08, "Banks Fumble At Operating Hedge Funds")

"Scheme Victims Face Lawsuits"

"It is bad enough for victims of the late **Kirk S. Wright**, the high-living hedge-fund manager ... that they were swindled out of about $92 million.... [F]ormer clients are facing lawsuits filed by the bankruptcy trustee trying to untangle the mess. Even some who say they lost much of their life savings are being pressed to forfeit payments they got from Mr. Wright before the 2006 collapse of his company, **International Management Associates LLC**. ... The trustee in the Wright case, accountant **William Perkins**, wants money back from many of the hedge-fund manager's clients who didn't lose everything they invested. Because the scheme involved collecting money from some investors in order to pay fictitious returns to other clients, anyone who received money from Mr. Wright technically was taking possession of cash that wasn't theirs, the lawsuits allege. ... Whatever money turns up would be pooled and then distributed to everyone who was cheated, after various expenses are deducted. This isn't the first time that people who lost money in an alleged Ponzi scheme have been sued. In Los Angeles, a bankruptcy trustee still is tangling with investors in a $21 million pyramid scheme run by **Gary Eisenberg**, who pleaded guilty in 2002 to securities fraud and mail fraud. ... Court records show that Mr. and Mrs. Eskridge invested roughly $1.5 million with Mr. Wright after meeting him through their pastor. 'We wanted to help him because he was African-American, and we wanted to support his business,' Mrs. Eskridge says. From March 2005 to February 2006, the couple received 30 checks or electronic funds transfers from Mr. Wright, the trustee's lawsuit alleges. But their net losses from the scheme total $983,000, they say. ... While clients should have been far more skeptical of the glib, Harvard-educated hedge-fund manager..." (WSJ, 6/7/08, "Scheme Victims Face Lawsuits") Becoming a victim of affinity fraud really shatters one's trust in mankind.

"Prosecutors in Bear Case Focus In on Email"

"The indictments of two former **Bear Stearns** Cos. hedge-fund managers are expected to cite a personal email sent from one to the other suggesting that the funds were headed for the rocks -- four days before they told investors there was little to worry about. Fund manager **Matthew Tannin** emailed his more senior colleague **Ralph Cioffi** that he feared the market for complex bond securities in which they had invested was 'toast.' He suggested they discuss the possibility of shutting down the funds, according to the email, which was sent from Mr. Tannin's private account. Federal prosecutors are set

to announce the indictments of the two men ... on securities-, wire- and mail-fraud charges.... The two managers have told associates that they quickly became convinced that Mr. Tannin's worry about the markets was unfounded....Four days after the Sunday-morning email, Mr. Tannin told fund investors on a conference call that he was 'quite comfortable' with their holdings. Mr. Cioffi used similar language. .... At issue: whether Messrs. Cioffi and Tannin deliberately misled investors about the strength and performance of their two portfolios, the **High-Grade Structured Credit Strategies Fund**.... Mr. Cioffi argued that the funds were expected to soon close on a new financing agreement with a large bank, these people say; therefore, the funds were well-positioned to invest in only the highest-quality bonds. ... During the investor call on Wednesday, April 25, hundreds of investors and others dialed in. ... Mr. Cioffi explained during the call, but the two funds appeared to have declined in value. Still, he said, the fund had plenty of 'liquidity' -- in other words, cash or securities easily converted into cash -- as well as marketable securities and lines of credit, and that he believed the portfolios were on solid ground. ... Over the weeks that followed ... investors grew increasingly concerned about renewed weakness in the subprime-mortgage market; they flooded Bear Stearns Asset Management with requests for their money back. ... Seeking to preserve the two funds by holding on to their cash -- roughly $300 million, according to people familiar with the matter -- the managers elected to freeze redemptions. It didn't work. Lenders who had provided the funds with billions of dollars in financing began making urgent 'margin calls,' or demands for additional collateral, in the form of cash or securities." (WSJ, 6/19/08, "Prosecutors in Bear Case Focus In on Email") On the civil side, how does one prove that /he/she/it intended to withdraw funds and would have done so but-for what was learned in the conference call? If one had made a redemption request, would funds have been available and disbursed? Even if funds were disbursed, what portion if not all, would be clawed back via a trustee-in-bankruptcy lawsuit? What did the two fund managers inform Bear Stearns to obtain $300 million?

"Locked In: When Hedge Funds Bar the Door"

"Investors once clamored to get into **Ritchie Capital Management**, a high-profile hedge fund. Now, some are scrambling to get out -- and are finding the doors locked. Following bad bets and big losses, A.R. Thane Ritchie has barred investors from leaving his fund.... The tussles illustrate the 'roach motel' nature of hedge funds, where once investors get in, they can't always get out. ... Funds say they have no choice: To return the money, they'd have to sell off assets, leading to deeper losses for all their investors. But critics say locking down investors' stakes chiefly benefits fund managers, who get to keep earning hefty management fees. ... [W]ith many funds invested in hard-to-sell, illiquid assets, some of those requests could be denied in the coming weeks -- and legal experts say a wave of litigation could follow. ... Mr. Ritchie made ... a series of decisions that would anger some of his investors -- and would ultimately lead many of them to run for the exit door. Rather than staying small and playing it safe, Mr. Ritchie expanded, raising more money and going into riskier investments. In doing so, he changed strategies, abandoning arbitrage in favor of investments in insurance, real estate and private equity -- all of which are harder to value and harder to sell than stocks. They were also areas in which he had little experience. Strictly speaking, a change in investing strategy is allowed under

Ritchie Capital's rules, which are laid out in a document clients are given before they invest. ... [S]ome investors say Mr. Ritchie didn't make clear to them the degree to which he shifted strategies until much later, ultimately jeopardizing their trust in him. ... Mr. Ritchie defends the decision to change investing strategies. He says his experience wasn't an issue because he had hired a team of qualified managers whom he relied on to make investment decisions. He also says investors were fully informed of the new strategy and that he built up the new strategies slowly.... Roughly half the main fund's 200 investors asked for their money back, says William Hobbs, Ritchie Capital's general counsel. ... Mr. Ritchie says he is now investing in an area he is familiar with: distressed assets, including investments in other hedge funds that have hit financial straits. He's approaching hedge funds and other investors, offering joint ventures in which Ritchie Capital provides capital in exchange for a share in the profits when the assets' value recovers. (WSJ, 7/2/08, "Locked In: When Hedge Funds Bar the Door") Would/should a reasonably prudent investor invest in a "roach motel"? Did investors count on Ritchie's investment abilities or his abilities to select experts? How does one supervise experts in an area in which one does not have expertise?

"Defrauded Fund Investors Sue Goldman"

"**Samuel Israel III** bilked his investors out of $250 million, but they are hoping to recoup some of their money from one of Wall Street's deepest pockets: **Goldman Sachs**. ... **Bayou**'s unsecured creditors committee sued Goldman in late May, claiming the investment bank had failed to detect Mr. Israel's fraud, one of the biggest ever in the hedge fund industry, and to investigate signs that something was amiss at Bayou. For six years, Goldman acted as the so-called prime broker for Bayou, clearing trades, taking custody of securities and providing reports on the fund firm's investments. The claim seeks $20 million. ... Bayou's creditors claim that Goldman should have realized something was amiss, and argue that Goldman did nothing to investigate various warning signs. 'G.S.E.C. failed to diligently investigate the red flags it was made aware of, to contact Bayou's auditors to request additional information, or to alert the appropriate authorities of what it had learned,' the suit says. ... Goldman provided monthly statements to Bayou outlining its losses. ... But Goldman knew that Bayou was reporting significant gains to investors, the suit charges. In September 2003, and in November of that year, Kyle R. Czepiel, a senior vice president at Goldman, requested marketing materials from Bayou. In early 2004, Bayou provided materials to Goldman that claimed it had earned a return of almost 18 percent since its inception — a figure the suit says was 'completely inconsistent with the actual returns the Bayou Funds had been realizing in their trading accounts at G.S.E.C., in which they had done nothing but lose money.'"(NYT, 7/18/08, "Defrauded Fund Investors Sue Goldman") Could/did Goldman reasonably assume that Bayou made profitable investments at other than Goldman? Would Goldman have been in a better legal position by not seeking Bayou's investor reports? Is aided/abettor liability theory still alive and well?

"Wood's Fund Takes a Beating"

The two-year-old hedge fund founded by **Jonathan Wood**, a former UBS AG trader, is down about 85% from its inception through July.... An added sting for investors: They haven't been able to cash out because they agreed not to withdraw money for as long as five years from when they signed up. Those are tight lockup terms, but Mr. Wood was able to command them because of his successful track record as a senior trader at UBS. ... The fund's problems underscore a lesson for investors: Traders who perform well at banks don't always fare as well at hedge funds. ... His flagship **SRM Global Master Fund** holds large equity positions in companies involved in mergers, financial restructurings and other corporate actions. ... Among its investors are large European institutions, including UBS, which put in about $500 million. UBS's prime brokerage unit also provides trading and lending services to SRM. ... Mr. Wood has been an advocate for shareholder rights.... Mr. Wood's company, **SRM Fund Management Cayman Ltd.**, is registered in the Cayman Islands, with offices in Monaco." (WSJ, 8/15/08, "Wood's Fund Takes a Beating") Is this a double standard or what? How can one be a so-called shareholders' rights advocate, while assuring one's own shareholders have, in effect, no recourse, whatsoever? Do investors ever consider the what-if scenario where so much goes wrong?

"Hedge Fund Founder Ordered to Pay $300 Million"

"A federal court in Philadelphia has ordered the former president and founder of a hedge fund to pay nearly $300 million for defrauding clients. Federal prosecutors indicted **Paul Eustace**, president and founder of the Philadelphia **Alternative Asset Management Company**, in November on two criminal counts of commodities fraud. The government said Mr. Eustace stole $200 million from clients from 2001 through 2005. The government accused Mr. Eustace, of Ontario, Canada, of creating false account statements, raising management fees based on false profits and transferring clients' money to himself. On Tuesday, the Commodity Futures Trading Commission said Mr. Eustace was ordered to pay $279 million in restitution and a $12 million civil penalty. ... Philadelphia Alternative, which traded in commodities futures and options, collapsed in 2005. ... The futures and options broker **MF Global** agreed in December to pay more than $77 million to settle federal charges that it failed to watch over Mr. Eustace. ... Mr. Eustace ... lost about $200 million while trading commodity futures and options. He hid the losses using false accounts and bogus account statements that showed huge profits." (8/20/08, AP, "Hedge Fund Founder Ordered to Pay $300 Million") What did MF Global know and when did it know it to create incentive to settle? $77 million is not chump-change. Does it know similar information about other hedge funds? Should hedge fund managers provide fidelity insurance payable to their customers?

"Hedge Funds Help Fill Gap In Lending for Property"

"As the credit crunch enters its second year, more investors seeking financing to acquire office towers, retail stores, hotels and the like are left with little choice but to turn to so-called hard-money lenders, lightly regulated businesses that charge high interest

rates for short-term loans. Right now, among the biggest players in the hard-money arena are hedge funds, which view commercial-real-estate lending as a way to diversify their traditional trading operations while still commanding double-digit returns. ... Hard-money lenders have always played a role in commercial real estate, but mostly on the fringes. In the past, such lenders targeted desperate investors and developers who needed cash fast or had too many credit problems to borrow from conventional sources. ... [A]s many as 140 hedge funds specializing in distressed assets or fixed-income securities also provide commercial-real-estate lending, estimates **Ken Heinz**, president of **Hedge Fund Research** in Chicago. ... So far, some investors have been eager to put their money into the funds. ... [H]edge-fund lenders say they are protecting themselves by being much more selective about the loans they make. ...[H]edge funds plan to hold the loans on their balance sheets, typically for one to two years." (WSJ, 8/27/08, "Hedge Funds Help Fill Gap In Lending for Property") Here we go, again. If they can't cut it in the areas that they supposedly know well --- stock and bond investing --- it is time to move into a new area. Hopefully, they will do a better job valuing the collateral than they did when purchasing sub-prime mortgage paper. However, as more hedge funds enter this new area, there may be a competitive race to lower quality investments. Those eager investors should proceed with caution, this time.

"SEC fines California hedge fund manager $100,000 in real estate investment case"

"The Securities and Exchange Commission … fined a California hedge fund manager and newsletter publisher $100,000 over claims he misled people into investing $20 million in two fraudulent real estate firms. **Mark J.P. Boucher** of Portola Valley helped raise the money by falsely claiming the investments were secured by real estate when one company never owned property and the other was 'wholly underwater in debt,' the SEC said." (Bloomberg, 8/28/08, "SEC fines California hedge fund manager $100,000 in real estate investment case") Real estate. Hmmm.

"Ospraie Closes Largest Fund As Commodity Losses Swell"

"Hedge fund **Ospraie Management**, one of the biggest players in commodities, said it is shutting down its largest fund after significant losses. The Ospraie Fund fell 27% in August alone due to bets on oil, natural gas and structured products, and the fund has been selling off its holdings over the past three weeks, possibly contributing to a decline in commodity prices. The fund, whose assets peaked at $3.8 billion late last year, is the biggest run by **Dwight Anderson**, a veteran commodities investor. ... The fund was shut down ... because any loss greater than 30% triggered a provision that allowed investors in the fund to pull money out as they wished. ... Ospraie managers are preparing to return 40% of the fund's value to investors by the end of September. Another 40% is expected to be returned by year-end, with the remaining taking longer because the assets are hard-to-sell illiquid investments...." (WSJ, 9/3/08, "Ospraie Closes Largest Fund As Commodity Losses Swell") It appears that a "hedge fund" has become just another excuse to gamble with other people's money and earn bigger-than-life fees.

"What Ospraie Taught Us"

"[O]spraie Fund --- lost nearly 39% of its value this year -- or almost $1.3 billion, with more than half of that in August alone -- the fund is being wound down. ... In one sense this is odd. In theory, hedge funds should offer refuge when financial markets are roiled. ... The problem is that every so often, investors get burned in spectacular fashion. Moreover, Ospraie enjoyed a solid reputation. That such a large, experienced fund manager was tripped up doesn't bode well for many others who have crowded into the commodities bull market." (WSJ, 9/4/08, "What Ospraie Taught Us")

"Mervyn's Sues Ex-Owners, Charges They 'Stripped' It"

"As more private-equity-backed companies file for bankruptcy protection, creditors and the companies themselves are expected to increase attacks on the financial structures used in the buyout deals. The transaction involving Mervyn's was struck during the earlier part of the decade when private-investment firms were snapping up struggling retailers less for their fashion sense and more for their real-estate value. Hedge-fund manager Eddie Lambert earned a fortune gaining control of bankrupt retailer Kmart and then selling off its real estate. Kohlberg Kravis Roberts & Co., Bain Capital and Vornado Realty Trust acquired Toys 'R' Us Inc. in part because of the value of its stores. The case against Sun and Cerberus is especially fraught for the private-equity industry, which is trying to shake off decades of criticism that the funds "strip" healthy companies with little regard for employees or institutions. It is that dynamic that forms the basis of the company's complaint." (WSJ, 9/4/08, "Mervyn's Sues Ex-Owners, Charges They 'Stripped' It") One only needs to follow the money to determine whether "stripping" occurred. On the other hand, the creditors, who knew or could have known the financial structures of the companies with which they dealt, may have assumed the risk, while factoring it into their pricing policies.

"Hedge Funds Get Rattled As Investors Seek Exits"

"With anxiety about hedge-fund woes gripping the market, funds have their own fear: their investors. Some investors, particularly what are known as 'funds of funds,' are demanding their money back and may ramp up requests in the weeks ahead. That has prompted hedge-fund managers to sell securities to raise cash. ... Funds-of-funds select hedge funds on behalf of pension funds, wealthy individuals or other investors, and charge a layer of fees on top of the hefty fees levied by hedge funds themselves. They often ask hedge funds for the option to redeem money as often as monthly and get good terms because they can bring in big chunks of cash at once. Some put in withdrawal notices to keep their options open, though they may ultimately decide to leave the money. Investors know that it can pay to be the first out the door of an underperforming hedge fund because as other investors cash out, the fund sells its holdings, pushing down prices. Many investors themselves have borrowed funds to juice their returns and when leverage amplifies their losses they can end up more eager to pull out. In some cases, funds-of-funds withdraw money at their investors' behest, despite solid performance from hedge funds. ... [T]he fund's (**RCG Capital Advisors** in Boulder, Colo.) manager, Ken Phillips,

says he is redeeming $100 million from 36 hedge funds because one of his key investors, a financial company, had a setback and needs its money now." (WSJ, 9/6/08, "Hedge Funds Get Rattled As Investors Seek Exits") Are the fees upon fees really worth it? Do large publicly traded mutual funds, which charge much lower fees, radically under perform hedge funds?

"Long-Term Capital: It's a Short-Term Memory"

A financial firm borrows billions of dollars to make big bets on esoteric securities. Markets turn and the bets go sour. ... The Long-Term Capital fiasco momentarily shocked Wall Street out of its complacent trust in financial models.... [W]all Street professed to have learned that even models designed by 'geniuses' were subject to error and to the uncertainties that inevitably afflict human forecasts. It also professed a newfound respect for the perils of borrowing. ... In its first four years, Long-Term Capital achieved phenomenal profits with virtually no downside. Thanks to its seemingly flawless computer models, as well as its formidable arbitrageurs ... it quadrupled its capital without having a single losing quarter. ... No firm had a closer view of Long-Term Capital than Bear Stearns, the broker that cleared its trades. ... As striking as the parallel is to Bear, Long-Term Capital's echo is far more profound. Its strategy was grounded in the notion that markets could be modeled. Thus, in August 1998, the hedge fund calculated that its daily 'value at risk' — meaning the total it could lose — was only $35 million. Later that month, it dropped $550 million in a day. How could the fund have been so far off? Such 'risk management' calculations were and are a central tenet of modern finance. 'Risk' is said to be a function of potential market movement, based on historical market data. But this conceit is false, since history is at best an imprecise guide. ... Before 1929, a computer would have calculated very slim odds of a Great Depression; after it, considerably greater odds. Just so, before August 1998, Russia had never defaulted on its debt — or not since 1917, at any rate. When it did, credit markets behaved in ways that Long-Term didn't predict and wasn't prepared for. This was the same mistake that scores of lenders would make in the housing industry. The United States had never suffered a nationwide contraction in housing prices; they assumed that the pattern would hold. ... The shock of their failure was such that hedge funds have been regarded as especially suspect ever since." (NYT Essay, 9/7/08, "Long-Term Capital: It's a Short-Term Memory") Mathematical/engineering principles are not easily transferable to financial market analysis and are not a substitute for common sense. Financial statement analysis is a different matter. *See, e.g.*, Financial Statement Analysis at http://www.ConcernedShareholders.com/CCS_FSA.html.

"Overheard"

"Hedge funds have pressed for more disclosure from companies. So it was interesting to see **Atticus Capital**, in a Sept. 4 investor letter, reveal its intention to 'suspend indefinitely the reporting of mid-month performance estimates.' The fund blamed those investors who had passed on the figures to journalists. That led to recent talk that Atticus was in trouble. Refreshingly, though, instead of running to regulators to complain, it pledged to use capital to 'take advantage of false rumors about us." Fighting

talk." (WSJ, 9/8/08, "Overheard") What? What do the agreements and sales literature state as to reporting to investors? Do those blabber-mouth investors actually exist? Is no news supposed to be good news? Will Atticus next assert a form of "executive privilege" to suspend providing all investment status information?

