



Hedge Fund Fraud: The common denominator

Last year, the hedge fund industry's reputation was tarnished by three principal factors: poor performance (relative to their absolute return promise), illiquidity and the unfolding of several fraud cases. The performance argument has been challenged by the fact that compared to equity indices; hedge funds have, overall, been able to limit their downside despite failing to neutralize it completely. The various restrictions applied on the shareholders' redemption rights will however leave a bitter taste that will take shareholders a long time to forget. The beta of a strategy or its exposure to potentially illiquid assets can be understood and perhaps forecast by scrupulous analysts, but what can be done regarding the risk of fraud? The UK's Serious Fraud Office (SFO) took the lead when it announced, in late May, that it was building a warning system to help identify hedge fund fraud and to assist the market in assessing which hedge fund features can give rise to fraud.

Before analyzing fraud in the hedge fund context, it is useful to ask oneself what are the drivers (or indicators) that lead to fraud. According to Cohen & Felton (1979), fraud, like any other crime, can be explained by three factors: a supply of motivated offenders, the availability of suitable targets and the absence of capable guardians. The risk of fraud is a product of both personality and environmental or situational variables. Motivation is what drives the act of fraud. Dishonesty is not always the sole driver. Two scenarios can be deduced: firstly, a dishonest person identifies suitable targets and, in the absence of capable guardians, organizes a scheme aimed to defraud the targets; or, secondly, in the course of business, a person reacts to a situation that will engender a motivation to commit a fraud. The situation can appear as a "low hanging" fraud opportunity to make money or as a stressed and unexpected situation.

If we apply the above definition to the financial world, and in particular to the hedge fund industry, the two scenarios can be rewritten as follows: a person forges himself an image of respectability and sells to naive investors the promise of high returns with little risk in the unique goal to defraud them from their wealth. In this case, the unscrupulous pseudo hedge fund manager will first have to commit a misrepresentation to convince the investors to entrust their money with him and then he will need a way to misappropriate the assets without getting caught by either the investors themselves or another "capable" guardian. The second scenario, which is probably the most common, is a case where during the life of the hedge fund an event engenders a brutal and unexpected loss which is of enough amplitude to potentially jeopardize the future of the fund and to put an end to the manager career. The nature of the event can be a financial loss due to a bad investment bet and/or a failed risk management, or an operational problem which results in a negative impact on the value of the fund's assets. Following the occurrence of this event the manager may have to choose between two options: to disclose on not to disclose the loss to the fund's shareholders. The structure of the fund and the independence and quality of the controls in place will determine, at first hand, if the manager has the possibility to misrepresent the value of the fund's assets and to hide the loss. A manager deciding to commit fraud will justify his act by believing that he will be able to recover the negative performance and get the fund back on track without anyone spotting the difference. The outcome is very often a death spiral where the manager takes more aggressive bets exposing the fund to further losses.

The common thread between the two scenarios described hereinabove is the ability of the fund manager to perform a misrepresentation of the value of the fund's assets. It is therefore important for investors, in their due diligence, to focus on assessing the safeguards in place to avoid the manipulation of the fund's NAV. The misrepresentation can occur at several levels, namely:

- At the custodian level. The custodian of the fund's assets misrepresents to the fund's administrator/valuation agent the current holdings. Based on those false statements, the administrator erroneously delivers to investors an "inflated" valuation of their shares. This is what happened in cases like *Madoff* and *Philadelphia*;
- Between the custodian and the administrator. In this scenario, the administrator will probably not have received all the statements and trade confirmations directly from the fund's custodians, but will instead receive all or part of the information related to the fund's holdings by the intermediary of the investment manager. The investment manager will therefore have the ability to falsify the information leading to a wrong valuation being provided to shareholders. The *Integral Investment Management* and *Manhattan* cases are good examples;
- Misvaluation. In this scenario, the investment manager has the ability to manipulate the way assets in the fund's portfolio are valued. If the fund's NAV is calculated by the investment manager himself the job is easy. If the fund has appointed an independent administrator, the investment manager can still intervene in the valuation (depending on the pricing policy in place) or, in illiquid markets, the manager can manipulate prices by, for example, buying small quantities on the valuation days to push the valuation up. This scenario was found in cases like *Beacon Hill* and *Lancer*;
- At the administrator level. The investment manager and administrator may collude together to provide wrong valuations of their holding to the fund's shareholders and;
- At the investor level. In this case, the shareholders do not receive their monthly holding statements directly from the fund's valuation agent but rather through the investment manager. The manager may falsify the statements before sending them out

The difficulty in assessing the risk of misrepresentation rests with the lack of observable factors. The "science" of the due diligence therefore hinges on the ability of finding the right information, provided by the right stakeholder that will allow the investor to get an accurate measure of the risk of misrepresentation. The analyst should avoid the pitfall of being "smart after the facts" since it is sometimes difficult to tell if the red flags, usually identified after the fraud was uncovered, could have been identified earlier, *a priori*. Reducing the risk of misrepresentation does not mean that investors should overlook the potential of a loss occurring from a wrong financial bet or from an operational failure because this is what will provide the motivation for the fraud and you never know how creative a fund manager can be when he is on the edge.

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