

# The Madoff Fraud and Implications for the Offshore Fund Industry

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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 has publicly acknowledged that 34 regulated funds have been directly affected by the fraud, and of course this does not count the many more funds which have indirect exposure, nor the multitude of service providers which are associated with those funds.

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

## **IMMEDIATE IMPACT**

Bernard Madoff chose a cruel time to confess his fraud in December, 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, or suspend redemptions or even initiate liquidation strategies. Those funds which merely deployed gates on their redemptions have come under even greater pressure in the run up to 31 March 2009, another watershed date with unprecedented levels of redemptions.

On a broader scale, the Madoff 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 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 which are driven by the fulfillment of election pledges and other political imperatives.

## LITIGATION AHEAD

Skirmishing has commenced. Big battles lie ahead over who could or should have spotted, prevented or ended the fraud: regulators, funds of funds, 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 are on the House of Lords, as they prepare to deliver judgment in 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 a strong financial services industry may not feel obliged or inclined to follow the same policy of punishing their accounting professionals.

Who will lead the charge in the wave of fault-finding litigation (aside from the class action plaintiffs’ lawyers)? Through 2008, the funds of funds (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 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, whose only assets are the causes of action which 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 which survive will likely return to their original position 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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