"Hedge Funds in a Fee-fall"

"When the going gets tough, the weak cut fees. At least that is the approach of **Camulos Capital**, which is offering to roughly halve its fees in a bid to retain clients after a 20% decline this year. ... How should this work? A dirty secret of hedge funds is high management fees, usually 2% or more of assets. Sure, there are computers to buy and support staff to pay. But, for most large stock-focused funds, a 1% management fee easily covers costs. The rest usually lands in the pockets of the hedge-fund manager, who also enjoys a 20% incentive fee on the returns generated." (WSJ, 9/9/08, "Hedge Funds in a Fee-fall") The fees are still too high!

"Hedge Funds Are Bracing for Investors to Cash Out"

First, the money rushed into hedge funds. Now, some fear, it could rush out. ... [N]ew worries were building inside the nearly $2 trillion world of hedge funds ... concerns that some investors will head for the exits. ... The big worry is that a spate of hurried sales could unleash a vicious circle within the hedge fund industry, with the sales leading to more losses, and those losses leading to more withdrawals, and so on. ... Now, the heady returns of the industry's glory days are over, at least for now. ... A growing number of hedge funds are closing down. About 350 were liquidated in the first half of the year. ...One little-known hedge fund barometer is pointing to trouble, however. The alphabet soup of complex investments that Wall Street created in recent years — R.M.B.S.'s, C.D.O.'s and the like — includes C.F.O.'s, short for collateralized fund obligations. Virtually unknown outside the industry, these investments are the hedge fund equivalent of mortgage-backed securities: securities backed by hedge funds. But last week, credit ratings agencies warned that they might lower the ratings of several C.F.O.'s, in part because of the concern that investors would withdraw money from the funds backing the investments. (9/29/08, NYT, "Hedge Funds Are Bracing for Investors to Cash Out") This might fall under the principle that a guaranty is only as good as a guarantor?

"Not Much Fun Now With the Fund of Funds"

"The market turmoil may reshape what is known as the 'fund-of-hedge-funds' industry. ...The funds pool investor money and distribute it among a collection of hedge funds. They promise to diversify risk, but investors pay an extra layer of fees.... Fund-of-funds firms account for about 40% of the roughly $2 trillion managed by hedge funds. ... Funds of funds can charge a management fee of up to 1.5% of assets plus a performance fee of 5% or 10% of gains. That comes on top of fees charged by managers at the underlying hedge funds. ... [I]nvestors can typically withdraw money from a fund of funds more easily than a fund of funds can pull its money from individual hedge funds,

which have lockups for months or years at a time. ... Some are considering the drastic step of imposing so-called gates to limit investor withdrawals, which is almost unheard of for funds of funds." (WSJ, 10/3/08, "Not Much Fun Now With the Fund of Funds")

"Smaller Hedge Funds Struggle As Money Pipeline Dries Up"

"**Mark Sellers (**a former stock analyst with Morningstar) **III**'s hedge-fund career peaked this summer about the time he turned 40. Then it cratered. Mr. Sellers, who once managed close to $300 million, is shutting his Chicago-based firm and retiring, at least until his distaste for the pressures of managing other people's money subsides. ... The past year has been brutal for hedge funds, and September looks to be the worst month in a decade in the industry.... Smaller hedge funds have advantages, such as being nimble in shifting markets. But they also have their burdens. Many are unable to attract big institutional investors such as pension funds and endowments, which are less likely to flee when times get tough. ... Smaller hedge funds are the most likely to fail in today's markets.... They often have shorter track records, and their overhead expenses eat up more of the fees they collect, leaving less wiggle room when profits decline. ... Three-fourths of the estimated 10,000 hedge funds globally have less than $500 million in assets.... 'Smaller shops have pluses and minuses,' says Colby Harlow, 30, who oversees $150 million in stock investments at **Harlow Capital Management LLC** in Dallas. ... It's a lean operation catering mostly to rich, or 'high net worth,' investors. Mr. Harlow does the trading. He has an administrative assistant and a marketing person. Mark Sellers III, of Sellers Capital, is closing his fund. Much of the money coming out of hedge funds right now belongs to wealthy individuals, who are the bread and butter of many smaller funds. Some of these clients are first-time hedge-fund investors, who put money with former Wall Street traders now running small hedge funds. ... Mr. Sellers contends that he probably could be riding out this year's storm if his client base included bigger, less-skittish clients. ... As his numbers got worse, he decided that enough investors would want to pull money out and that holding on until some of his biggest investments rebounded wasn't plausible.... Mr. Sellers's fund now holds just two stocks -- the biggest by far being Contango Oil & Gas Co., which has lost half of its value since June. He's staying with those in hopes they'll rebound." (WSJ, 10/4/08, "Smaller Hedge Funds Struggle As Money Pipeline Dries Up") Is an investment in Contango a disguised bet on commodity prices? It appears that smaller "hedge funds" do not have the luxury of buying quality investments and, if the price declines, averaging down, while waiting for price recovery. For those interested in the latter strategy, see http://www.ConcernedShareholders.com/CCS_FSA.html .

"MFA decries call for hedge fund ban"

"The $1.9 trillion hedge fund industry has gone on the defensive following a recent statement by Italian finance minister Giulio Tremonti, who suggested a move to abolish the alternative-class investments in Italy. ... Speaking at the Italian embassy, he characterized hedge funds as "absolutely crazy bodies that have nothing to do with capitalism," according to published reports. While acknowledging he would consider

abolishing hedge funds, Mr. Tremonti described them as "demented, dark and opaque." (InvestmentNews, 10/15/08, "MFA decries call for hedge fund ban")

"Lahde Quits Hedge Funds, Thanks `Idiots' for Success"

Andrew Lahde (head of Santa Monica, California-based **Lahde Capital Management LLC**), the hedge-fund manager who quit after posting an 870 percent gain last year, said farewell to clients in a letter that thanks stupid traders for making him rich and ends with a plea to legalize marijuana. ... 'I was in this game for money,' Lahde, 37, wrote in a two-page letter today in which he said he had come to hate the hedge-fund business. 'The low-hanging fruit, i.e. idiots whose parents paid for prep school, Yale and then the Harvard MBA, was there for the taking. These people who were (often) truly not worthy of the education they received (or supposedly received) rose to the top of companies such as AIG, Bear Stearns and Lehman Brothers and all levels of our government. ... All of this behavior supporting the Aristocracy, only ended up making it easier for me to find people stupid enough to take the other sides of my trades. God Bless America.' Lahde, who managed about $80 million, told clients he'll be content to invest his own money.... Lahde graduated from Michigan State University with a degree in finance and holds an MBA from the University of California, Los Angeles. He worked at Los Angeles-based hedge fund Dalton Investments LLC before founding his own firm two years ago with about $10 million." (Bloomberg, 10/17/08, "Lahde Quits Hedge Funds, Thanks `Idiots' for Success") Two themes emerge --- (1) luck does such wonders for one's ego, and (2), if one truly has faith (based in reality) in his/her investment abilities, it is not necessary to endure the hassles of managing OPM. On the other hand, as a wise trader/salesperson once said at the Kansas City Board of Trade, "It is much easier convincing investors that I know what I am doing than actually knowing what I am doing." Perhaps, Lahde should have expressed words of thanks to his great teachers and mentors and to his investors for recognizing his investment genius.

"Hedge Funds' Steep Fall Sends Investors Fleeing"

"The gilded age of hedge funds is losing its luster. The funds, pools of fast money that defined the era of Wall Street hyper-wealth, are in the throes of an unprecedented shakeout. Even some industry stars are falling back to earth. This unregulated, at times volatile corner of finance — which is supposed to make money in bull and bear markets — lost $180 billion during the last three months. Investors, particularly wealthy individuals, are heading for the exits. ... 'For the past five or six years, it seemed anybody could go to their computer and print up a business card and say they were in the hedge fund business, and raise a pot of money,' said Richard H. Moore, the treasurer of North Carolina, which invests workers' pension money in hedge funds. 'That's going to be gone forever.' ... Now Wall Street is buzzing about how much money could be pulled out of hedge funds — and which funds might bear the brunt of the redemptions. ... But now that the days of easy money are over, some fund managers are throwing in the towel. ...And what wealth there has been. More than anything else, hedge funds are vehicles for their managers to take a big cut of profits. The lucrative economics of the industry is known as 'two and 20.' Managers typically collect annual management fees equal to 2

percent of the assets in their funds, and, on top of that, take a 20 percent cut of any profits. ... But with the industry under pressure, those fat fees are being questioned. Mr. Moore and other investors are starting to ask whether hedge funds deserve all that money." (NYT, 10/23/08, "Hedge Funds' Steep Fall Sends Investors Fleeing") Why were those fat fees not questioned in the past? Does investor greed blind one to reality that there are points of diminishing returns in compensating for advisory competence?

"Selling Hedge-Fund Stakes"

"Growing numbers of hedge-fund investors, desperate to redeem their money and avoid further losses, are turning to a secondary market in which to sell their stakes... Right now, buyers and sellers can find one another using their industry contacts, or through a service called **Hedgebay Trading Corp.**, which operates the only secondary market that matches buyers and sellers of hedge-fund stakes. Discounts on such stakes have gotten as high as 50% in extreme cases. ... For a while, Hedgebay was dominated by investors -- either individuals or funds of funds -- who wanted to sell their stake for a profit, or get out of a poor-performing fund. But now, many more pensions and endowments are putting stakes up on Hedgebay. The reasons sometimes have to do with the stricter rules they face. ... Many funds of funds, which invest in several different hedge funds, have asked to redeem more money than they actually need out of fear that the funds they hold might put up a gate or suspend redemptions. If a hedge fund does suspend redemptions, that can force the fund of funds to do the same. ...Several hedge funds have suspended redemptions this year.... A recent report from J.P. Morgan Chase & Co. estimated there would be about $100 billion in redemption requests for funds of funds in the fourth quarter. ... **Permal Group**, a unit of Legg Mason Inc., said last week it is launching a $500 million fund dedicated to buying distressed-priced hedge fund stakes. A person with some knowledge of Permal said the fund will use Hedgebay to find and buy stakes, but will also find business using its existing relationships with investors and distributors." (WSJ, 10/23/08, "Selling Hedge-Fund Stakes") Let the complex games continue as the rats leave a sinking ship!

"Hedge Fund Withdrawals Stress Market"

"Hedge funds are aggravating the worst market selloff in 50 years as they dump assets to meet investor redemptions and keep lenders at bay. ... [M]anagers are selling assets to repay departing investors and meet demands from lenders for more collateral. Others ... are hoarding cash to soothe nervous clients and wait for signs the worst is over. When stocks rally, hedge funds take advantage to unload what they can. ... Investors withdrew a record $43 billion from hedge funds last month...." (Bloomberg, 10/24/08, "Hedge Fund Withdrawals Stress Market")

"Hedge Fund Selling Puts New Stress on Market"

"Hedge funds are selling billions of dollars of securities to meet demands for cash from their investors and their lenders, contributing to the stock market's nearly 10% drop over the past two days. ... One of the biggest hedge funds, $16 billion **Citadel**

Investment Group, is being asked by several major banks to post additional collateral to cover big losses on its investments.... Citadel, which is run by **Kenneth Griffin**, was until recently considered a possible savior for troubled Wall Street firms. But his biggest hedge fund has fallen nearly 40% this year.... Citadel executives say ... they have significant amounts of cash to satisfy their lenders. ... Hedge funds have emerged as the latest serious problem in the global financial system. .... Hedge funds are sitting on a record amount of cash, estimated at about $400 billion.... The recent rush of withdrawal notices to hedge funds comes as investors, including endowments, pension funds and wealthy individuals, see other investments shrink; in some cases these investors need cash to meet their own obligations. It also marks a sharp reversal of sentiment among these big institutional investors, which jumped into hedge funds and similar investments in recent years. ... The result is a downward spiral where hedge funds sell off thinly traded securities such as convertible bonds and corporate loans, driving down their prices, and leading to bigger losses and more demands for cash." (WSJ, 11/7/08, "Hedge Fund Selling Puts New Stress on Market") Perhaps, in yesteryear, hedge funds, with their use of 40-to-one leverage caused investments to become overvalued. Then, there were no complaints or concerns. De-leveraging is just a natural part of the economic cycle --- but it can cause much pain if one was late to the game.

"Judge Tosses Fund's Fraud Suit Against WaMu"

"A Connecticut hedge fund will not be able to pursue federal securities fraud claims against Washington Mutual in an effort to recover $7 million lost in bad mortgage-backed securities investments, a federal judge ruled Tuesday. Judge Jed S. Rakoff issued an order Tuesday dismissing the claims filed by Connecticut-based Good Hill Partners LP against the failed thrift.... In the order, the judge dismissed ... federal securities fraud claims with prejudice... The investment at issue was Good Hill's purchase of $18.45 million in mortgage-backed securities, which came from an offering backed by $1.5 billion in subprime mortgages – including junior-lien and senior-lien mortgages, court documents said. The mortgages were held by a Washington Mutual entity, WaMu Series 2007-HE2 Trust. Junior-lien and senior-lien loans sold in the Washington Mutual offering were used in combination by the same borrowers to finance the same properties, Good Hill's complaint said. Such combo loans, or 'piggyback' loans, were used frequently by borrowers in the real estate boom to obtain 100-percent financing to purchase homes, according to news reports. Good Hill said in its complaint that Washington Mutual representatives assured the firm that the combination loans would be treated as single loans in the event of default and foreclosure, meaning that charge-offs would be applied equally to both junior- and senior-lien loans. For that reason, the hedge fund thought it would have steady cash flow from its investment for at least a year, and it was willing to pay 98 percent of the face value of the bonds..." (Securities Law 360, 11/5/08, "Judge Tosses Fund's Fraud Suit Against WaMu") Did anyone representing Good Hill read the sales literature? What does the sales literature say as to the charge-offs? Real Estate 101 teaches the differences between senior and junior liens. Basically, the junior takes the hit first. In any event, why would any investor be involved with 100% financing, which, under the laws of many states, is

without recourse for purchase money financing if a deficit arises during foreclosure. Perhaps, the hedge fund manger should answer to its investors for the $7 million lost.

"Capitol Hill Questions Hedge-Fund Managers"

"A congressional committee grilled five of the country's wealthiest hedge-fund operators, chiding them for failing to pay their share of the nation's taxes and for taking big, undisclosed risks that could threaten the wider financial system. ... [T]hey maintained that such funds, which cater to the wealthy and big investors such as pension funds, can play an important role in a recovery, lending money where banks won't and buying up toxic assets like mortgages that others won't touch. ... George Soros, the philanthropist and author who started Soros Fund Management in New York ... said Thursday that the financial system in general should be regulated to prevent asset bubbles like the housing-market buildup that led to the current credit crisis. ... Congress is expected to propose changes that would raise taxes on billions of dollars earned by hedge-fund managers, and also push provisions requiring regular examinations of all hedge funds above a certain asset size and more-thorough disclosure to regulators." (WSJ, 11/14/08, "Capitol Hill Questions Hedge-Fund Managers")

"Perot Fund Liquidates as Debt Bets Turn Sour"

"Last week's record plunge of the commercial real-estate securities market has claimed its first major casualty: a $1.5 billion fund with investors including Texas billionaire H. Ross Perot and members of his family.... Other hedge funds and money-management firms that invested in real-estate debt face the potential for more margin calls. ... The woes of these funds promise to put more strain on the banking sector. Banks that have made short-term loans to these funds mightn't recoup all their money even if the funds liquidate. **Parkcentral Global Hub Ltd.**, the fund overseen by Parkcentral Capital Management LP, a Plano, Texas, firm controlled by the Perot family, peaked this year at $2.5 billion in assets. It used borrowed money to amplify its bets, said people familiar with the matter, and began dumping assets last week. That leverage helped hasten the fund's meltdown as the commercial mortgage-backed securities, or CMBS, market cratered last week, and the borrowings also could leave lenders with tens of millions of dollars in losses.... Petra has met margin calls by using cash on hand and asset sales.... The structure of the Petra hedge fund was creative, complicated and risky.... At its peak, Petra leveraged the $418 million it raised in equity to buy $1.6 billion in high-yield commercial real-estate debt. Key to the fund's success was its ability to borrow at much lower rates than those being paid by the debt it was buying. It did this initially by borrowing short-term money on the 'repo' market. Then Petra's plan was to pay off the short-term loans by packaging the debt it purchased into a long-term collateralized debt obligation and selling it to investors. By doing that, Petra insulated itself from margin calls because it wouldn't have to repay the CDO bondholders before its assets matured. But Petra's strategy was tripped up by the market. It succeeded in selling one CDO totaling $1 billion. However, as the credit crisis intensified, the CDO market collapsed.

That left Petra holding some short-term repo debt." (WSJ, 11/26/08, "Perot Fund Liquidates as Debt Bets Turn Sour")

"Fortress, the Hedge Fund, Is Crumbling"

"When **Wesley R. Edens** and his partners founded their investment firm a decade ago, they chose a name that evoked unshakeable bastions: Fortress. ... Cracks are spreading throughout the **Fortress Investment Group**, once a leading player in the worlds of hedge funds and leveraged buyouts. On Wednesday, Fortress's shares fell 25 percent to $1.87, a new low, after the company temporarily suspended withdrawals from its largest hedge fund. Investors had asked to withdraw $3.51 billion from the money-losing fund, **Drawbridge Global Macro**. ... The once-celebrated company has lost 89 percent of its market value over the last year.... It is a remarkable turnabout for Fortress, which less than two years ago was soaring along with the rest of Wall Street. Its debut as a public company, in February 2007, was heralded as the dawn of a new age of big hedge funds and buyout firms. ... But life as public companies has proved treacherous for Fortress, Blackstone and the other so-called alternative investment firms that sold stock to the public shortly before the credit crisis erupted. ... Fortress's plight reflects the ills plaguing much of high finance. Investors are abandoning hedge funds in growing numbers, and the industry, once so profitable, is now in the midst of a wrenching shakeout. ... But while Fortress's earnings will suffer because of the redemptions — hedge funds earn fees based on both the amount of assets they manage and the performance of those funds — the withdrawals alone do not necessarily spell the company's doom. Less than 30 percent of Fortress's $34 billion in assets under management are subject to investor redemptions. Most are locked up in private equity funds that do not allow quick withdrawals of capital. Still, private equity firms have been hurt by the near-freeze in the credit markets, which has limited their ability to strike new deals and dealt a severe blow to many of the debt-laden companies they own. ... Just as it was the first major alternative-investment manager to go public, Fortress is now being watched closely as a canary in the coal mine. ... For months, Fortress has been the subject of gallows humor suggesting that it might simply buy back its shares and take itself private once more." (NYT, 12/4/08, "Fortress, the Hedge Fund, Is Crumbling") Did any analyst/advisor, at or about the time of the IPO, speak to the issue of why these greedy kings of the investment universe were willing to share their supposedly unending good fortune with those commoners who inhabit the investing public?

