

Normal service resumed?

Bernard Madoff may have picked the worst possible time to reveal the extent of his fraudulent practices, but as **Jeremy Walton** reports, a resulting reboot could be just what the funds industry needs

Waves from the tsunami that was the 'Madoff fraud' have washed ashore in Bermuda, the British Virgin Islands (BVI) and the Cayman Islands. Early spin-doctoring by industry representatives has more or less ceased. At the time of writing, the Cayman Islands Monetary Authority had acknowledged publicly that 34 regulated funds had been directly affected by the fraud, and of

course this does not count the many more funds that have indirect exposure, nor the multitude of associated service providers.

Like all seismic events, there are short, medium and long-term consequences that are likely to follow.

The immediate impact

Bernard Madoff chose a cruel time to confess his fraud in December 2008, exacerbating liquidity problems at all levels of the funds world: it immediately accelerated the pace of investor redemptions and put further pressure on the ability of funds to meet existing redemption requests for 31 December

2008. As a result, more funds had to deploy redemption-in-kind strategies, suspend redemptions or even initiate liquidation strategies. Those funds that merely deployed gates on their redemptions will be under even greater pressure by 31 March 2009, which is

widely expected to be another watershed date with unprecedented levels of redemptions.

On a broader scale, the fraud damages the credibility of the fund industry's responses to those who sought to blame them for the credit crunch: that it was fundamentally the banks and not the funds which were at fault; that light and flexible disclosure-based regulation was

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sufficient to protect investors; and that there were still relatively few instances of fraud and in relatively small numbers. All three of these arguments have been weakened by the manner and scope of Madoff's fraud on the investor community.

The knock-on effect from this loss of credibility will be to spur on the regulatory changes that have been promised or threatened by a variety of authorities. Even though offshore regulators recognise that it makes more sense for changes to be market-driven (and investors will be very vocal on the subject), it may be difficult to resist the pressure caused by onshore regulatory changes that are driven by the fulfillment of election pledges and other political imperatives.

Litigation ahoy

Big battles lie ahead over who could or should have spotted, prevented or ended the fraud: regulators, funds of funds (FOFs), auditors and most recently custodians have emerged as likely targets among the usual suspects. Out of these, this writer predicts that 2009 will be the year of litigation against auditors. That said, audit firms in the offshore world are reasonably well positioned: current jurisprudence is supportive of the position that auditors will take in defence of their work. All eyes will be on the House of Lords in March 2009 as it considers the appeal in *Stone & Rolls v Moore Stephens*: the 'very thing' doctrine (which holds that the detection of fraud is the very thing that auditors are there to spot) may suddenly gain new life, if England's highest court bows to public pressure to find a way to bring audit firms 'to account'. However, any endorsement of such a doctrine would transparently be a policy-driven decision, which means that offshore centres with strong financial services industries may not feel obliged or inclined to follow the same policy of punishing their accounting professions.

Who will lead the charge in the wave of fault-finding litigation (aside from the class action plaintiffs' lawyers)? Through 2008 the FOFs had generally trodden a careful path between the funds who owed them duties as investors and the investors to whom they owed equivalent duties. This generally disinclined them against litigation, not wanting to draw adverse attention to their investment troubles or to set precedents for similar claims being made against them by their own investors. Now the FOFs with significant Madoff exposure are being



Madoff: bad timing

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OFFSHORE

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pilloried for a perceived failure to add any value, and they have little other incentive or choice of action. FOFs should be among the first in 2009 to make their own litigation moves, seeking recoveries on behalf of the FOF investor community even as they prepare to defend themselves in relation to their due diligence practices.

Insolvency developments

It is inevitable that most or all of the so-called conduit or feeder funds will be

wound up, paving the way for those über-litigators – the liquidators. They will inherit completely illiquid insolvencies, the only assets of which are the causes of action that those funds will have against the perceived wrongdoers. However, those claims are potentially massive and lucrative when ranged against an array of well-insured professional firms and corporate service providers. Investors will want the claims to be pursued, but few will have the appetite or resources to fund those claims. Liquidators will therefore have to resort to innovative

methods to fund their litigation activities. This will in turn create tremendous opportunities for what is currently a fledgling liquidation financing industry.