"J.P. Morgan Seizes Fund's Collateral"

"**J.P. Morgan Chase & Co.** seized tens of millions of dollars of collateral from a commercial-property debt fund run by **Guggenheim Partners LLC** and started to auction it off this week following the fund's failure to come up with additional capital to meet margin calls.... Late last month, a $1.5 billion real-estate debt fund with investors including the family of onetime presidential candidate H. Ross Perot was forced to liquidate to pay off creditors. The seizure and sale of collateral by creditors is adding to the downward pressure on prices of debt backed by office buildings, hotels, shopping centers and other commercial property. ... The fund that has problems got tripped up by

leverage like other funds that have invested in debt used to finance commercial property. ... The short-term debt triggered margin calls in recent weeks as the weakening economy wreaked havoc in the commercial real estate debt market. Under the terms of that debt, a drop in the value of the fund's collateral led lenders to demand additional cash. ... Investors in this Guggenheim fund include such big-name institutional investors as the California Public Employees' Retirement System, the largest U.S. public pension fund known as Calpers, and Oregon Investment Council, which manages the $54 billion Oregon Public Employees Retirement System. ... It isn't clear whether the fund will survive. Investors may still come to the rescue because a liquidation of the entire fund would likely cause them losses." (WSJ, 12/4/08, "J.P. Morgan Seizes Fund's Collateral") One should wonder how prudent retirement fund managers act when they invest retirement funds in financial instruments on margin?

"Lawyer Is Accused in Massive Hedge Fund Fraud"

"His legal lineage was impeccable. A Yale man with a law degree from Harvard, he was a litigation powerhouse, a leader at some of the more prominent firms at the New York bar who then started a top-shelf practice of his own. But when the lawyer, **Marc S. Dreier**, stepped off a flight from Canada on Sunday night, federal authorities in New York arrested him in a $100 million fraud scheme, portraying his recent undertakings as more high-stakes grifting than high-end lawyering. [M]r. Dreier, who in 1996 founded a 250-lawyer firm that bears his name, is said to have tried to take advantage of the current financial crisis by selling phony debt to hungry hedge funds looking for deals. ... [H]e peddled forged promissory notes — utterly worthless paper.... He backed up his claims with phony financial statements and bogus audit opinions from a reputable accounting firm, correspondence on the stationery of the New York real estate developer who supposedly issued the debt.... With these tools and little more, he allegedly took hedge fund executives for $100 million in one instance alone, money that the authorities say remains unaccounted for. ... Questions in the case abound. Why — and perhaps more important, when — did Mr. Dreier begin the multimillion-dollar con game detailed in the criminal complaint? How did sophisticated investors, and his highly educated colleagues, get duped?" (NYT, 12/9/08, "Lawyer Is Accused in Massive Hedge Fund Fraud") Has anyone verified the alleged Yale-Harvard pedigree? Which hungry hedge funds bought the phony paper? Does someone have a bridge to sell them?

"Prominent Trader Accused of Defrauding Clients"

"On Wall Street, his name is legendary. ... At age 70, he had become an influential spokesman for the traders who are the hidden gears of the marketplace. But on Thursday morning, this consummate trader, **Bernard L. Madoff**, was arrested at his Manhattan home by federal agents who accused him of running a multibillion-dollar fraud scheme — perhaps the largest in Wall Street's history. ... [**B**]**ernard L. Madoff Investment Securities**, the firm he founded in 1960, operated more than two dozen funds overseeing $17 billion. These funds have been widely marketed to wealthy investors, hedge funds and other institutional customers for more than a decade.... The Madoff funds attracted investors with the promise of high returns and low fees. ... Competing

hedge fund managers have wondered privately for years how Mr. Madoff generated such high returns, in bull markets and bear, given the generally low-yielding investment strategies he described to his clients. 'The numbers were too good to be true, for too long,' said **Girish Reddy**, a managing director at **Prisma Partners**, an investment firm that invests in hedge funds. ... Mr. Reddy said his firm had looked at the Madoff funds but decided against investing in them because their performance was too consistently positive, even in times when the market was incredibly volatile." (NYT, 12/12/08, "Prominent Trader Accused of Defrauding Clients")

"Top Broker Accused of $50 Billion Fraud"

"**Bernard L. Madoff**, a former chairman of the Nasdaq Stock Market and a force in Wall Street trading for nearly 50 years, was arrested by federal agents Thursday, a day after his sons turned him in for running what they said their father called 'a giant Ponzi scheme.' ... [M]r. Madoff also oversaw an investment-advisory business that managed money for high-net-worth individuals, hedge funds and other institutions. ... The FBI complaint quotes two senior Madoff employees as saying Mr. Madoff ran the investment arm on a separate floor of the firm's offices. The two employees said Mr. Madoff kept the financial statements from the firm under lock and key and was 'cryptic' about the firm's investment business. ... Both complaints say Mr. Madoff told his sons he believed losses from his fraud exceeded $50 billion. ... Such a scheme would dwarf past Ponzi schemes. ... Earlier this month, the criminal complaint says, Mr. Madoff told one of his sons that 'clients had requested approximately $7 billion in redemptions, that he was struggling to obtain the liquidity necessary to meet those obligations.' ... Mr. Madoff's asset-management business appealed to investors for its remarkably steady returns for investing in the stock market. His investors consistently enjoyed small monthly gains, usually between zero and 2%. Mr. Madoff told investors his strategy was to trade in and out of large-cap stocks and buy options on those shares to help smooth the ups and downs. When he failed to see opportunities in the market, he would shift to U.S. Treasurys, according to fund marketing documents and people familiar with his strategy. Mr. Madoff's **Fairfield Sentry Ltd.**, a hedge fund run by Madoff Investment Services to invest in shares in the S&P 100, claimed to be up 5.6% through the end of November, a period when the Standard & Poor's 500-stock index was down 37.65%. In October, Fairfield Sentry was said to be down 0.06%, a month when the S&P 500 lost 16.8%. Since its inception in December 1990, the fund averaged a 10.5% annual return, according to fund documents. Such returns sparked widespread skepticism for years on Wall Street. News stories raised questions about his approach. A number of traders suggested his firm could be buying shares for its own account just before it filled orders for customers, an illegal act called front-running. In 2001, Mr. Madoff told Barron's that charges of front-running were 'ridiculous.' An executive in the securities industry, **Harry Markopolos**, contacted the SEC's Boston office in May 1999, urging regulators to investigate Mr. Madoff. Mr. Markopolos continued to pursue his accusations over the past nine years.... 'Bernie Madoff's returns aren't real and if they are real, then they would almost certainly have been generated by front-running customer order flow from the broker-dealer arm of Madoff Investment Securities LLC,' Mr. Markopolos wrote to the SEC in November 2005. The SEC declined to comment on the matter." (WSJ, 12/12/08,

"Top Broker Accused of $50 Billion Fraud") When things seems to be too good to be true, some on Wall Street suspected problems. Where was the SEC? The Inspector General of the SEC might look into the matter of the SEC's actions. An annotated copy of the Markopolos letter to the SEC is available at: http://www.LGEsquire.com/LG_MarkopolosMemoToSEC.pdf .

"Fees, Even Returns and Auditor All"

"**Bernard L. Madoff** is alleged to have pulled off one of the biggest frauds in Wall Street history. But there were multiple red flags along the way, including a series of accusations leveled against Mr. Madoff's operation. Now some are asking why regulators and investors didn't pick up on the alleged scheme long ago. 'There's no smoking gun, but if you added it all up you wonder why people either did not get it or chose to ignore the red flags,' says **Jim Vos**, who runs **Aksia LLC**, a firm that advises investors and came away worried after examining Mr. Madoff's operation. ... The first tip-off for some was the steady returns generated by the firm in every kind of market. Mr. Madoff would buy a basket of stocks resembling an S&P index while simultaneously selling options that pay off for the buyer if these stocks soar, while also buying options that pay off if the index tumbles. The supposed goal was to have smooth, steady returns. **Harry Markopolos**, who years ago worked for a rival firm, researched Mr. Madoff's stock-options strategy and was convinced the results likely weren't real. 'Madoff Securities is the world's largest Ponzi Scheme,' Mr. Markopolos, wrote in a letter to the U.S. Securities and Exchange Commission in 1999. Mr. Markopolos pursued his accusations over the past nine years, dealing with both the New York and Boston bureaus of the SEC.... In a statement late Friday, the SEC said 'staff from the Division of Enforcement in New York completed an investigation in 2007, and did not refer the matter to the Commission for enforcement action.' ... It's not clear what the focus of the 2007 investigation was, or why it was closed. ... Also striking some as odd: Mr. Madoff operated as a broker dealer with an asset management division. Why not simply act as a hedge fund and pocket big gains, rather than profit from trading commissions.... **Joe Aaron**, for long a hedge fund professional, found that structure suspicious and in 2003 warned a colleague to steer clear of the fund. 'Why would a good businessman work his magic for pennies on the dollar? Conflicts of interest also proved a concern. 'There was no independent custodian involved who could prove the existence of assets,' says **Chris Addy**, founder of Montreal-based Castle Hall Alternatives, which vets hedge funds for clients seeking to invest money. 'There's a clear and blatant conflict of interest with a manager using a related-party broker-dealer. Madoff is enormously unusual in that this is not a structure I've seen.' ... Recent securities filings showed that the firm held less than $1 billion of shares, raising questions about where the rest of the money was. Some of Mr. Madoff's investors say they were told the firm put the bulk of its money in cash-equivalents at the end of each quarter, explaining why the public filings showed so few shares, but raising questions about where the proof was for all the cash. ... Until at least November, 2006, the firm, which claimed to manage billions of dollars and be among the largest market makers in the stock market, used as its auditor Friehling & Horowitz, a small New City, New York firm. Mr. Vos says his firm hired a private investigator and determined that the accounting firm had only three employees, one of whom was 78 and lived in Florida, and

another was a secretary, and that it operated in a 13 foot by 18 foot office. His firm felt that was too small an operation to keep an eye on such a large firm operating a complicated trading strategy. ... Meanwhile, a series of media stories also raised questions about Madoff's operations, including a piece entitled 'Madoff Tops Charts; Skeptics Ask How' in industry publication MAR/Hedge in May, 2001, and a subsequent story in Barron's. Mr. Madoff generally brushed off reporters' questions, citing the audited results and arguing that his business was too complicated for outsiders to understand." (WSJ, 12/13/08, "Fees, Even Returns and Auditor All") SEC investigators are not dumb. Were they pressured by superiors to protect a venerated member of the club? Will the SEC's IG investigate the SEC actions and issue a public report?

"The 17th Floor, Where Wealth Went to Vanish"

"The epicenter of what may be the largest Ponzi scheme in history was the 17th floor of the Lipstick Building, an oval red-granite building rising 34 floors above Third Avenue in Midtown Manhattan. ... It was called the 'hedge fund' floor, but federal prosecutors now say the work Mr. Madoff did there was actually a fraud scheme whose losses Mr. Madoff himself estimates at $50 billion. ... But a question still dominates the investigation: how one person could have pulled off such a far-reaching, long-running fraud, carrying out all the simple practical chores the scheme required, like producing monthly statements, annual tax statements, trade confirmations and bank transfers. Firms managing money on Mr. Madoff's scale would typically have hundreds of people involved in these administrative tasks. Prosecutors say he claims to have acted entirely alone. ... Scrutiny is also falling on the many banks and money managers who helped steer clients to Mr. Madoff and now say they are among his victims. Mr. Madoff was not running an actual hedge fund, but instead managing accounts for investors inside his own securities firm. While many investors were friends or met Mr. Madoff at country clubs or on charitable boards, even more had entrusted their money to professional advisory firms that, in turn, handed it to Mr. Madoff — for a fee. Investors are now questioning whether these paid advisers were diligent enough in investigating Mr. Madoff to ensure that their money was safe. Where those advisers work for big institutions like Banco Santander, investors will most likely look to them, rather than to the remnants of Mr. Madoff's firm, for restitution. ... Nevertheless, Mr. Madoff attracted and held the trust of companies that prided themselves on their diligent investigation of investment managers. One of them was **Walter M. Noel Jr**., who struck up a business relationship with Mr. Madoff 20 years ago that helped earn his investment firm, the **Fairfield Greenwich Group**, millions of dollars in fees. Indeed, over time, one of Fairfield's strongest selling points for its largest fund was its access to Mr. Madoff. But now, Mr. Noel and Fairfield are the biggest known losers in the scandal, facing potential losses of $7.5 billion, more than half the firm's assets. ... Fairfield was founded in 1983 by Mr. Noel, the former head of international private banking at Chemical Bank, and Mr. (**Jeffrey**) **Tucker**, a former Securities and Exchange Commission official. ... Fairfield boasted about its investigative skills. On its Web site, the firm claimed to investigate hedge fund managers for 6 to 12 months before investing. As part of the process, a team of examiners conducted personal background checks, audited brokerage records and trading reports and interviewed hedge fund executives and compliance officials. In 2001, Mr. Madoff called Fairfield and

invited the firm to inspect his books after two news reports questioned the validity of his returns, according to a person close to Fairfield. Outside auditors hired to inspect Mr. Madoff's operations concluded that 'everything checked out,' this person said." (NYT, 12/15/08, "The 17th Floor, Where Wealth Went to Vanish") Written reports, if any, containing the results of Fairfield's alleged due diligence should definitely become a part of business school case studies. How often were those alleged inspections conducted? What was the scope of the assignment of the "outside auditors"? What is the extent, if any, of the malpractice coverage of the auditors?

"Investors May Have to Surrender Gains"

"Investors are unlikely to get back much of the money they invested with Bernard Madoff, and those who took out money in recent years may have to give it back. It is a complicated situation. ... If the money were stolen from a brokerage, as much as $500,000 per client should be covered by the Securities Investor Protection Corp., a nonprofit funded by the securities industry. However, SIPC doesn't cover investment losses, and many of Bernard L. Madoff Investment Securities LLC's clients had millions of dollars invested with the firm, far above the SIPC limit. ... Though dramatically smaller in scale, Bayou (Group LLC) is being discussed in connection to the Madoff scandal. That is because the federal bankruptcy court overseeing the Bayou case decided this year that investors who had pulled their money out of Bayou in some cases years before Bayou's fraud was detected had to reach into their pockets to give back profits, and even some of their initial investments, to help offset losses by other investors who got snared in the scheme. That decision was based on a legal notion called fraudulent conveyance, which concerns the illegal transfer of property with the intent to commit fraud. ... Bankruptcy-receivership practices make all investors vulnerable. ... Still, it is doubtful, given the alleged scope and structure of Mr. Madoff's scheme, that investors who feel they have lost everything will find much relief. ... If the same holds true with Mr. Madoff's case, people who pulled money to pay for home mortgages, retirements or children's college bills could end up trapped. Some investors will be able to partly recoup losses through tax moves. ... Mr. Madoff would send monthly statements ... detailing all trades made, usually in blue-chip stocks and stock-index options. At the end of the year, the statements reflected that Mr. Madoff had sold all the securities and put the proceeds in Treasury bills, before starting the strategy again in January.... The gains kept clients happy, but the rapid trading led to high tax bills.... How much relief investors will get from SIPC is unclear." (WSJ, 12/15/08, "Investors May Have to Surrender Gains") Hmmm. What could be the rationale for going into cash at the end of each year? Could it be to generate needless commissions? Isn't that enough to make one suspicious of conflicts of interest with Madoff's brokerage operation that executed the trades? Where was the Compliance Officer in the brokerage operation?

"SEC Had Chances for Years to Expose Madoff's Alleged Ponzi Scheme"

"An enforcement case 16 years ago gave the Securities and Exchange Commission its first shot at figuring out how Bernard Madoff could rack up favorable returns with such uncanny consistency. After that, it received repeated warnings from

outside whistle-blowers and at least twice looked into Mr. Madoff's brokerage itself. Each time, it blew its chance. ... In a 2001 interview with a trade publication, Mr. Madoff compared himself to a broker who handles investors' accounts and gives them tips on where to put their money. He was in fact a broker-dealer and regulated as such by the SEC. Several former SEC regulators said they thought Mr. Madoff's broker-dealer business dealt entirely with trading by Wall Street firms, not by individual investors. Mr. Madoff enjoyed a good reputation on Wall Street that may have helped him evade suspicion. His market-making business serving institutional investors went back to 1960, and he was a former chairman of the Nasdaq Stock Market. The SEC itself tapped his expertise, naming him to a 25-member advisory committee on market structure in 2000 and frequently calling on him to be a commentator at agency round-table discussions. ... In a statement late Friday, the SEC said its inspections unit reviewed Mr. Madoff's market-making business in 2005 and found that he violated technical rules about executing trades. The agency's enforcement division in 2007 investigated a part of a whistle-blower's concerns, but closed the probe without bringing a case. ... The earliest clues to Mr. Madoff's business may have come in 1992, when the SEC sued two accountants who had been collecting money from investors to be managed by Mr. Madoff. The accountants raised money from Florida residents and guaranteed returns of 13.5% to 20%. The SEC sued the accountants but not Mr. Madoff, who claimed not to know they raised money illegally. An SEC official told The Wall Street Journal in a Dec. 16, 1992, article that the agency began its investigation of the accountants fearing a scam. A court-appointed trustee concluded that the money investors thought they had in Madoff accounts was in fact all there." (WSJ, 12/15/08, "SEC Had Chances for Years to Expose Madoff's Alleged Ponzi Scheme") What are the details concerning the "repeated warnings from outside whistle-blowers"? Was political influence exercised to quash investigations? What do the individual SEC inspectors say? Is the moral of the story that a whistle-blower's communications to the SEC is a waste of one's time?

"Madoff investors burned by SEC, too"

"Now that the Madoff fraud has been exposed there are still a slew of fundamental questions outstanding. ... Not long ago the Securities and Exchange Commission reportedly looked into Madoff's operation and found nothing wrong! Hell-oo?! Anybody home?! Did the SEC ask who the custodian of these investments was? I guess not. That's disgraceful negligence on the part of the SEC. ... So, bottom line, could investors have avoided Madoff? And what can you do to make sure you don't get suckered by the next smooth talking, cheap-trick artist? Good questions. What follows are some simple steps to crook-proof your portfolio. Forgive me if some of them seem elementary. But apparently a couple thousand people just lost many billions of dollars. 1. Don't invest in something you don't understand. The attraction of Madoff's investing philosophy was that he employed what is known as a 'split-conversion' strategy. OK. Stop right there. I would guess 99 percent of you reading this have no idea what that means. ... [T]his stuff is serious gobbledygook. Greek to us mere mortals. You want nothing to do with it. Avoid it like the toxic waste that it is. ... 4. Don't stand for no or low disclosure. I was looking at my neighbor's 'statements' from Madoff and they were ridiculous. Nothing in them. Just 'balance at the beginning of period,' 'balance at the end' kind of

stuff. Why bother with all the other numbers? What's the matter, you don't trust us? I did note the fund would only let her take money out twice a year. Nice.' **...** I do think some of the investors in Madoff's funds should have known better. But many didn't know better. Either way, here's the crux: What in heaven's name were they doing down at the SEC?" (Fortune Magazine, 12/15/08, "Madoff investors burned by SEC, too")

"Merkin Gets Questions on Madoff"

"As investors burned by the alleged scandal surrounding Bernard Madoff look for answers, some are questioning whether the disclosure practices of a money manager who invested with him were adequate. **J. Ezra Merkin**, the chairman of lender GMAC, also is head of **Gabriel Partners**, a $5 billion money-management firm whose clients include wealthy families and university endowments. One of Mr. Merkin's funds, the $1.8 billion **Ascot Partners LP**, had substantially all of its assets invested with Mr. Madoff.... Several Ascot clients say they had no idea that Mr. Merkin had most of the fund's money invested with Mr. Madoff. ... An Ascot offering document ... mentions Mr. Madoff once, explaining that Bernard L. Madoff Investment Securities LLC currently serves as a principal custodian for the partnership's assets and as clearing agent. The Ascot fund charged a 1.5% management fee on clients' assets. ... Ascot lays out its strategy in the offering memorandum. The memorandum says the strategy involves buying a basket of stocks resembling an S&P index while simultaneously selling options that pay off for the buyer if these stocks soar, while also buying options that pay off if the index tumbles." (WSJ, 12/16/08, "Merkin Gets Questions on Madoff") What was Ascot supposed to do to earn 1.5% management fee? What did Ascot do and when --- concoct investment strategies, due diligence and/or supervision of those concocting investment strategies? Perhaps, prospective investors should inquire of their investment advisors as to exactly what they do to earn their fees. Let the search for deep-pockets begin! One should compare Bernie's "black box" approach with the near complete disclosure of sources and methods at Financial Statement Analysis (http://www.ConcernedShareholders.com/CCS_FSA.html) --- an investment concept advocated by the sponsor of this website.

"Madoff Misery for Hedge Funds"

"The fund-of-hedge-funds industry needed the Bernard Madoff scandal like a hole in the head. ...[F]unds of funds, or FOFs, are responsible for nearly half of all investment in hedge funds. FOFs sold themselves to investors -- both institutional and retail -- on the basis they offered three important advantages: diversification, access to sought-after managers and due diligence. ... The case for FOFs as a means of diversification has been undermined by poor results. ... Losses have often been amplified by the effects of leverage, plus extra layers of fees. Investors must pay steep FOF charges as well as those on underlying funds. ... But what makes the Madoff scandal so toxic is that it strikes at the most important claim of all: that FOFs vigorously checked out the managers to whom they committed capital. True, Madoff was not a typical hedge fund; many leading FOFs spotted enough warning signs to give him a wide berth and many of Madoff's victims seem to have been exposed via private banks. Those will face reputational risk and

potential costs from legal claims or making their clients whole. ... Few investors -- either institutional or retail -- have the time, expertise or scale to do their own due diligence on individual hedge-fund managers. The risk is that if they lose faith in FOFs, they will turn their back on the hedge-fund industry altogether." (WSJ, 12/16/08, "Madoff Misery for Hedge Funds") It will be interesting to learn why some FOF's missed or ignored the "warning signs." More interesting will be the excuses they offer.

"In Fraud Case, Middlemen in Spotlight"

"As a go-between who shepherded clients and their money to Bernard L. Madoff, **Walter M. Noel** became so prosperous that he was only too happy to show off his good fortune to the world. ... [H]is investment empire, the **Fairfield Greenwich Group**, which had $14.1 billion in February. Mr. Noel's firm ... now has the distinction of being the biggest known loser in the Madoff scandal, to the tune of $7.5 billion. For Fairfield Greenwich and a handful of other big feeder funds that were essentially pouring billions of dollars each into Bernard L. Madoff Investment Securities.... The Fairfield Greenwich Group charged clients an annual fee of 1 percent of assets invested for providing access to exclusive hedge funds and performing due diligence on them, in addition to a fee of 20 percent on investment gains each year... At that rate, an investment of $7 billion paid Mr. Noel's company $70 million annually, and then $140 million more in a year in which Mr. Madoff reported a 10 percent gain (he steadily reported returns of 10 to 12 percent). Other middlemen for Mr. Madoff's vehicles — like J. Ezra Merkin and his Ascot Partners fund and Gerald Breslauer, a financial adviser in Los Angeles who invested with Mr. Madoff ... also collected millions in fees.... Mr. Noel's largest fund, the $7.3 billion Fairfield Sentry fund, invested exclusively with Mr. Madoff. Mr. Noel has not disclosed how much of that was his own or belonged to family members and how much was his investors'. ... The 78-year-old Mr. Noel had a master's degree in economics and a law degree — both from Harvard.... People in the industry continue to question Fairfield's due diligence. **Michael Markov**, a hedge fund consultant, said that he was hired by a fund two years ago to look into Fairfield Sentry's returns and found that it was 'statistically impossible to replicate them,' he said. Mr. Markov said that he found only one hedge fund whose returns correlated to Mr. Madoff's. That was the Bayou fund, which was prosecuted by the government for fraud in 2006." (NYT, 12/17/08, "In Fraud Case, Middlemen in Spotlight") Just like a pretty girl's cheap perfume, an advisor's personal investment in and/or receipt of fees from the fund to which he/she directs prospective investors clouds the advisor's judgment.

"Fairfield Extended Madoff's Reach"

"An investment fund with ties to Bernard Madoff is emerging as a central player in helping the financier raise billions of dollars world-wide, extending the reach of an alleged Ponzi scheme. The Securities and Exchange Commission, as part of an investigation into Mr. Madoff's activities, determined in 2006 that the fund, **Fairfield Greenwich Group**, hadn't properly disclosed that Mr. Madoff oversaw its investment decisions.... Since then, Fairfield Greenwich has in marketing documents touted its close relationship with Mr. Madoff.... This marketing effort ultimately broadened the scope of

Mr. Madoff's alleged fraud far from his bases in New York and Florida. ... Fairfield Greenwich -- run by financier **Walter Noel Jr.**, his four sons-in-law and a former SEC official -- had a total of about $7.5 billion with Mr. Madoff through its flagship **Fairfield Sentry** fund when Mr. Madoff's business imploded. For fees it collected from clients, Fairfield handed that money to Mr. Madoff to manage. ... Mr. Noel founded Fairfield Greenwich in 1983. The Sentry fund, which drew investors from scores of countries and smaller funds, required a $100,000 minimum investment and was billed as a way to tap Mr. Madoff's trading expertise using 'algorithmic technology' while Fairfield stood close watch, conducting 'systematic investment compliance,' according to a 2008 Sentry document. In 2006, the SEC, warned by a tipster that Mr. Madoff might be running a Ponzi scheme, interviewed Mr. Madoff and reviewed documents. The SEC also took the testimony of **Jeffrey Tucker**, a former SEC official and a Fairfield executive who oversaw the firm's day-to-day operations. The SEC, according to an agency document, found no evidence of fraud.... '[Fairfield Greenwich Group's] deep, ongoing joint venture relationships with its managers greatly facilitate communication and a continuing dialogue with managers. ... Independent information sources aid FGG's review of portfolios down to the individual security level.' *Fairfield Greenwich marketing document, 2006* Hoping to capitalize on its success in recent years, Fairfield Greenwich tried to sell a stake in the firm. Several private-investment firms conducted due diligence on the firm. But when they asked to look more closely at Mr. Madoff's business, they were told that Mr. Madoff wouldn't allow prospective investors to view his books.... Fairfield charged clients larger fees than most similar firms do, including a 20% share of profits on investments, about double the norm for firms that farm out clients' money to a variety of fund managers. Mr. Madoff didn't charge additional fees but instead said he charged a commission on trades he allegedly executed. This is an unusual arrangement that raised suspicions among rival money managers, some of whom doubted that could generate sufficient fee income. Fairfield Greenwich's co-founder, Mr. Tucker, introduced Mr. Madoff and his securities business to the firm in 1989. The son of an accountant, Mr. Tucker earned a law degree at Brooklyn College and from 1970 to 1978 worked as an SEC lawyer. For the last three of those years, he held a supervisory role in the agency's enforcement division. ... 'Mr. Tucker's is a gold-plated résumé for securities enforcement, compliance and oversight,' said **Jacob Frenkel**, a former SEC lawyer now in private practice. When the SEC investigated Mr. Madoff's activities in 2006, the agency interviewed Mr. Tucker, who had not been aware of the claim that led to the inquiry...." (WSJ, 12/19/08, "Fairfield Extended Madoff's Reach") What did Fairfield do to earn its exorbitant referral fees? Madoff's reliance on commissions only provided incentive to churn the accounts. If Fairfield could not get Madoff to open his books to a prospective purchaser of Fairfield, evidently, Fairfield, in doing its own alleged "'systematic investment compliance," had not observed those books. The SEC auditor took Tucker's deposition, which should have involved questions indicating to Tucker that there were suspicions of a Ponzi scheme, even if he was not previously aware. Therefore, if you were Tucker, would you not be concerned enough to double any "due diligence" if not to protect Fairfield's clients, but to cover-your-assets? That "gold-plated résumé" has been somewhat tarnished. If not previously aware from his law school education, Tucker will learn about the concept of "constructive notice," where one is deemed to know what a reasonable person would have learned by following the trail of suspicious information.

He may have to explain "algorithmic technology" to a jury. Do you think that SEC auditors were dazzled by the opportunity meet so many SEC and NASD legends in their own minds during one investigation. Why bother to investigate thoroughly when such legends are on the scene? Fairfield, get out your checkbooks!

"Former Mayor, Millions Lost, Describes How He Was Lulled"

"When he was mayor of Fort Lee, N.J., Burt Ross turned down a $500,000 bribe from a group linked to organized crime and reported the incident to authorities, putting his life at risk. Today his world has been turned upside down by another alleged racket. Mr. Ross believes he has lost about $5 million, the bulk of his net worth, investing with New York financier Bernard Madoff.... Semiretired from the real-estate business, Mr. Ross, 65 years old ... had money invested directly with Mr. Madoff and through a money-management firm that invested solely in Mr. Madoff's funds. Mr. Ross's predicament casts light on one of the most puzzling aspects of Mr. Madoff's alleged scam: how he managed to attract affluent and apparently savvy investors in the U.S. and Europe. Mr. Ross himself once worked as a Wall Street stockbroker. He bought into the reputation Mr. Madoff had developed among an elite circle of affluent people: that he was a financial genius who could deliver consistent returns in good markets and bad. Mr. Madoff picked up clients by word of mouth, which lulled some investors into a false sense of security. He was so respected by his investors that his expertise was rarely questioned. ... After graduating from Harvard University in 1965, Mr. Ross went to work as a stockbroker at L.F. Rothschild, an investment-banking boutique. ... Mr. Ross left the brokerage business in 1975 amid a bear market not unlike today's. He moved to the affluent suburb of Englewood, N.J., where he ran a commercial real-estate company. For years, his assets were tied up in 13 commercial buildings he owned and managed. In 2003, when he turned 60, he decided to sell 11 of the buildings and to invest the proceeds of more than $5 million. ... Mr. Ross says his friend, whom he says he doesn't blame, agreed to do him a 'favor' and phone an associate of Mr. Madoff, who tracked down the investor on a trip in Europe. 'It was harder to get into Bernie's fund than to get into Harvard,' Mr. Ross says. The second friend suggested Mr. Ross place some of his money with J. Ezra Merkin, the chairman of car-loan giant GMAC, who also runs a $5 billion money-management firm for wealthy families and university endowments. Mr. Ross agreed, putting money into two of Mr. Merkin's investment units: Gabriel Partners and Ascot Partners LP. He says he already had allocated some retirement money and some of his children's trust funds to Ascot. In 2006 Mr. Ross learned that Ascot was invested entirely in Mr. Madoff's funds. Last week he discovered that part of his money in Gabriel also was invested with Mr. Madoff. ... Mr. Ross put much of the rest of his net worth in other hedge funds, including Cerberus Capital Management and Thomas H. Lee's BlueStar I, LLC. The Cerberus fund in which Mr. Ross invested is up modestly this year. The BlueStar fund is down about 40% for the year. Expecting the funds to increase in value, Mr. Ross planned to make regular withdrawals to pay down the mortgage on his home. ... He also received confirmation records of trades in Mr. Madoff's fund, he says, which showed purchases and sales of shares of big companies, along with some transactions in Treasury bonds and options. Mr. Ross says he remembers being puzzled about how Mr. Madoff was able to show positive returns, even in months when the stocks

Mr. Madoff's fund owned were down. He pushed such thoughts aside. ... 'This guy has a formula involving computerized trading....It's like Coke. We're not supposed to know the formula.' Mr. Madoff's returns were so impressive that Mr. Ross recommended to friends and family members that they also put their money with Mr. Madoff. ... Mr. Ross's wife, Joan, says she had always been nervous about whether their money was safe with Mr. Madoff. 'We would revisit the issue from time to time,' she recalls." (WSJ, 12/20/08, "Former Mayor, Millions Lost, Describes How He Was Lulled") This guy is exactly where he should be based upon what he did or didn't do. At 60, flush with cash, he should have paid the entire mortgage on his home. He should not have invested solely in black boxes --- hedge funds. He should have trusted his highly educated instincts when he was "puzzled." He should have listened to his wife.

"Betrayal"

"In certain circles, having Madoff manage your money was something to brag about, like a luxury car or fancy house. However, unlike many other successful money managers, Madoff was reluctant to discuss his investing style. ... This is the problem with personality-driven investing. ... Investment manager like to paint their strategies as so complex that only mathematical geniuses can understand them. As a result, investors are left to simply trust that these gurus won't blow their hard-earned cash. ... In May 2001, the respected Barron's ran a story openly questioning Madoff's trading techniques and raising potential ethical issues with the secretive way he operated." (LAT, Op-Ed, 1/20/08, "Betrayal")

"Don’t Ask, Don't Tell"

"Bernie Madoff might as well hang that sign on his secretive hedge-fund empire. Even adoring investors can't explain his enviably steady gains. ... A Madoff hedge-fund offering memorandums describes his strategy ... as the "split-strike conversion" strategy. ... [S]ome on Wall Street remain skeptical about how Madoff achieves such stunning double-digit returns using options alone. The recent MAR Hedge report, for example, cited more than a dozen hedge fund professionals, including current and former Madoff traders, who questioned why no one had been able to duplicate Madoff's returns using this strategy. Likewise, three option strategists at major investment banks told Barron's they couldn't understand how Madoff churns out such numbers. ... Madoff dismisses such skepticism. "Whoever tried to reverse-engineer, he didn't do a good job. If he did, these numbers would not be unusual." Curiously, he charges no fees for his money-management services. Nor does he take a cut of the 1.5% fees marketers like Fairfield Greenwich charge investors each year. Why not? 'We're perfectly happy to just earn commissions on the trades,' he says. Perhaps so. But consider the sheer scope of the money Madoff would appear to be leaving on the table. A typical hedge fund charges 1% of assets annually, plus 20% of profits. On a $6 billion fund generating 15% annual returns, that adds up to $240 million a year. The lessons of Long-Term Capital Management's collapse are that investors need, or should want, transparency in their money manager's investment strategy. But Madoff's investors rave about his performance -- even though they don't understand how he does it." (Barron's,

5/1/01, "Don't Ask, Don't Tell") Madoff's statement about being "happy to just earn commissions on the trades" should have created the suspicion that his firm "churned" accounts. Further, such a purported market guru does not need to bother with advisory customers when he could have borrowed low interest funds and engaged solely in proprietary trading. Such an article should have caused the SEC and/or FINRA (NASD) to investigate.

"Madoff Suspicions Are Only in Hindsight"

"Why do people wind up with the **Bernie Madoff**s of this world? Because they've neglected one of Ronald Reagan's favorite sayings, 'Trust, but verify.' ... Madoff played to two of our most serious weaknesses as investors and human beings. As investors, we love to believe in market wizards who hold the secret to making serious money. In fact, there's no such secret, but admitting it is like abandoning a childhood faith. ... As human beings, we love status symbols and, to those who knew him, Madoff was status on wheels. Investing with him proved your wealth, position and general superiority to the poor slobs bobbing around on the fringe. ... Even if you tried, it might seem that Madoff would have been impossible to catch. But at least two warning signals flashed for anyone to see. First, Madoff's accounting firm, **Friehling & Horowitz** in New City, N.Y., was a rinky-dink shop, as a simple Google search shows. The firm doesn't have a Web page. ... That's an unlikely auditor for the $17 billion that Madoff claimed to have under management. When the fraud came to light, F&H turned out to be a tiny office which, neighbors said, wasn't even open all the time. (The office didn't answer its phone.) Second, Madoff held your securities (or what he claimed were your securities) in his own advisory firm. That's not the way reliable advisers handle publicly traded investments. The custodian should always be a large, independent financial institution that reports cash flows and trading activity to you directly. When you invest new money, you should make out the check to that account. ... Also, give your ego a reality check. There's nothing more gratifying than being asked to play with the big boys, but they can lose a few million and go on. Maybe you can't. ... I once asked one of America's super-rich women what the hardest thing was about managing wealth. 'Avoiding fraud,' she said. It never arrives in the obvious form of a carnie barker. It's always someone like, well, Bernie Madoff, solid, smiling, generous, and with an arctic heart." (Washington Post, 12/21/08, "Madoff Suspicions Are Only in Hindsight") Gee, the same criteria one learned from the Bayou implosion would have made one suspicious of Madoff. The human factor causes story to repeat itself!

"A Beverly Hills investor's ties to Madoff sink many"

"Many in Los Angeles' Jewish community had invested with **Stanley Chais**, who had seemed like a low-key safe bet. But he had bet all their money in the alleged Ponzi scheme run by Bernard Madoff. Sarah Mandell and her husband, Bob Chew, wanted to cut their expenses and lead a 'simpler life,' so in 2004 they sold their house in Los Angeles and set out for the mountains of Colorado. To secure their future, they took the money from the house and invested it with Stanley Chais of Beverly Hills. It seemed like a safe bet: Chais was a wealthy investment advisor and trusted family friend who had

produced strong returns for Mandell's relatives for two decades. ... The couple learned days ago that their $1.2-million investment account had been ... invested directly with Bernard L. Madoff Investment Securities or through 'feeder funds' like Chais'. ... Chais, 82 ... told the Jewish Journal that he and his family also were swindled and had lost 'a huge amount of money.' ... Whether Chais was merely a victim is the $250-million question in a federal lawsuit filed last week in Los Angeles, alleging that is the sum scores of investors gave to him and his **Brighton Co.**, a limited partnership formed to manage their money. ... The full scope of the alleged fraud and Chais' possible role in it have yet to be spelled out. ... Like others in what has been described as an 'affinity fraud,' Chew said he and Mandell were brought in by relatives. Until it all collapsed, they had enjoyed consistent returns of about 15% a year from what they knew as 'private arbitrage accounts,' Chew said. Chais took a piece of the profits as management fees, Chew said, usually about 3.8%. In hindsight, he said, there were things that should have raised <u>red flags</u>, including an air of exclusivity and the notion that not just anyone could get in. ... Chew thought he and his wife were invested in currencies, stocks and other securities; Madoff's name was never mentioned. But quarterly statements were so vague, Chew said, that he couldn't tell 'what trades were made or how they were made or who made them.' **Frank Mantovani**, the Encino accountant who kept Chais' books and tracked the investments, did not respond to interview requests. However, in a 'Dear Partners' letter dated Dec. 17, Mantovani told Chew and other investors that he too had been duped. He said he had relied on inaccurate information provided to him in preparing quarterly statements. ... In all, Chew and Mandell, and her extended family, have lost about $30 million, they say, including $300,000 that her 84-year-old mother relied on to pay for her assisted-living arrangements. ... The Securities and Exchange Commission and the California Department of Corporations said last week that they had found no record of Chais registering as an investment advisor or broker. It's unclear whether he was required to have a securities license, because that depends on how many investors he had and how much money he managed." (LAT, 12/21/08, "A Beverly Hills investor's ties to Madoff sink many") So, why is it such a red flag to be informed that you are special? You know you are special. However, you know that those seeking your money do not know you well enough to know that. In their minds, only easy access to your money makes you special. Vague quarterly statement is another issue. What questions did Crew raise with whom? What was the response to each? The preparer, Mantovani, is an accountant. What questions did he raise with whom? What back-up documentation did he seek from Madoff? What discussions did he have with Chais as to any concerns? Why would anyone place such a large amount of funds with an advisor that had so few clients or so few funds under management to not be required to register with federal or state regulators? Greed springs eternal and causes the suspension of all disbelief.