An ending – or a beginning

Speculation that Madoff will bring about the demise of this industry is exaggerated and premature. Economic conditions had already initiated the upheavals to be caused by industry contraction, product restructuring and increased regulation. Once these have subsided the 'true' hedge

funds that survive will likely return to their original positions in the alternative investment space, smaller but nimbler in their investment strategies, freed from the liquidity demands of skittish investors and dedicated only to the pursuit of absolute returns. Such funds will be well placed to attract fresh subscriptions for the investment opportunities that lie ahead as we emerge from the bottom of the market. ■

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Credit guard

Cayman has not been left standing in the global economy, says **Philip Paschalides**

It has become increasingly clear that credit is the oxygen in the financial ecosystem. Without it the system shuts down and exhibits symptoms of dysfunction. In the oxygen-enriched atmosphere of the boom years, where credit fuelled the aggressive expansion of the mature and emerging economies, the Cayman Islands vehicle has been an active participant in cross-border operations.

Cayman's exempted companies and limited partnerships have been very familiar in the financial ecosystem, whether as special-purpose vehicles (SPVs), collateralised debt obligation (CDO) issuers, hedge funds or private equity funds. It will come as no surprise that, post-crunch, Cayman vehicles have continued to play an active role and have even introduced a degree of liquidity and credit.

From a Cayman perspective, since August 2007 there has been a noticeable and dramatic reduction in the volume of those commoditised debt finance transactions that used to pass through offshore jurisdictions and, in particular, Cayman. So-called 'flow' work has evaporated as risk-aversion has intensified, confidence in the rating agencies has perhaps for a while been lost and there has been a flight from complexity and a return to simplicity and transparency. To many, those sorts of finance transactions that characterised flow work served to introduce liquidity to the financial sector, enabling cheaper mortgages, generating more consumer credit options, facilitating the benefits of infrastructure projects sooner rather than

later... and the list goes on. As appetite for such commoditised products decreased, liquidity dried up – and the effect of this on financial institutions in particular has been well documented since.

In the absence of the kick-start to the wholesale markets solicited in Chris Ricciardi's open letter to Hank Paulson of September 2008, Cayman vehicles started to edge into slightly different roles than their staple, featuring in highly evolved, bespoke transactions of a structured nature, occurring both at a 'macro' level in the various global economies as well as at a 'micro' level. Often, achieving liquidity was a core objective of those transactions for at least one of the participants.

In the latter half of 2008, there were the vast, bespoke, public transactions such as the Merrill Lynch-Lone Star deal, where a highly engineered Cayman SPV acquired from Merrill Lynch a \$30.6bn (£21.17bn) CDO portfolio, financed to a significant extent by a Merrill Lynch entity. Another transaction involving the extension of relief to a stricken financial institution's balance sheet was the \$22bn (£15.22bn) Blackrock-UBS deal, again involving the acquisition of a large portfolio of so-called 'toxic' assets by a Cayman vehicle, this time a Cayman exempted limited partnership. There have been many other smaller transactions, where SPVs have, by taking assets off an entity's balance sheet, assisted in easing the market tensions. Cayman SPVs have entered into repurchase transactions, have aggregated assets stuck in separate warehouse portfolios in transactions that could not go to market and have injected equity into deals that would otherwise have encumbered balance sheets and reduced the agility of the large global players. Investors in these structures have accepted illiquidity, but clearly in the expectation that returns will be theirs once the market stabilises



and risk can be priced and valued accurately.

At a micro level, the Lehman administration has created illiquidity, leaving many hedge funds facing claims from withdrawing investors, but denying them access to assets trapped in Lehman brokerage and custodial accounts. Innovative quasi-repackaging vehicles, generally Cayman exempted companies, have been worked into hedge fund structures, not for the purposes of monetising illiquid assets, but in order to unbundle those assets and facilitate a distribution to shareholders of tradeable instruments whose value is ultimately referable to trapped assets. Against this background, Cayman has remained central to the business of asset finance, which has continued to prosper.

Across the spectrum of the financial markets, whether concerning equity or debt, Cayman vehicles have been involved in structures and transactions the purpose of which is to acquire positions, often involving illiquid or 'toxic' assets, and holding them within a structure that has a longer time horizon (or more aggressive risk profile). Cayman vehicles, whether in corporate form, as trusts or as limited partnerships, have proved themselves versatile and eminently suitable for accommodating the complex and varying appetites and risk profiles that may need to coexist within a single structure. Whether as producers of financial assets, consumers of financial assets or scavengers looking to pick up residual value in distressed assets, Cayman SPVs remain active participants in today's financial ecosystems. ■

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