<u>**"Shana Madoff's Ties to Uncle Probed"**</u>

"**Shana Madoff**, Bernard Madoff's niece of the man who ran Bernard L. Madoff Investment Securities LLC, didn't know of her uncle Bernie's arrest until authorities turned up at his 64th Street apartment in Manhattan, according to her spokesman. But her long tenure in the Madoff market-making business and deep Washington connections have swept her up in the scandal surrounding the firm, whose family bonds were once a

source of comfort to investors. Ms. Madoff was a rules-compliance lawyer at the firm's market-making arm and the daughter of Bernard Madoff's brother Peter, who was head of compliance at the firm. Neither she nor her father have been charged with any crime, and Ms. Madoff's spokesman says she played no role in the firm's money-management side, where an alleged Ponzi scheme has resulted in up to $50 billion in investor losses. ... In Washington, she served on the compliance advisory committee at the Financial Industry Regulatory Authority, the industry's chief self-policing body. She held a similar role at the Securities Industry and Financial Markets Association, or Sifma, the industry's main lobbying group, where her father served on the board. ... Sifma is one of the financial industry's most powerful advocates in Washington. ... People familiar with Ms. Madoff's association work said her participation, like their own, provided access to regulators. ... In 2003, the National Association of Securities Dealers, now part of Finra, invited her onto its market regulation committee, part of its self-policing apparatus, which made regulatory recommendations. ... A person familiar with the workings of the organization says Ms. Madoff always appeared to have mastered the thick briefing book sent to committee members, and could quote regulations nearly verbatim. 'She wasn't a geek about it, but that's her job,' this person said." (WSJ, 12/22/08, "Shana Madoff's Ties to Uncle Probed") Hmmm. She won't be able to plead lack of sophistication as to Compliance Department responsibilities. If volumes of advisory trades were processed through accounts at a securities brokerage firm, the Compliance Director and others in the Compliance Department should have known the details. If the trades of a related advisory firm (where the advisor was an employee of the brokerage firm) were processed elsewhere, the Compliance Department should have thoroughly investigated. No trade being processed anywhere would create much suspicion. Hopefully, someone will think to ask to see the Compliance Department inspection reports. One can foresee expert testimony of Compliance Directors in proceedings against Shana and her pop. Further, one should wonder about the quality of self-regulation and self-regulators --- people who either they unable to recognize fraud or close their eyes to it.

"Firm Built on Madoff Ties Faces Tough Questions"

"Since **Bernard L. Madoff** was arrested 11 days ago in connection with a $50 billion Ponzi scheme, the Fairfield Greenwich Group has portrayed itself as an unwitting victim of the fraud, the biggest of Mr. Madoff's many losers. Clients of Fairfield, a secretive hedge fund advisory company based in Connecticut, lost $7.3 billion to Mr. Madoff's fund. But for Fairfield, working with Mr. Madoff was hugely profitable. Internal documents from Fairfield show that the firm has taken more than $500 million in fees since 2003 alone from the money it placed with Mr. Madoff. Nearly all those fees went to a handful of Fairfield executives, including **Walter M. Noel**, Fairfield's founder, who used the money to build a glamorous life, splitting his time between homes in New York, Connecticut, Florida and the Caribbean. As it raised money all over the world, Fairfield also made detailed pledges about how it would monitor and track Mr. Madoff's investments.... Similar questions may arise for the dozens of banks and hedge funds around the world that reaped extraordinary fees for steering investments to Mr. Madoff over the last decade. None of them, however, earned more from their Madoff business than Fairfield did during the firms' 20-year relationship. Fairfield promised its investors

that money could not be moved from its accounts with **Bernard L. Madoff Investment Securities** without two signatures. It said that it would independently calculate the value of the funds it invested at Mr. Madoff's firm at least once a week. It promised to reconcile statements from individual trades with Mr. Madoff's custodial records. It is not clear what Fairfield did to make good on those pledges. ... [F]airfield highlighted its close control over the fund and the protections it would provide investors. In a 'due diligence questionnaire' made available to potential investors in Sentry, Fairfield promised that it calculated the value of Sentry's assets weekly and monthly. It also said **Citco Fund Services**, an independent hedge fund administrator based in the Netherlands, separately calculated the value of Sentry's assets each month. Further, Fairfield promised that both it and Citco double-checked the monthly statements from Mr. Madoff's firm it received against records of the assets held in the fund. To prevent unauthorized stock trades or the unauthorized removal of cash from Sentry's accounts, 'the movement of cash among the Fund's accounts requires two signatures,' Sentry said. ... Another document, this one prepared in 2007 as Fairfield Greenwich considered selling itself in what at the time was a very rich market for hedge-fund advisory companies, shows just how much money it made from its relationship with Mr. Madoff. According to the document, Fairfield generated $250 million in revenue and $200 million in profit for the year that ended Sep. 30, 2007. Nearly 65 percent of that money came from fees on Sentry, and nearly all the profits were distributed among the firm's 21 partners. Fairfield's employees were also lavishly compensated, with at least four receiving more than $5 million in pay. In early 2008, several private equity and investment firms were approached by Fairfield about purchasing a share of the company. A partner of one that considered buying a stake ... said that he was scared off about 20 minutes into his initial meeting with a team of Fairfield managers. 'They were just incredibly squishy and vague even during the warm-up,' said the prospective buyer, who spoke on condition of anonymity because of a non-disclosure agreement with Fairfield. 'I asked them to tell me about the manager of the fund Sentry feeds into, and I was told, "We don't really talk about him."' ... Mr. Noel, whose primary residence and office remain in Greenwich, has at least five luxury homes. Along with his Greenwich house, whose value has been estimated at $4.2 million, he has homes in Southampton and Palm Beach. And since 2000, the Noels have also maintained a pied-à-terre at 812 Park Avenue. The combined value of those homes is more than $20 million." (NYT, 12/22/08, "Firm Built on Madoff Ties Faces Tough Questions") Fairfield wanted to sell part of its lucrative business, but no one was buying. Did anyone at Fairfield wonder why there were no takers? Perhaps, Fairfield personnel will be less "squishy and vague" when they explain to a jury their understanding of what Madoff did or did not do. Did Fairfield fail to promise investors some aspect of asset supervision that would normally be considered a part of "due diligence" and would have spotted Madoff's improper activities? We see findings of breach of contract, negligence, reckless disregard, breach of fiduciary duty, constructive fraud and fraud coming down the pike. Prospective creditors might seek writs of attachment on all those assets.

"Madoff Fund Operator De La Villehuchet Found Dead in New York"

"**Thierry Magon de La Villehuchet**, who ran a fund that invested with Bernard Madoff, was found dead at his Madison Avenue office today, a New York City police

officer at the scene said. The death appeared to be a suicide, he said. De la Villehuchet, 65, was a founding partner and chief executive officer of **Access International Advisors**.... Access invested $1.4 billion with Madoff.... Access's **LUXALPHA SICAV-American Selection** invested solely with Madoff...." (Bloomberg, 12/23/08, "Madoff Fund Operator De La Villehuchet Found Dead in New York") Will he be the first of many? Will some key players take flight? Investigators need to increase the pace of the investigations.

"With Roots in '70s, Madoff Scheme Takes New Toll"

"Suspicions about Mr. Madoff's trading also go back further than whistle-blowers have alleged. In 1991, a consultant hired to review a corporation's investments with Mr. Madoff made in the late 1980s grew suspicious about his returns. According to client statements and other information gathered by the consultant and reviewed by The Wall Street Journal, between 1980 and 1990, the consultant found that Mr. Madoff claimed to his client to have earned 22.6% per year, double the average return on the Dow Jones Industrial Average during that time. The review of trades for that account showed frequent trades in options on stocks, but the consultant found that the number of options purchased for the strategy often outnumbered the amount of options that actually changed hands on public exchanges, according to the documents and a person familiar with the review. Mr. Madoff claimed to have traded more options than had been traded in the entire market on a given day, meaning his strategy would have been impossible to execute. That pattern was apparent on client statements from as recently as 2006, meaning Mr. Madoff had been making the same improbable claims to his investors for at least 17 years. Given the length of the alleged fraud and the deep involvement in the firm of Mr. Madoff's brother, two sons and a niece in the business, investigators are trying to determine who else might have known about the alleged scheme. Mr. Madoff operated the investment-management business separately from the family's stock-trading operation, where his family members worked." (WSJ, 12/24/08, "With Roots in '70s, Madoff Scheme Takes New Toll") What did the consultant and the corporation do with his/her discovery of Madoff's improper activities? Did either confront Madoff or alert any regulator? Did the consultant inform other clients? It appears that the accounts of those scammed sat on the books of Madoff's securities brokerage firm, which was a member of the NASD. Further, Madoff was an employee who engaged in known outside financial activities. Madoff's relatives populated the Compliance Department, which has investigatory duties concerning accounts, trading in those accounts and employee related activities. Those relatives were supposedly knowledgeable in securities brokerage firm rules and regulations. FINRA (NASD) bestowed positions of prominence upon them. You connect the dots to infer who knew (fraud, reckless disregard) or should have known (negligence) what and whose credibility is suspect.

"L'Oreal Heiress Bettencourt Invested With Madoff"

"**Liliane Bettencourt**, the world's wealthiest woman, entrusted part of her $22.9 billion fortune with **Bernard Madoff** through the fund manager found dead in New York yesterday, two people familiar with the matter said. The 86-year-old daughter of L'Oreal

SA founder Eugene Schueller was the first investor in a fund managed by **Access International Advisors**.... The body of Access co-founder **Thierry Magon de La Villehuchet**, 65, was found in his Madison Avenue office yesterday. Police said he probably killed himself. ... Access, which oversaw $3 billion, raised money mainly from wealthy European investors. Access said in a Dec. 12 letter to clients that funds including its **LUXALPHA SICAV-American Selection** invested solely with Madoff's eponymous investment firm. The fund had $1.4 billion in assets as of Nov. 17.... Access says it carries out 'extensive' due diligence on the funds to which it allocates money, a process that can take as long as six months and cost $100,000. It also hires private investigators to run 'extensive background checks' on fund managers, including searches on professional credentials, regulatory filings and bankruptcy, according to marketing documents dated September." (Bloomberg, 12/24/08, "L'Oreal Heiress Bettencourt Invested With Madoff") Perhaps, if Access spent $100,000 and six month's time to investigate Madoff, it should have passed. Ask to see the cancelled check(s) and interim and final reports. Also, how much time, effort and money did Bettencort spent to check-out Access?

"Madoff Spotlight Turns to Role of Offshore Funds"

"The investigations into Bernard L. Madoff are expanding into offshore tax havens. ... Of particular interest is whether Mr. Madoff and some of his investors used funds based in offshore tax havens to evade American taxes.... Also under scrutiny is whether certain charities invested with Mr. Madoff had improperly allowed their donors to shift money offshore, and whether foreign banks had withheld American taxes on Madoff accounts, as required by the Internal Revenue Service.... [I]t is hardly surprising that such funds are coming under scrutiny. Offshore entities played key roles at Bayou Management, a Connecticut hedge fund that collapsed in scandal in 2005, as well as at Enron, which used nearly 900 offshore entities, mostly in the Cayman Islands, to conceal bogus trades and accounting fraud. ... Nearly all hedge funds, including funds of funds, operate affiliates and partnerships offshore. ...At least a dozen offshore entities were involved with Mr. Madoff's firm, according to several regulatory filings." (NYT, 12/31/08, "Madoff Spotlight Turns to Role of Offshore Funds") This is evolving into what goes-around comes-around.

"'Dr. Doom' Didn't Predict Madoff Blowup"

"**Henry Kaufman**, the former Salomon Brothers chief economist whose bearish views decades ago earned him the nickname 'Dr. Doom,' lost several million dollars with Bernard Madoff, making him one of the most prominent Wall Street figures to emerge as a victim of the alleged Ponzi scheme. Mr. Kaufman, 81 years old, had the money in a brokerage account with Bernard L. Madoff Investment Securities for more than five years.... Mr. Kaufman earned the Dr. Doom nickname as a result of his consistent predictions while at Salomon Brothers in the 1970s and early 1980s that interest rates would rise and bond prices would fall. More recently, Mr. Kaufman was a director of **Lehman Brothers Holdings Inc.** and was chairman of the Lehman board's finance and risk committee before the Wall Street firm's September descent into bankruptcy. ... In an

interview Tuesday, Mr. Kaufman said his Madoff loss was 'no more than a couple percent of my entire net worth' and 'immaterial to my financial well-being.' ... Despite the Madoff losses, Mr. Kaufman made money in 2008, he said, in part by shorting the Standard & Poor's 500." (WSJ, 12/31/08, "'Dr. Doom' Didn't Predict Madoff Blowup") What is going on here? Why would a supposed investment guru voluntarily and publicly broadcast that he was swindled? Is he bragging that Madoff allowed him directly to open an account? Is he touting his non-bond shorting abilities? Reminding the public of his stint on the Lehman BOD as chairman of the "finance and risk committee" and the associated potential substantial liabilities is not smart. He won't be able to claim poverty if he becomes a judgment debtor.

"Madoff Chasers Dug for Years, to No Avail"

"Bernard L. Madoff Investment Securities LLC was examined at least eight times in 16 years by the Securities and Exchange Commission and other regulators, who often came armed with suspicions. SEC officials followed up on emails from a New York hedge fund that described Bernard Madoff's business practices as 'highly unusual.' The **Financial Industry Regulatory Authority**, the industry-run watchdog for brokerage firms, reported in 2007 that parts of the firm appeared to have no customers. ... The failure to stop Mr. Madoff also is an embarrassment for **Mary Schapiro**, the Finra chief who has been nominated by President-elect Barack Obama as the next SEC chairman. Finra was involved in several investigations of Mr. Madoff's firm, concluding in 2007 that it violated technical rules and failed to report certain transactions in a timely way. Ms. Schapiro declined to comment. Mr. Cox has previously acknowledged mistakes by the SEC. The agency declined to comment. ... For years, Mr. Madoff told regulators he wasn't running an investment-advisory business. By saying he instead managed accounts for hedge funds, Mr. Madoff was able to avoid regular reviews of his advisory business. In 1992, Mr. Madoff had a brush with the SEC's enforcement division, which had sued two Florida accountants for selling unregistered securities that paid returns of 13.5% to 20%. ... The SEC probe turned up money that had been managed by Mr. Madoff. ...[T]he scheme indicated Mr. Madoff was managing money on behalf of other people. ... In 2005, the New York staff began a broader examination, interviewing Mr. Madoff, his brother, two sons and a niece, all of whom worked at the firm. The SEC found that his investment-advisory business had 16 clients and managed $8 billion. Any firm that offers advice to more than 14 clients is required to register with the agency and undergo reviews. Mr. Madoff 'would not acknowledge' that these accounts were an investment-advisory business, the 2005 report by the New York staff said, because he received commissions from trades, not a percentage of the profits, the typical arrangement for hedge funds. ... A predecessor to Finra conducted its own review in 2005 and found no violations. ... Finra's full-scale examination in 2007 indicated that parts of Mr. Madoff's firm had no customers. It didn't provide an explanation of this finding." (WSJ, 1/5/,09, "Madoff Chasers Dug for Years, to No Avail") "Industry-run watchdog for brokerage firms" is an oxymoron. The last time we checked, the definition of investor advisor relates to whether one renders advice not the nature of compensation, if any. The morale of the story --- as an investor, you are on your own!

<u>"UBP mulls pulling assets from hedge funds"</u>

"Due to large losses from Bernard Madoff's alleged $50 billion Ponzi scheme, **Union Bancaire Privée** is threatening to pull billions of dollars of assets from some of the largest U.S. hedge funds because they don't use a full-time independent administrator.... UBP acknowledged last month that it had about $700 million in exposure to New York-based Bernard L. Madoff Investment Securities LLC through funds of funds and client portfolios. UBP is one of the world's largest investors in hedge funds...." (InvestmentNews, 1/9/09, "UBP mulls pulling assets from hedge funds") Any response/justification from the hedge funds would be interesing.

<u>"Inside a Swiss Bank, Madoff Warnings"</u>

"Swiss bank **Union Bancaire Privée** kept hundreds of millions of dollars of its wealthy clients' money in Bernard Madoff's alleged Ponzi scheme despite warnings from its own research team.... While others in the investment community had questioned Mr. Madoff's strategy and chosen to stay away, the instance offers a sign that red flags were raised within one of the large institutions that actually invested with Mr. Madoff. .... By early 2007, though, UBP's research department had raised various concerns about Mr. Madoff's business, and later recommended that he be stricken from a list of fund managers approved for its clients' investments.... The people say that some of the bank's most senior executives were aware of the concerns and discussed them. ... UBP has told clients it was the victim of a 'massive fraud,' and that it conducted due diligence, including visits with Mr. Madoff and various principals. ... In an email exchange during February and March 2008 ... UBP's then-deputy head of research, Gideon Nieuwoudt, listed a number of worries, including the lack of even basic information such as how much Mr. Madoff had in assets, how many feeder funds there were, and how the investment strategy worked. In one email, Mr. Nieuwoudt said he had spoken to more than 100 funds that invest or had invested with Madoff, but none of them could explain how the strategy produced such consistent returns. ... Among those included in the email discussion were at least two members of UBP's executive committee: Christophe Bernard, who headed the asset-management business, and Michael de Picciotto, head of the bank's treasury. ... Mr. Nieuwoudt left UBP last year to join another firm." (WSJ, 1/14/09, "Inside a Swiss Bank, Madoff Warnings") Those customers who bring legal action against the bank may face an interesting cause-effect defense, which would reduce their recovery. If they pulled their funds from Madoff in 2007, based upon warnings from the bank, those funds could be clawed-back by the bankruptcy trustee. They would only be entitled to the redistribution from the trustee, which they will receive. Thus, the bank's inaction caused no harm! However, the bigger picture deals with whether the bank's original recommendation to do business with Madoff was backed by adequate due diligence.

<u>"Suit Claims Madoff's Role Was Kept From Investors"</u>

"How did Bernard L. Madoff manage to raise so much money for so long from so many supposedly sophisticated investors? Apparently, by keeping many of them in the

dark about his own role. That fresh perspective on Mr. Madoff's alleged Ponzi scheme emerged in recent days from a lawsuit filed in federal court in New York that claims he specifically forbade managers who gathered assets for him from mentioning his name in their marketing literature and other reports. The lawsuit, which names Mr. Madoff as well as **Bank Medici**, the Viennese firm that invested more than $3 billion of its clients' money with him, helps lift the veil on the network of middlemen who proved so effective at gathering funds for Mr. Madoff. ... Judging from the lawsuit as well as interviews with investors, it appears there were different strategies for collecting money. In certain affluent circles and with professional managers, the Madoff name was quietly bandied about. But many other clients were not in the know about who exactly was supposed to deliver the stellar returns investors were promised for years. ... [T]he lawsuit, filed by **Repex Ventures** ... contends that many other investors never knew of Mr. Madoff's role, and instead considered Bank Medici to be the actual investment manager. ... In presentations for potential investors in the feeder funds, as well as internal marketing documents from Bank Medici that have now come to light, there is no mention of Mr. Madoff's firm, **Bernard L. Madoff Investment Securities**. Instead, according to a June 2008 statement of assets from one Medici-managed feeder fund, Thema International, holdings like United States Treasury bills and foreign exchange currency contracts are duly recorded. In another section, seemingly safe blue-chip stocks are listed as having been bought and sold.... Also named in the lawsuit are ... **HSBC Holdings**, the fund's custodian; **Ernst & Young**, its auditor; and Bank Medici's former chief executive, Peter Scheithauer." (NYT, 1/17/09, "Suit Claims Madoff's Role Was Kept From Investors") Would a reasonable feeder fund not wonder or, itself, be suspect when it agrees to hide information from prospective investors? What is their explanation of such activity? Is that called fraud by omission (of a fact upon which a reasonable investor would rely in making an investment decision)? Did any investor inquire as to the background/experience to the individual who would be making the ultimate investment decisions? FINRA claims that it did not drop the supervision ball as Bernard L. Madoff Investment Securities (as opposed to some advisory entity) was not involved in the scheme. So, where did Bank Medici wire the funds it collected and from whom did it receive funds that it disbursed? The plot thickens.

"'92 Ponzi Case Missed Signals About Madoff"

"Seventeen years ago, federal investigators questioned for the first time whether **Bernard L. Madoff** was connected to a Ponzi scheme. Their inquiry centered on Frank Avellino, an accountant who had been funneling investors to Mr. Madoff since the 1960s. The investigators did not get far. Within days, Mr. Avellino agreed to return to investors the money he and his partner had raised and to pay a small fine to the Securities and Exchange Commission. The inquiry petered out, and Mr. Avellino — represented in the case by **Ira Lee Sorkin**, the same lawyer who now represents Mr. Madoff — kept sending money to Mr. Madoff. Now questions have again arisen about the ties between Mr. Madoff and Mr. Avellino. ... [A]rchived court documents from the 1992 case reveal numerous red flags that raise questions about the S.E.C.'s failure to examine Mr. Avellino and Mr. Madoff long before Mr. Madoff's apparent Ponzi scheme spread worldwide. The documents show that Mr. Avellino and Michael Bienes, his business partner, kept almost

no records at Avellino & Bienes, a firm that oversaw $440 million. When court-appointed auditors asked Mr. Avellino to prepare a balance sheet, he responded that 'my experience has taught me to not commit any figures to scrutiny.' Subsequently, Mr. Sorkin and Mr. Avellino managed to curtail the audit, even though a federal judge eventually concluded that Mr. Avellino had not been a credible witness in the case. The S.E.C. also took at face value Mr. Avellino's depiction of the deal he offered investors, which guaranteed returns of up to 20 percent a year while requiring him and Mr. Bienes to make up any shortfalls. ... As early as 1962, according to the S.E.C.'s complaint against him, Mr. Avellino began raising money for Mr. Madoff.... Their business expanded until 1992, when the S.E.C. received marketing materials showing that Avellino & Bienes had promised investors annual returns of up to 20 percent. Commission officials said at the time that they believed they had stumbled upon a Ponzi scheme. But when the investigators went to Mr. Avellino, they found, to their surprise, an apparently legitimate explanation. The money, $441 million from 3,200 clients, was being managed by Mr. Madoff, whose brokerage firm by then was one of the biggest stock traders on Wall Street. In a deposition, Mr. Avellino explained that he had promised returns of 13.5 to 20 percent a year. If Mr. Madoff fell short of producing those returns with his stock trades, Avellino & Bienes would make up the difference, Mr. Avellino said. ... No one at the securities commission seems to have questioned why Mr. Avellino and Mr. Bienes offered clients a double-digit guaranteed return on money that they did not even control. Nor do the records offer any hint that the commission considered whether Mr. Madoff, rather than Avellino & Bienes, might be operating a Ponzi scheme. Instead, once the commission was satisfied that the money existed in Mr. Madoff's accounts and would be returned, it quickly reached a deal with Mr. Avellino and Mr. Bienes. Through Mr. Sorkin, the lawyer who once oversaw the regulator's New York office, the men agreed to return the money to investors, shut down their firm, undergo an audit and pay a fine of $350,000. ... But court records reveal a much messier investigation. On Nov. 17, 1992, as part of the deal, a federal judge ordered Price Waterhouse to audit the financial statements of Avellino & Bienes. The accountants soon learned that Avellino & Bienes did not keep conventional books, only the basic ledgers necessary to prepare tax records. Price Waterhouse then asked Mr. Avellino to put together records for 1992. He declined. ... Even after learning of the missing records, the commission did not reopen its investigation. ... Mr. Avellino and Mr. Sorkin complained about Price Waterhouse's fees and demanded that federal Judge John E. Sprizzo, who was overseeing the case, quickly end the audit. ... By the end of January 1993, both the securities investigation and the Price Waterhouse audit were effectively over. But in a hearing over the disputed fees in April, Judge Sprizzo sharply criticized Mr. Sorkin, who acknowledged that Avellino & Bienes had agreed to the audit in part to avoid a deeper investigation. ... In an interview, Mr. Sorkin said this week that he could not recall whether Mr. Madoff referred Mr. Avellino and Mr. Bienes to him. He has known Mr. Madoff since at least the early 1980s..." (NYT, 1/17/09, "'92 Ponzi Case Missed Signals About Madoff") What did the SEC feel was the economic advantage to Avellino to make up the difference between the promised 20% return and what was allegedly earned by Madoff? Did Sorkin and/or Sorkin's SEC background intimidate some SEC newbie investigator? What was the result of the audit by Price Waterhouse? If Avellino did not keep records, how could the SEC or the Court be assured that all funds were properly returned to his investors?

Should a due diligence investigation by a fund of funds have led to this same information? Some claimed that they spent $100,000 on investigations. What did they get from their investigators?

"Florida Fund Manager Missing; Clients Say Money Gone"

"**Arthur Nadel**, a hedge-fund manager in Sarasota, Florida, has disappeared and clients are concerned they may have lost hundreds of millions of dollars.... Nadel, 76, is president of **Scoop Management Inc.**, which oversees funds including **Valhalla Investment Partners LP**. ... Indiana investment adviser **Marcus Schrenker** was taken into custody by police in Gadsden County, Florida, earlier this week after he allegedly attempted to fake his death in a plane crash and use a motorcycle to escape. Authorities said Schrenker may have defrauded investors through three companies he owns in a suburb of Indianapolis...." (Bloomberg, 1/17/09, "Florida Fund Manager Missing; Clients Say Money Gone") It's one o'clock and do you know where your money is?

"Hedge Funds, Unhinged"

"[M]anagers typically charge 20 percent of profits and 2 percent of total funds under management — the latter of which they earn regardless of performance. ... Orin Kramer, another hedge fund manager, who also helps oversee the New Jersey pension fund, says that what bothers him most is that managers who are freezing their funds are still charging 2 percent management fees on money they have trapped. 'It's like telling someone at a hotel that they can't check out and then charging them for the privilege of staying,' Mr. Kramer says." (NYT, 1/18/09, "Hedge Funds, Unhinged")

"Nadel's 32% Returns in Doubt as Manager Disappears"

"(Investors) whose money was invested by Nadel's **Scoop Management Inc.** in Sarasota may have lost as much as $350 million.... The Federal Bureau of Investigation joined local police ... in the search for (**Arthur**) **Nadel**, 76.... Nadel said in a prospectus for **Valhalla Investment Partners** that he developed computer-generated investment and trading programs, which had been used by other hedge funds since 1999." (Bloomberg, 1/19/09, "Nadel's 32% Returns in Doubt as Manager Disappears") Due diligence becomes easier when one could learn the identities of the other funds and inquire whether they employed Nadel's software and, if so, the results that were achieved with the software.

"Spanish Bank Offers $1.8 Billion to Settle Madoff Claims"

"**Banco Santander**, Spain's largest bank, has offered to pay 1.38 billion euros or $1.8 billion to reimburse private banking clients who had invested with the disgraced financier **Bernard L. Madoff**, a settlement that could prompt other financial institutions to follow suit. ... [I]nvestors brought a class-action suit against the Spanish bank in Federal District Court in Miami. They accused the bank of not adequately scrutinizing the Madoff investments.... Santander said in December that it had an exposure of $3 billion

to Mr. Madoff's firm, the largest of any commercial bank. ... Santander said in a statement Tuesday that the bank had acted 'at all times with the due diligence' and 'in accordance with all applicable laws and sound banking practices.' ... Santander said clients would receive a quantity of preferred shares in the bank equal to their initial investment. ... The bank ... would close seven of its funds because clients had been withdrawing money from them." (NYT, 1/28/09, "Spanish Bank Offers $1.8 Billion to Settle Madoff Claims") One should wonder what formal discovery efforts might have yielded about the bank's due diligence efforts. Is one round of discovery efforts worth a $1.2 billion discount?

"Madoff Feeder Maxam Sues Own Auditors for Not Unearthing Fraud"

"A **Maxam Capital Management LLC** fund that placed all of its $280 million in holdings with alleged Ponzi-scheme mastermind Bernard Madoff sued its own auditors for not detecting the fraud at the New York investment firm. The **Maxam Absolute Return Fund LP** sued **McGladrey & Pullen LLP** and **Goldstein Golub Kessler LLP** for professional negligence ... While the auditors issued an opinion that Maxam's financial statements conformed with general accounting principles, they 'negligently relied solely on documents created by Madoff and sought no independent confirmation that trades had been executed or that assets existed,' according to the complaint." (Bloomberg, 2/2/09, "Madoff Feeder Maxam Sues Own Auditors for Not Unearthing Fraud") Will the accountants raise the issue of comparative negligence with respect to the fund's (lack of) due diligence? Will the investors learn enough from the conflict to sue the fund and the accountants? Will this become another instance of what goes around, comes around?

"Aggrieved Investors Turn Sights to Banks"

"Investors who said they lost money to Bernard Madoff are taking aim at the big banks that played administrative roles in their investments. **HSBC Holdings PLC**, **UBS AG**, **J.P. Morgan Chase & Co.** and other financial middlemen are facing lawsuits from clients of Mr. Madoff who are trying to recover funds in the alleged Ponzi scheme. ... Back-office businesses, including custodial services that hold in safekeeping the assets of an individual or firm, generate billions of dollars a year for some banks. Some investors of Mr. Madoff contend that financial institutions handling money for his firm should have known about the alleged fraud. ... HSBC was accused of a 'lack of scrutiny' that 'falls far short of the legal duties owed and representations made.' HSBC was a custodian bank for Bernard L. Madoff Investment Securities LLC. ... One of the sticking points in the Madoff case is related to the flow of information regarding the value of Madoff fund assets. 'The biggest challenge for a custodian is to make sure the assets are properly valued. If there is a lack of transparency, it would certainly make the custodian's job a lot more difficult in getting accurate information on behalf of the client,' said John Guidice of Buttonwood International Inc., a New York consulting firm."(WSJ, 2/3/09, "Aggrieved Investors Turn Sights to Banks") This gets confusing. What were the supposed "assets" over which the administrators were custodians? Is this not another way claiming that someone else should have done due diligence?

"Hedge-Fund Manager 'Gad' Grieve Sued for Fraud by SEC"

"Hedge-fund manager **Grant 'Gad' Grieve** and two New York investment advisory firms he controlled were sued by U.S. regulators over claims he listed a fictitious auditor while fabricating financial statements. Grieve, who managed **Finvest Asset Management LLC** and **Finvest Fund Management LLC**, created two 'sham' firms that purportedly vouched for accounting and profits.... He raised more than $11 million from U.S. clients since 2004, and began soliciting Europeans last year.... Money managers who report consistent profits amid rising and falling markets are under scrutiny by investors and regulators after Bernard Madoff's alleged $50 billion fraud." (Bloomberg, 2/10/09, "Hedge-Fund Manager 'Gad' Grieve Sued for Fraud by SEC")

"Imprisoned Felon Was Adviser to Madoff Investor"

"One of the top advisers to the money manager **J. Ezra Merkin**, who invested $2 billion of his clients' money with **Bernard L. Madoff**, is a convicted felon who worked for Mr. Merkin while still in federal prison.... The adviser, **Victor Teicher**, who had been convicted of federal securities fraud and was barred from the securities industry, advised Mr. Merkin on the management of his **Ariel Fund Ltd.** through phone calls made to Mr. Merkin's Park Avenue office from a New Jersey prison. Information about Mr. Teicher's relationship with Mr. Merkin was contained in court papers filed by New York University, one of several institutions now suing Mr. Merkin. ... There was, however, one piece of Mr. Teicher's investment advice that Mr. Merkin did not follow: Mr. Teicher warned Mr. Merkin that Mr. Madoff's trading results were impossible to achieve. ... [T]he university said that none of the Ariel fund prospectuses disclosed that 'Victor Teicher, a convicted felon, and his staff were the persons actively managing the majority of the Ariel assets, and that hundreds of millions of dollars of Ariel's funds had also been delivered for management to Madoff — even though Teicher had warned Merkin than Madoff's returns were not possible.'" (NYT, 2/14/09, "Imprisoned Felon Was Adviser to Madoff Investor")

"Mezzanine Debt Loses Its Shine With Investors"

"In the fading years of the commercial real-estate boom, mezzanine debt was all the rage among yield-chasing private-equity firms and hedge funds like **Fortress Investment Group LLC, Fillmore Capital Partners LLC and Petra Capital Management LLC**. Firms made an estimated $50 billion to $75 billion in mezzanine -- dubbed 'mezz' -- loans, debt that fills the gap between the borrower's equity and the first mortgage. Billions of dollars already have been lost and the figure is likely to balloon as the steep downturn in the commercial-property market deepens. ... Mezz debt was one of the biggest culprits that enabled commercial real-estate investors and developers to participate in the broader speculative binge on Wall Street. ... Now mezz investors are suffering a massive casualty rate with some mezz funds facing total losses. Almost all the firms that specialized in the once-promising investment are spending their days fighting with borrowers to salvage some of their loans while defending themselves against

creditors who financed their operations. ... The attraction of mezz debt to investors was twofold: the rate of return on such debt -- once levered up -- was in the teens if the borrower kept current and, if the borrower defaulted, the investor in the debt would have the right to take over the property. ... But that strategy isn't working in many cases because properties are no longer generating enough cash to cover the first mortgages, much less the mezz debt. For the mezz investors to take over the property, they would have to reach into their own pockets to pay debt service on the first mortgage. ... Investment firms that specialized in mezz debt have been shown the door when they have asked investors for more capital to salvage deals. ... Firms that have invested heavily in mezz debt first began running into trouble because they borrowed heavily, using their loans as collateral. As the value of those loans tanked, they faced margin calls. ... Most recently, borrowers have begun to default on mezz loans, forcing the mezz investors to try to foreclose. But this isn't easy even in cases in which the mezzanine holders believe their position is worth something. Often the mezz debt is broken up into slices with different degrees of risk and claims on the property. Also, for the mezz holders to take over the property, they often have to pay what is owed or refinance the first mortgage, a difficult feat in this credit-starved environment." (WSJ, 2/18/09, "Mezzanine Debt Loses Its Shine With Investors") Cutting through the complexity, this is nothing more than leveraged second trust deed investing, with its concomitant risks and rewards. Did investors think through an exit plan based the most negative scenarios? It would be educational to observe any risk disclosure materials presented to prospective investors.

"Westgate manager arrested, charged with fraud"

"James Nicholson, manager of investment firm **Westgate Capital Management LLC,** was arrested Wednesday on charges of securities fraud and bank fraud... Nicholson, 42, told investors that Westgate Capital had assets under management ranging from $600 to $900 million when, in fact, the true value of its assets was materially less. ... Westgate also said in an offering document that its **Westgate Strategic Growth Fund** was audited by an independent accounting firm located in New York. However, the address of the firm is a business known as 'The New York City Virtual Presence.' Nicholson leased 'virtual space' for the accounting firm in 2004 and arranged, for a time, for an answering service to direct calls to phone numbers he provided.... Marketing brochures ... claimed ... uniformly positive returns...." (MarketWatch, 2/25/09, "Westgate manager arrested, charged with fraud") One would think that smart investors are now investigating whether accounting supposed firms actually exist, a easy task.

"Consultants Touted Firm Accused in Fraud"

"Money managers Paul Greenwood and Stephen Walsh, arrested this week on fraud charges, boasted a healthy list of pension and endowment clients thanks in part to several prominent consulting firms that recommended them. The consulting firms, including **Wilshire Associates**, **Cambridge Associates** and **Mercer** investment consulting, provided glowing reports about the managers' firm, **Westridge Capital Management Inc.**, to prospective investors, who now find themselves potentially facing millions in losses. ... [C]onsulting firms were key in bringing Westridge some of its

biggest clients. ... Wilshire, of Santa Monica, Calif., did thorough due diligence on Westridge, reviewing audited financial statements, regulatory filings and bank-account records before recommending Westridge to clients, said Kim Shepherd, a spokeswoman for the firm. ... Consulting firms are crucial players in the investment business, advising hundreds of institutional investors on where they should put their money. Their vetting of money managers can take months and their blessing can lead to hundreds of millions of dollars of new cash for the money managers. Allegations against Westridge strike at the heart of consultants' business, industry participants say. Typically, clients pay big consulting firms a flat fee for a multi-year contract or a small percentage of assets that the clients invest. ... Federal authorities Wednesday accused Messrs. Greenwood and Walsh of promising clients they would invest the bulk of their funds in a stock-exchange index arbitrage strategy, but actually investing only a small amount, diverting most of it for their own personal use. ... Mr. Greenwood, a former economics professor who had taught at Ohio State University and York University in Toronto, teamed up with Mr. Walsh, a former options trader, in 1979 in a brokerage firm that eventually was called Walsh, Greenwood & Co. ... The following year (1986), the SEC accused the company of violating federal securities law. The SEC allegations included that the firm used more than $6 million in customers' securities as collateral for some of its own bank loans, and failing to maintain accurate records of the securities' location. The company later settled the charges, without admitting them, and agreed to a series of corrective actions, SEC records show." (WSJ, 2/26/09, "Consultants Touted Firm Accused in Fraud") So, how did the "consultants" miss it? What were the "red flags"? Will we learn that the consultants received benefits from those they were supposed to vet? Perhaps, we need a community of consultants to be able to locate other consultants á la funds of funds?

"Connecticut Town Sues Over Madoff Losses"

"The town of Fairfield, Conn., has sued its investment adviser and auditor for failing to alert it to potential fraud at two hedge funds that invested everything with Bernard L. Madoff, who is accused of running a $50 billion Ponzi scheme. Fairfield, which lost about $40 million in the Madoff debacle, contends that both its auditor, **KPMG** and its investment consultant, **NEPC**, failed to thoroughly examine Mr. Madoff's firm. NEPC, which was once known as New England Pension Consultants, was hired in 2006 by two Fairfield pension funds ... to review its portfolio of hedge fund investments. Before it hired NEPC, Fairfield had investments totaling about $40 million with **American Masters Broad Market Fund**, a hedge fund firm that put all its money with Mr. Madoff. KPMG was also hired to audit the American Masters fund at the time and Fairfield says the accounting firm never looked into Mr. Madoff. In 2007 and 2008, Fairfield decided to move its money from the American Masters fund to **Maxam Capital Management**, a hedge fund run by Sandra L. Manske that also invested everything with Mr. Madoff. Fairfield asserts that NEPC approved of the town's investment in Maxam even after conducting diligence on the firm. NEPC said in a statement that Fairfield chose to invest with Mr. Madoff through American Masters long before the firm was retained as the town's pension adviser in 2006. NEPC said it recommended that the town reduce its investments with Mr. Madoff, but officials disregarded the advice." (NYT [DealBook], 2/27/09, "Connecticut Town Sues Over Madoff Losses") On what bases did

Fairfield decide to move its funds? Does it make sense to change from one feeder fund to Madoff to another? The disputants will learn the importance of detailed engagement letters and confirming written communications or lack thereof. Experts may need to opine as to what is expected of consultants with such engagements and whether each fulfilled those expectations.

"Fairfield Greenwich Says Madoff Provided Bad Data"

"After funneling billions in investor money to Bernard Madoff over nearly two decades, **Fairfield Greenwich Group** is offering up its explanation to investors: It scrutinized Mr. Madoff's trading, but the documentation he provided was false. ... Fairfield says the Madoff firm supplied falsified trading documents, including what Fairfield says now appear to have been fake electronic records from Depository Trust & Clearing Corp., an independent firm that inventories much of Wall Street's stock and bond holdings. ... In the spring of 2001, a pair of articles in Barron's ... and a hedge-fund industry publication questioned the performance by Mr. Madoff. In a visit to Mr. Madoff's offices around the time, **Jeffrey Tucker**, Fairfield's co-founder, discussed the articles with Mr. Madoff, according to a spokesman for the firm. Mr. Madoff gave Mr. Tucker a chance to do his own spot check, letting him randomly select two dates and, from those days, select two stocks that had been traded in Fairfield's accounts.... Mr. Madoff showed Mr. Tucker paper records of trades for those stocks. Then Mr. Madoff showed Mr. Tucker a computer screen that appeared to show the stocks held by the Madoff firm as tracked by Depository Trust & Clearing Corp. It all matched.... As evidence that the meeting occurred, Fairfield points to an internal email from August 2008 that was reviewed by The Wall Street Journal, in which the firm says a top Fairfield executive discussed the meeting. 'I believe that Jeffrey may have verified the existence and segregation of assets in the past by tracking stocks from trade blotter to the stock record to DTCC and back to client accounts,' wrote **Amit Vijayvergiya**, head of risk management at Fairfield. ... Fairfield also says that auditors from PricewaterhouseCoopers, Sentry's auditor starting in 1993, accompanied by a Fairfield employee, went to Mr. Madoff's offices in 2002 and scrutinized a number of Sentry's trades and didn't raise any concerns to Fairfield. Fairfield says it looked into Mr. Madoff's options trading, which industry observers and the lawsuits have said posed a red flag that the Madoff investment business was a fraud. The main issue is whether there was enough options-trading volume to absorb the strategy Mr. Madoff said he was employing. If not, that could have signaled to investors like Fairfield that the strategy as stated wasn't being executed. ... Mr. Madoff told them he was doing options trading in the over-the-counter market, not through the CBOE. ... Fairfield asked Mr. Madoff who his counterparties were on the OTC trades, but Mr. Madoff wouldn't name them." (WSJ, 3/2/09, "Fairfield Greenwich Says Madoff Provided Bad Data --- Firm Asserts Falsified Trading Documents That Were Supplied Fooled It and Auditor PricewaterhouseCoopers") How many minutes did the Madoff-Tucker meeting last? If Tucker was so suspicious, why didn't he take some technical people with him or independently verify information with DTCC? Does a hear-say memo dated 7 years after the alleged events have much credibility? Where is Tucker's contemporaneous memo of the events with supporting documentation? Did Tucker look into the improbable investment performance aspects?

Did PWC become suspicious when Madoff refused to identify his alleged trading counter-parities? Was a justification, if any, for the refusal reasonable? Stay tuned.

"Ponzi Scheme Victims All Missed an Easy Clue: Bogus Auditors"

"The arrest of Bernard Madoff's accountant highlights the peril posed by bogus auditors at the heart of Ponzi schemes that have bilked investors out of billions of dollars. David Friehling's arrest for securities fraud yesterday followed at least four other cases this year in which money managers accused of defrauding clients created sham auditors or hired accountants not up to the job. Investors may have avoided about $74 billion in losses if they had examined, or just tried to shake hands with, accountants supposedly verifying the books. ... The auditor for James Nicholson, the hedge-fund manager arrested in February for conning investors out of as much as $900 million, was a mail drop in Manhattan. Phones rang unanswered when regulators called R. Allen Stanford's auditor in Antigua. Friehling was sole proprietor of Friehling & Horowitz, an accounting firm run from a 13-by-18-foot storefront in the New York City suburb of New City. ... Fund managers typically disclose those details (who audits their books, handles their trades and has custody of their assets) privately to investors, who may try to independently verify them. ... A week after Madoff's arrest, Georgia currency trader James Ossie tried to reassure clients in a letter, claiming outside accountants verified his books every 90 days. It wasn't true, the SEC said in a January lawsuit accusing him of running a $25 million Ponzi scheme. Ossie falsely told some clients he was audited by Robert Half International Inc., a Menlo Park, California-based recruiting company, the agency said. His attorney, William Leonard in Atlanta, declined to comment. New York hedge-fund manager Grant 'Gad' Grieve created two 'sham' firms to vouch for his profits, the SEC said in a February lawsuit. Grieve sent at least one investor an audit report on letterhead from one of the fictional firms, for which he had arranged an Internet address, the agency said. ... Hedge fund operator Nicholson defrauded clients at his firm in Pearl River, New York, by overstating assets, according to claims filed by the SEC and prosecutors at federal court in New York. He allegedly said his books were audited by a firm called Havener and Havener on East 41st Street in Manhattan. When an FBI agent visited the address last month, he discovered Nicholson had signed a lease in 2004 with a company that provides 'virtual' office space, letting customers use it as a mailing address, prosecutors said. For some time, Nicholson even arranged for the leasing company's answering service to take calls to the auditor, forwarding messages to him. ... People burned by frauds sometimes don't look for warning signs because it conflicts with what they want to believe, said Stephen Greenspan, professor emeritus of educational psychology at the University of Connecticut and author of the 2008 book 'Annals of Gullibility: Why We Get Duped and How to Avoid It.' Greenspan speaks from experience: He invested more than $250,000 with Madoff." (Bloomberg, 3/19/09, "Ponzi Scheme Victims All Missed an Easy Clue: Bogus Auditors")

"Criminal Case Ensnares Aides to Ex-New York Comptroller"

"In an alleged pay-to-play scheme that drew in many hedge-fund and private-equity firms, two top aides to a former New York State comptroller extracted millions of

dollars from investors seeking to manage money for the state's pension fund, federal and state authorities charged Thursday. About $30 million in so-called finder fees were paid to **Henry Morris**, a top political adviser and chief fund-raiser for former New York Comptroller **Alan Hevesi**, and Mr. Morris's associates, according to allegations by the New York attorney general and the Securities and Exchange Commission. Investors, not charged in the case, paid the fees to secure lucrative business with the public pension fund, one of the nation's largest with about $122 billion in assets at the end of 2008. Mr. Morris, 55 years old, and former New York Deputy Comptroller **David J. Loglisci**, 38, were arrested Thursday and criminally charged in a 123-count indictment.... Mr. Hevesi, who resigned as comptroller in 2006 after pleading guilty for defrauding the government in a separate matter, was not charged. ... Public pension funds are enormously important clients for private-equity firms and hedge funds, as they control significant sums and have the staying power to make long-term investments. Some firms use middlemen known as placement agents to help get pension-fund business. Firms pay agents a fee, typically 2% of any investment they receive through the placement agent. ... The suit charges that Mr. Loglisci told firms interested in managing New York's pension money that they should hire Mr. Morris. After the money managers agreed to pay Mr. Morris a fee, then 'Loglisci approved the proposed deal with the investment management firm,' the SEC alleged....Pension-fund pay-to-play schemes have been a national problem for many years." (WSJ, 3/20/09, "Criminal Case Ensnares Aides to Ex-New York Comptroller") The practice might decrease if a few hedge fund operators did the "perp walk" for bribing public officials.

"SEC targets hedge funds for 'preferential redemptions'"

"The Securities and Exchange Commission is investigating whether hedge funds gave favored employees or investors 'preferential redemptions' by allowing them to withdraw money while freezing redemptions for other clients.... [T]he regulator has launched dozens of active investigations into hedge funds and is focusing on several other issues, including abusive short selling, valuation concerns with illiquid assets and potential insider trading. The current financial crisis, she said, has also raised the possibility of hedge funds' offering frauds, where managers use the fact that the hedge fund industry is largely unregulated and non-transparent to conceal Ponzi schemes.... Despite the scarcity of regulation of hedge funds, the SEC has filed more than 100 suits against such funds in the last five years, primarily by using its anti-fraud authority." (InvestmentNews, 3/20/09, "SEC targets hedge funds for 'preferential redemptions'")

"Fairfield Greenwich Charged With Fraud in Madoff Case"

"Massachusetts securities regulators charged **Fairfield Greenwich Group**, a major feeder fund for Bernard Madoff, with fraud, saying the company breached its fiduciary duty to clients by failing to provide promised due diligence on its investments. An administrative complaint filed on Wednesday by Secretary of the Commonwealth William F. Galvin alleges a 'profound disparity between the due diligence that Fairfield represented to its investors that it would conduct with respect to Bernard L. Madoff Investment Securities and the due diligence it actually conducted.' ... The charges, not

criminal, are the first regulatory action against a so-called feeder fund, a fund that gained access for investors to Mr. Madoff. ... 'Investment advisers have a fiduciary responsibility to their clients under law," Mr. Galvin said. "The allegations against Fairfield in this complaint outline a total disregard for such responsibility which helped the Madoff scheme to stay afloat for so long.' The complaint seeks restitution to Massachusetts investors for losses and disgorgement of performance fees paid to Fairfield by those investors, as well as an administrative fine. The complaint says that Mr. Madoff coached Fairfield officials in 2005 on how to respond to questions from SEC attorneys who were looking into concerns voiced by Harry Markopolos, later credited with bringing information to the agency raising questions about Mr. Madoff's operations." (WSJ, 4/1/09, "Fairfield Greenwich Charged With Fraud in Madoff Case") Details of the "coaching" would be most interesting. Where's the SEC, now that we need it? Which other feeder fund will be next? Perhaps, criminal proceedings are on the horizon.

"How did Bernard Madoff's victims fall for his $65bn scam?"

"How could so many smart, successful people have been so spectacularly gullible? ... One answer, according to newly disclosed legal documents, is that some of his closest associates blithely turned a blind eye to warning signs. ... The Massachusetts' secretary of state, Bill Galvin, has filed fraud charges against **Fairfield Greenwich**, a hedge fund which was among the biggest 'feeder funds' to Madoff's investment empire. ... In a marketing document for clients, Fairfield boasted it would never have invested in a crooked venture like Bayou – a notorious hedge fund run by Samuel Israel, who famously faked his suicide to avoid prison for fraud. The reason?: 'We would question Bayou's obscure auditing firm.' This is fairly brazen since Madoff was audited by a single-man accountancy firm called Friehling & Horowitz based in a strip mall outside New York City. A Fairfield client once asked about this auditing outfit, prompting Fairfield's chief financial officer, **Dan Lipton**, to 'investigate'. He rang up Friehling's only employee, then emailed his client the following reassurance: 'Friehling & Horowitz CPAs are a small- to medium-sized audit and tax firm specialising in broker dealers and other financial services firms. They have hundreds of clients and are well respected in the local community.' Lipton's subsequent interview with regulators is worth reproducing: Q. How did you determine they had hundreds of clients? A. That's what the partner said on the phone to me. Q. Did you corroborate it in any way? A. No. Q. How did you determine that they were well respected in the local community? A. That's what our conversation – my conversation with one of the partners at Friehling & Horowitz – that's what was told to me. Hardly the due diligence skills of Hercule Poirot, are they? ... When the SEC felt moved to investigate, Fairfield's chief counsel, **Mark McKeefrey**, had a phone conversation with Madoff to discuss what they should say to regulators during interviews. According to a transcript, Bernie's opener in that conversation was: 'Obviously, first of all, this conversation never took place, Mark, okay?' ... At various stages, (**Jeffrey**) **Tucker**, Lipton and Fairfield's chief risk officer, **Amit Vijayvergiya**, all received tours of Madoff's market making operation – but they didn't see the floors where Madoff's crucial so-called 'split strike' trading operation was supposed to take place. Nor did they meet any of the individuals supposedly involved in executing it, according to this week's regulatory complaint. How, inquired investigators, did they therefore know

that such people existed or that Madoff's strategy was being executed? Vijayvergiya replied: 'Madoff, after, you know, 18 years of a very lengthy and trusted relationship, an individual who had a stellar reputation and great credibility in the industry, provided us with this information, so we had every reason to believe it was true.' That's not quite good enough, is it?" (guardian.uk, 4/2/09, "How did Bernard Madoff's victims fall for his $65bn scam?") After all is said and done, no one will ever believe him/herself to have acted unethically or incompetently or to obstruct justice. No one. How did all this happen? They became addicted to what lots of money could buy.

"Madoff Scandal Casts Light on Investment Advisers"

"**NEPC** (one of the nation's largest investment consultants) and businesses like it play a pivotal — and at times controversial — role as the gatekeepers of the investing world. They stand between trillions of dollars of public and corporate pension money and investment professionals who want a piece of it. ... NEPC says it urged (the City of) Fairfield to reduce its investments in a Madoff-linked fund before the scheme came to light. ... Fairfield paid NEPC $100,000 a year to help it pick investments. The two sides are arguing in court over who will bear the blame for $19 million in losses. The Madoff affair is rife with finger-pointing. ... For years, troubling questions about these businesses have percolated through the financial industry and the courts. Now, calls for change are growing. Some consultants, their critics maintain, have conflicts in cases where they collect money as consultants and from the funds they recommend. ... [I]nvestment consulting took off during the mid-1990s as hedge funds, private equity funds and other so-called alternative investments exploded onto the financial scene. Big investors like pension funds and endowments wanted a piece of the action, but many lacked the time, staff and expertise required to sift through the growing list of investment options. Enter the consultants. ... The Labor Department, for instance, started examining the industry in 2007, and its inquiry is starting to bear fruit. This month, the department settled with **Consulting Services Group**, based in Memphis, over conflicts of interest. Last December, it sued **Zenith Capital Partners**, a Santa Rosa, Calif., pension consultant, claiming that Zenith had accepted payments from a hedge fund for steering pension clients to it. ...A common complaint is that consultants shirked their responsibility to protect their clients and pushed public pension boards into hedge funds to collect large fees." (NYT, 4/7/09, "Madoff Scandal Casts Light on Investment Advisers") Outsourcing due diligence can be dangerous. On the other hand, perhaps the solution is another layer of consultants to render advice on hiring consultants. Consultants, supposedly acting in a fiduciary capacity, should find themselves in deep financial do-do if they fail to disclose adequately blatant conflicts of interest. Clients of Consulting Services Group and Zenith Capital Partners should take notice.

"Financier Charged In Madoff Fraud"

"**J. Ezra Merkin**, a money manager who funneled $2.4 billion from universities and nonprofit organizations into Bernard Madoff's firm, was charged Monday on allegations he 'betrayed hundreds of investors' by repeatedly lying to them about how he invested their money. Mr. Merkin, a New York philanthropic leader and the former

chairman of finance company GMAC, raised billions of dollars for his three hedge funds, telling clients he was managing the money himself. But instead, according to a civil fraud complaint filed by New York state's attorney general, Andrew Cuomo, Mr. Merkin collected hundreds of millions of dollars in fees over more than a decade while weaving a 'panoply of lies' to conceal that he was channeling much of his clients' funds to Mr. Madoff. 'Merkin held himself out to investors as an investing guru... In reality, Merkin was but a master marketer,' Mr. Cuomo said in the complaint. ... The sales pitches for Mr. Merkin's three funds -- **Ascot Partners LP**, **Gabriel Capital Corp.** and **Ariel Fund Ltd.** -- included promises that he actively managed their funds, according to the complaint. ... ... By 2008, Mr. Merkin was collecting about $25.5 million a year from managing Ascot -- generating management fees of about $169 million from Ascot from 1995 to 2007, the complaint says. ... Mr. Merkin also told investors in his other two funds, Gabriel and Ariel, that he was investing in distressed assets and bankruptcies, when he actually transferred large portions of those funds' money to Mr. Madoff starting in about 2000, the complaint says. Mr. Madoff's supposed strategy involved stocks and stock options, not distressed assets. The complaint also alleged Mr. Merkin ignored several warning signs about Mr. Madoff's investing returns. In the early 1990s, **Victor Teicher**, a money manager who had worked for Mr. Merkin, told him not to invest with Mr. Madoff because the steady returns he claimed to produce were impossible, according to the complaint. ... Mr. Merkin also kept in his files two 2001 news articles questioning the steadiness of Mr. Madoff's returns -- one published in Barron's and one by a hedge-fund newsletter called MARHedge, according to the complaint. (WSJ, 4/7/09, "Financier Charged In Madoff Fraud") One might wonder as to the content of annual/quarterly reports setting forth the exact nature of the funds' investments. On the other hand, Merkin may have claimed that investors were not entitled such proprietary information. Merkin should be charged with constructive knowledge, *i.e.*, knowledge one would have obtained after conducting a reasonably diligent search after suspicious information comes to one's attention, of Madoff's scheme. Merkin will have to explain how, if at all, he followed the suspicious information.

"Public Pension Managers Rethink Hedge Fund Ties"

"From New York to California, public pension funds staked billions in good times on the highest of Wall Street high rollers: hedge fund managers and corporate buyout specialists. But for many of these pension funds — and the millions of people who are relying on them for their retirements — that gamble is not paying off as hoped. Even before state and federal regulators began investigating whether several prominent investment firms had made improper payments to gain business from New York's state pension fund, public pension funds were backing away. These private investments were supposed to outpace the stock market but, in many cases, lost value instead. Public pension funds that embraced these ventures — which range from real estate to commodities to private equity funds — have grown uneasy over the costs and secrecy typically associated with them, as well as with their inability to withdraw their money quickly if needed. Now news from New York is shining an uncomfortable spotlight on hedge funds and private equity, which helped define the boom years on Wall Street. ... Many public employees — teachers, police officers and the like — may not even realize

that part of their nest eggs are tied to hedge funds and corporate buyouts. In 2005, just 13 percent of all public pension funds invested in hedge funds. By 2008, 40 percent did so, having a combined $78 billion invested in such funds. About half now invest in private-equity funds. ... Public pension funds feel they may have some luck in gaining concessions on fees and greater view into often-secretive hedge fund operations. No less an industry leader that the California public pension plan known as Calpers, the nation's largest, is heading an effort to reduce hedge fund fees and change the terms of its hedge fund investments. This comes after Calpers saw its hedge fund investments fall to $5.9 billion from a high of $7.6 billion. In addition, since beginning to invest in hedge funds in 2002, Calpers has experienced a modest 3.5 percent annual rate of return, far less than the market-beating returns that hedge fund managers had promised. ... Calpers wants to segregate its money from that of other investors and have it individually managed, and it wants more timely information and greater transparency into the funds' investments." (NYT, 4/15/09, "Public Pension Managers Rethink Hedge Fund Ties") It is truly amazing how conflicts of interests go unrecognized by the temporary beneficiaries and clouds honest thinking. Why would pension funds, supposed fiduciaries, ever throw money at hedge funds, ask no/few questions and pay irrational fees? Would they treat their own hard-earned funds in the same manner? If so, pension funds should ask them to seek employment elsewhere. Curriculum in MBA programs has failed to keep the thinking of an entire generation from being corrupted.

"In State Pension Inquiry, a Scandal Snowballs"

"The inquiry into corruption at the New York State pension fund started simply enough. **Alan G. Hevesi**, the former comptroller, was accused of using state workers as chauffeurs for his ailing wife. But by the time Mr. Hevesi resigned his office in late 2006, investigators for the Albany County district attorney's office were examining a more troubling problem: allegations that Mr. Hevesi's associates had sold access to the state's $122 billion pension fund, using one of the world's largest pools of assets to reward friends, pay back political favors and reap millions of dollars in cash rewards for themselves. ... Hundreds of investment firms have been subpoenaed. Three people have been criminally charged and another has pleaded guilty to a felony. And the scandal has grabbed the attention of Wall Street, as members of the investment establishment's top tier now face scrutiny. The **Carlyle Group**, the politically connected private equity firm, is among the companies whose transactions are being examined. **Steven Rattner**, just appointed to serve as the Obama administration's point man in the bailout of the auto industry, has emerged as a significant figure. ... At the heart of the case are the fees paid by investment firms to associates of Mr. Hevesi as the firms sought business from the pension fund. Such fees are legal, unless they are used, either directly or indirectly, to bribe public officials. The two associates of Mr. Hevesi who have been indicted — **Hank Morris**, once a nationally prominent political consultant, and **David Loglisci**, the pension fund's chief investment officer — are accused of encouraging investment firms to direct money to friends and allies set up as 'sham' intermediaries, according to court filings. ... On Friday, a White House spokesman said President Obama had full confidence in Mr. Rattner, a former New York Times reporter and a founder of the **Quadrangle Group**, a private equity firm. Mr. Rattner arranged to have Quadrangle pay a company that

employed Mr. Morris more than $1 million as it sought business from the pension fund, a person with knowledge of the inquiry said this week. According to S.E.C. filings, the Carlyle Group and another firm paid $10 million to the company that employed Mr. Morris. ... The inquiry has put a spotlight on not only the well-known investment bankers and firms, but more high-profile figures and unconventional business transactions." (NYT, 4/18/09, "In State Pension Inquiry, a Scandal Snowballs") Honest providers of financial services cannot effectively compete with creeps, whose parents did not teach them right from wrong! Why is there any need for middle persons? To think that the payments were intended to be other than bribes insults the public's intelligence. One will learn more about the prosecutor's integrity if the hedge funds *mavens* are not prosecuted. The hedge funds could have reduced their fees by the amount of the money paid to secure business from the pension funds.

"Quadrangle Questioned on Pension Disclosure"

"The New York City comptroller said Tuesday it is conducting an internal investigation into whether private-equity firm **Quadrangle Group** 'intentionally misled or deceived' the city pension funds by failing to disclose paying finder fees to the firm of the now-indicted political adviser **Hank Morris**, a comptroller spokesman said. Quadrangle paid fees to Mr. Morris's former employer, **Searle & Co.**, in 2005 for an $85 million investment in the New York City Pension Funds.... But in disclosures to the pension fund, Quadrangle didn't mention retaining or paying fees to Searle, according to a spokesman for the New York City comptroller, **William Thompson**, who oversees the fund. Rather, Quadrangle told the pension fund it used two other placement agents -- companies that help investment firms secure business from pensions, endowments and foundations. The former firm of Obama adviser **Steven Rattner** is under scrutiny. A spokesman for Quadrangle said: 'This came as a complete surprise. We plan to gather all the facts and intend to clear up the issue as soon as possible.' Meanwhile, details are emerging of changes New York Attorney General Andrew Cuomo might pursue in light of the pension pay-to-play case.... Under consideration is a ban on third-party marketers and placement agents. Instead, investment firms like private-equity and hedge-fund firms would have to market directly to a pension. Another possibility are campaign-contribution limits that could prohibit firms that donate to state comptroller campaigns from getting pension-fund business for two years. ... Quadrangle is the former firm of Steven Rattner, now leading President Obama's auto-industry bailout. The firm agreed to pay finders fees to Searle to secure New York State pension-fund business." (WSJ, 4/22/09, "Quadrangle Questioned on Pension Disclosure") What are details of the alleged surprise? Surprise that they were caught?

"Hennessee Settles Bayou Case"

"U.S. regulators charged hedge-fund consultant **Hennessee Group LLC** with securities violations for recommending investments in **Bayou Management LLC**, a Connecticut hedge fund that collapsed in 2005 after it was shown as a fraud. ... The case holds broad ramifications for the fund-of-funds industry that helps people pick hedge-fund investments. ... The SEC complaint said that ... Hennessee failed to respond to red

flags and it didn't vet Bayou's accounting firm. Without confirming or denying the allegations, Hennessee agreed to pay $814,644 in disgorgement and fines." (WSJ, 4/23/09, "Hennessee Settles Bayou Case")

"Hedge Fund Manager Nicholson Indicted On Fraud Charges"

"Hedge-fund manager **James Nicholson** was indicted Thursday on fraud and other charges in a Ponzi scheme that cost investors at least $150 million. Nicholson, who was the president and sole managing member of money-management firm **Westgate Capital Management LLC**, was charged in a four-count indictment with securities fraud, investment adviser fraud, bank fraud and improper structuring of withdrawals. ... Nicholson, of Saddle River, N.J., has been in custody since his arrest in February on bank fraud and securities fraud charges. Prosecutors have alleged that Nicholson, 42 years old, falsely represented to investors that Westgate's funds had assets under management ranging from $600 million to $900 million. At the time of his arrest, the government said at least $100 million was invested with the firm. Nicholson founded the firm in August 1999 and the alleged fraud began in 2004, the government said. Prosecutors claim Nicholson falsely represented that one of the firm's funds, the Westgate **Strategic Growth Fund LP**, was audited by an independent accounting firm located in New York. ... The funds' performance was materially lower than represented to investors, prosecutors said. ... The government is seeking at least $150 million in forfeiture and properties in the Hamptons; Palm Beach, Fla.; and New Jersey. ... Prosecutors have alleged Nicholson's scheme fell apart in December after a number of investors sought to redeem their investments following the arrest of Madoff. Checks to nearly two dozen investors totaling $5 million bounced in December, the government said." (DowJones, 4/23/09, "Hedge Fund Manager Nicholson Indicted On Fraud Charges") Who was the alleged auditor? How many more times will we read similar stories? Did everyone, for the past so many years, drink from the gullibility punch bowl?

"How Bernie did it"

"The SEC launched an investigation in 2006. A whistleblower named **Harry Markopolos** had spent years trying to persuade the SEC that Madoff was running a Ponzi scheme (he had been a key source for the Mar/Hedge article). The SEC also examined whether **Fairfield Greenwich**, a giant feeder fund, was properly disclosing the extent of its reliance on Madoff. ... This time Madoff was being asked specifically about his fraudulent investment business. Once again he prepared -- not only himself but also his customer Fairfield Greenwich. A phone conversation with representatives of Fairfield Greenwich in December 2005 was taped, transcribed, and ... provides a revealing example of Madoff's thinking and his ability to manipulate. 'Obviously, first of all, this conversation never took place ... okay?' Madoff began. ("Yes, of course," was the reply from Fairfield Greenwich's risk manager, though the company has since asserted that it informed the SEC of the conversation at the time.) Madoff proceeded to spin a strange, fragmentary ... self-contradictory set of talking points for Fairfield to follow in its SEC interview. ... Madoff was telling Fairfield to deny the obvious: that he was managing their money. ... Madoff went on to disparage the SEC investigation as a 'fishing expedition,'

saying that 'these girls' -- the SEC's lawyers -- might not understand the strategy, and implying that they might not press too hard because SEC lawyers have ambitions to go into lucrative private practice and don't want to alienate the sorts of firms that might hire them. Madoff's lies paid off -- at least, at the time. The SEC 'found no evidence of fraud,' as a staff attorney wrote in a 'case closing recommendation' (this despite the fact that the SEC had previously noted that Madoff's firm 'misled the examination staff' and withheld information). The punishment: Madoff's firm had to register as an investment adviser. (Fortune, 4/24/09, "How Bernie did it") When will the SEC publicly release the full examination report, along with the examiners' notes? Did the SEC send in its A-team? Did the examiners understand Markopolos' allegations? Did Madoff intimidate "the girls"? Are the examiners now in "lucrative private practice"? Did the NASD's examiners suffer the same fate? Is there any evidence that Fairfield informed the SEC of the existence of the conversation at or near the time that it occurred?

"Once Again, There's Trouble in Quant Land"

"A number of quantitative hedge funds have been crushed lately, even as the stock market soars, causing a stir on Wall Street. These funds, which rely on sophisticated computer models, generally have beaten the market over the past few years. But they have suffered sharp losses in short time spans, such as in August 2007. That is something their whiz-bang models said was almost impossible, raising questions about their approach. ... Troubles in quant land sometimes are a canary in the market's coal mine; when their computers are off kilter, it can suggest trouble below the market's surface. ... What has really happened is that quants, with a strategy of focusing on high-quality companies and betting against riskier shares, are getting clobbered. The market rally has been led by growth stocks, bombed-out financial shares and companies with poor balance sheets and lower profit margins. The troubles of some big quant funds raise as many questions about the sustainability of the market's recent surge as they do about the efficacy of their models." (WSJ, 5/11/09, "Once Again, There's Trouble in Quant Land")

"Simons Questioned by Investors"

"Investors in a hedge fund run by **James Simons** are asking questions about why a fund held by Mr. Simons and fund associates is racking up big gains while another held mostly by outside investors is losing money. In a conference call Wednesday, investors asked Mr. Simons about why the **Renaissance Institutional Equities Fund** lost 17% this year through April, lagging behind the stock market, while another fund -- held nearly exclusively by Mr. Simons and his colleagues -- surged 12%. The fund, known as RIEF, also lost money in 2008 while the internal fund jumped 80%. ... The 71-year-old manager rose to fame on Wall Street using sophisticated computer models to engineer trading strategies that indicate when to buy and sell stocks, bonds and futures. ... The performance gap was even wider last year, when **Medallion** surged 80% even after its higher-than-average fees were deducted, and RIEF declined 16%. ... The SEC also is examining hedge-fund trading and whether sophisticated strategies -- including ones driven by computers and known as 'quantitative' -- involve manipulative or abusive

practices...." (WSJ, 5/15/09, "Simons Questioned by Investors") Shocking!? Did anyone bother to read the conflict of interest disclosures, if any, in the disclosure statement?

"Hedge Fund Manager Accused of Fraud"

"A hedge fund manager in Beverly Hills, Calif., bilked investors out of about $44 million while claiming annual returns of as much as 60 percent, prosecutors said. The manager, **Bradley L. Ruderman**, 46, was taken into custody on Friday. Mr. Ruderman, the founder and manager of **Ruderman Capital Partners**, faces as much as 20 years in prison if convicted of wire fraud. He raised $44.3 million over the last eight years from 22 investors, mostly family members.... Mr. Ruderman sent a letter to the investors last month saying the funds were almost depleted. Mr. Ruderman spent $8.7 million of the money on personal expenses, including two Porsches and $5.2 million he lost in poker games, prosecutors said." (Bloomberg, 5/16/09, "Hedge Fund Manager Accused of Fraud") Did anyone seek details of an investment strategy that could produce a 60% per annum return or why he would even bother with investors? One can only wonder about what explanation he used for the cause(s) of the depletion.

"Red Flags For Hedge Fund Investors Attract Increased Attention"

"Clearly, the days of lackluster hedge fund due diligence are over. ...What are the best ways to avoid hedge fund fraud? ... In retrospect, many of the recent frauds should have been easy to detect.... In the end, one's gut feeling is important; however, the following are clear red flags that a fund may be in trouble sooner rather than later. • Lack of or Weak Valuation Policy ... All funds, regardless of size or strategy should have well documented processes for valuing the assets of the fund. ... • Substantial Change in Assets Under Management – A substantial change in AUM should be considered a potential warning sign that operational capabilities may be strained, or that the fund may be an 'asset gatherer' versus an 'asset manager.' • Personnel Concerns - lack of segregation of duties, especially related to cash controls, as well as turnover of key personnel, should be reviewed carefully. • Establishment of Side Pocket Investments ... • Strategy/Style Drift – investors should steer clear of hedge fund managers that cannot clearly articulate and follow the stated strategy. ... • Change in Leverage Amount – dramatic changes in leverage have the potential to multiply losses, or at the very least, complicate the accounting and operational controls around cash, margin requirements and counterparty management. • Counterparty Concentration ... • Unknown or Affiliated Service Providers ... • Outdated Legal Documents ... The provision of outdated or inconsistent documents may indicate a lack of proper corporate governance." (FINalternatives, 6/12/09, "Red Flags For Hedge Fund Investors Attract Increased Attention")

"Hedging on Hedge Fund Scrutiny Fine With Court"

A unanimous three-judge panel of the 2d U.S. Circuit Court of Appeals in New York threw out a suit that **South Cherry Street LLC** brought against **Hennessee Group LLC** for steering South Cherry's money into Bayou Group funds. Those were the ones run by since-convicted felons **Samuel Israel III** and Daniel Marino. ... The U.S.

Supreme Court made it even tougher to win such cases in 2007. And now, the 2d Circuit has arguably made it harder yet. The upshot is this: No matter how careless the financial adviser, no matter how many broken promises of scrutiny, no matter how many warning signs ignored, unless the investor has compelling evidence of intentional chicanery, the securities fraud claim is dismissed. Plus, getting that evidence is almost impossible because the 1995 law requires the investor to somehow find it before getting access in court to the other side's records. Before the case goes further, the judge must balance the allegation that the adviser meant to cheat against a defense claim that any failures were unwitting. The plaintiff is must somehow show that it knows what's in the defendant's mind. The claim fails unless the judge decides the allegation of intentional fraud is at least as plausible as an explanation it was an innocent mistake. The timing is especially infuriating to the plaintiffs in the Hennessee case. In April the SEC found that Hennessee hadn't performed the due diligence it had advertised and had ignored red flags. Bayou had given conflicting reports about its auditor, for example, and at one point simply invented an auditor. State accounting board records listed the bogus firm and named a Bayou principal as its registered agent. Surely even minimal scrutiny would have turned that up. ... As for Hennessee, it has agreed to settle SEC charges by paying more than $800,000 for having put about 40 clients into Bayou funds. The firm neither admits nor denies the SEC's charges, as is standard in this sort of thing. ... South Cherry Street also lost a claim that Hennessee breached a contract, because its promises of due diligence were oral and not part of a signed agreement. And when the trial judge kicked out a claim that Hennessee breached its fiduciary duties, South Cherry didn't appeal." (Bloomberg, 7/22/09, "Hedging on Hedge Fund Scrutiny Fine With Court") This decision does not pass the "stink test." Appeal. Go to state court --- negligence, reckless disregard. Don't get removed to federal court.

"Cerberus Investors Choose to Withdraw"

"Clients of **Cerberus Capital Management**'s core hedge funds have opted to withdraw the majority of money from the funds, marking a sharp rebuke to the weakened firm and its boss **Stephen Feinberg**. ... That a significant portion of investors decided to walk is a comedown for Mr. Feinberg and Cerberus, long one of the biggest and most successful private equity and hedge-fund firms and best known of late for its two failed investments in Chrysler LLC and GMAC LLC. Just a few years ago, investors clamored to get into Mr. Feinberg's funds, as the firm benefited from a boom in hedge funds and its own strong track record. The development also shows the difficulties hedge-fund investors have getting out of so-called illiquid assets, which often are heavily concentrated in a few companies or involve stakes in private companies and which have been hard to sell except at steep discounts during the financial crisis. ... Cerberus says it will gradually sell the assets and return cash. Investors don't know how long the process will take, with some expecting to wait as long as several years, nor do they know how much money they'll get back." (WSJ, 9/22/09, "Cerberus Investors Choose to Withdraw")

"Arrest of Hedge Fund Chief Unsettles the Industry"

"For years, whenever anyone asked **Raj Rajaratnam** about the success of his hedge fund, the **Galleon Group**, he chalked it up to being hungrier than everyone else. ... Now prosecutors are claiming that Mr. Rajaratnam, 52, crossed the line into criminal activity. ... [M]r. Rajaratnam was arrested ... charged with running the biggest insider trading scheme involving a hedge fund ... relying on a vast network of company insiders and consultants to make more than $20 million in profit from 2006 to 2009. ... News of Mr. Rajaratnam's arrest has also shaken the secretive hedge fund world, in which intelligence on companies is often shared among Wall Street analysts, traders and other investors. 'The defendants operated in a cozy world of "'you scratch my back, I'll scratch your back,'" Preet Bharara, the United States attorney for the Southern District of New York, said on Friday. He added that the case should be a 'wake-up call' for hedge fund managers who even think about insider trading. Hedge funds often use lobbyists, investigators and other connected people to dig for information about a company or industry. Most of the information is obtained legally. But the government's use of wiretapping and confidential witnesses in the Galleon case raises questions about when investors can act on nonpublic information. ... By the time he was arrested, Mr. Rajaratnam had cemented his position as a member of New York's financial elite." (NYT, 10/19/09, "Arrest of Hedge Fund Chief Unsettles the Industry")

"Hedge fund insider-trading scandal expands"

"Two years ago, hedge fund managers were acclaimed as financial whizzes, envied and even grudgingly respected for raking in gobs of money with daredevil investment strategies. Now the hedge fund industry, facing public scorn in the wake of the financial crisis and still reeling from steep investment losses last year, is at the center of the biggest insider-trading scandal in a generation, pitted against prosecutors who are moving aggressively to stamp out what they fear is widespread abuse of confidential information on Wall Street. ... The criminal complaint and a companion civil lawsuit filed Thursday depict an insider-trading network brazenly swapping information about planned corporate mergers and taking such elaborate steps to avoid detection that authorities likened the methods to those used by narcotics traffickers. To build their case, authorities used informants, wiretaps and a stakeout on a Manhattan street corner.... A key figure in the charges is **Zvi Goffer**, a former employee of New York hedge fund firm **Galleon Group**. ... Goffer used disposable cellphones to hide his actions and after finishing with one of them, broke it in half, bit its memory card, threw away half of the phone and instructed another defendant to dispose of the other half elsewhere, the complaints allege. ... According to the complaints, Goffer and another defendant, **Craig Drimal**, paid money for inside information, primarily from **Arthur Cutillo**, an attorney at Boston-based law firm **Ropes & Gray**, which worked on several mergers. Drimal worked in Galleon's office but was not employed by the firm. ... 'It is absolutely stunning that such a massive criminal scheme was perpetrated by such elite members of the financial services industry,' said Chris Bebel, a former federal prosecutor. ... For years, the SEC has suspected the superior investment returns obtained by hedge funds relied at least in part on illegal use of confidential information, said Amy Greer, a former SEC

lawyer who is now a partner at Reed Smith in New York. 'The agency believes that insider trading is rampant at hedge funds,' Greer said. ... In a country deeply divided on many issues, 'there seems to be one common enemy, and that's hedge funds,' said Ron Geffner, a New York hedge fund lawyer. 'It seems that many hedge fund managers have an invisible target on their back.'" (LAT, 11/6/09, "Hedge fund insider-trading scandal expands") What has the SEC been doing to protect the investing public when, during the past few years, it suspected hedge fund malfeasance? How does one become an "elite member of the financial services industry"? Should we place all such "elites" under suspicion? Hmmm --- not a bad idea in today's environment of greed and lack of accountability.

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