Praise for The Hedge Fund Fraud Casebook

"This book includes a cutting edge scope. Bruce Johnson delivers the primer needed and offers full legal context of history that could fascinate reading. Along with the case chronologies comes the story of the companies and their investors’ attempt to uncover and predict fraud.”

—John A. Protess, Editor and Executive Director, Deron Jones, Dow Jones

"This book is an essential read for hedge fund investors and analysts who seek to deepen and enhance their fraud awareness. Extensively researched and well written, this insightful examination of the frauds that have occurred in the hedge fund industry will be of as much interest to the business community as it will be to regulatory, legal, or other professionals in the field. The first book to present its findings in the form of a complete, chronological overview of hedge fund frauds, this book offers a unique and invaluable analysis to a hedge fund investor serious about understanding the changing dynamics of risk and of frauds relating to the hedge fund industry. It will serve as a reference work for anyone interested in hedge fund frauds or in preventing them.”

—Robert Bauer, Co-Managing Partner, Cahill

"This book is a big dose of realism about the world of hedge funds and the potential fraud that surrounds all of us. It's a must read for a living. Bruce Johnson has added-on the key components of each issue of the hedge fund world more than 30 years of the hedge fund industry. Over time, he has created the equivalent of a periodic table of hedge fund frauds. This book is an essential tool for anyone interested in understanding the hedge fund industry and its risks.”

—Joel Dinsmore, Co-Managing Partner, Cahill

"This is a well written book that is a must-read for anyone who evaluates and selects hedge fund managers.”

—Teresa Barger, CEO, Cartica Capital

"Disclaimer in the market for two entire decades, I have a deep appreciation for what Bruce Johnson has accomplished in this book. It opens a rare window into the ‘dark side’ of the often secretive world of hedge funds. This is a well written book that is important reading for anyone who wants to understand some of the outer reaches of what constitutes rational risk.”

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—BRUCE JOHNSON

"As a decade as a hedge fund practitioner, managing and advising funds, I was CEO of Albourne America LLC, the U.S. arm of Albourne Partners, a hedge fund advisory firm based in London. While at Albourne, Johnson researched new approaches to hedge fund due diligence including the quantitaive analysis of “fund failures” and hedge fund credit. After an earlier career as an architect and city planner in New York and London, Johnson has gained twenty-four years worth of experience in finance, including extended postings in Sydney, Hong Kong, and London. While head of Global Research for Baring Securities, he published an important paper on the future of the Chinese and Indian economies, correctly predicting their current impact on global trade, and also created and managed the first investible global emerging markets equity index.

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To my mother,

who passed away before this could be published
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All Roads Start Somewhere Else

At the outset of this book, I had accumulated nearly 20 years of research experience in the financial industry, including work as a securities analyst, the head of a research department, chairman of all securities research for an investment bank, and as an independent research consultant. My work has spanned both sides of the philosophic divide that separates “fundamental” analysts from “quantitative” analysts as well as within both methodologies characterized as “top down” and “bottom up.”

Chronologically, the first half of my career was devoted to Japan and the emerging markets and the second was dedicated to hedge funds. The first contact with the “hedgies” began in the mid- to late 1980s as a broker with hedge fund clients. It did not take long to observe that these folks were a strange tribe particularly for their near total lack of interest in the seemingly important facts that we analysts took so much trouble to produce and for the opacity of whatever it was that did interest them. In 1997, I set up my own institutional advisory company, with a focus on subjects related to index investment, an area in which I had gained expertise as a broker. Through this work, I became directly involved in the research strategies and management of hedge funds. Not long after that I “drank the Kool-Aid” and became a full-time hedge fund advisor in Hong Kong and, later, a hedge fund consultant in San Francisco.

In 2003, I returned to the United States to manage the U.S. office of an international hedge fund consultancy. The mostly young, bright, and hard-working professional staff there were engaged in activities that were familiar to me from my days as a fundamental company analyst, such as visiting hedge funds, asking a lot of questions, putting the results into analytic text and numbers and advising the client-investors on what to buy and sell. A smaller number of more quantitative people were responsible for aggregating the analyst data, along with broader top-down data on the economy and the markets to produce high-level strategic advice that went into performance assessment, asset allocation, and portfolio construction.

What’s Doing in Due Diligence?

Given an in-built aversion to repeating challenges and wishing to avoid competing with people half my age, I became a connoisseur of unpopular research topics. The more undesirable the topic, the more time I could spend in peaceful contemplation. After asking around for the ugliest and most tedious subject available, the universal response was due diligence.
So began six years of research that culminated in a book on hedge fund fraud. Work on my new research topic started inauspiciously enough, trying to understand why it was so unpopular and yet so important. Early observations established the fact that due diligence was an extremely labor-intensive and, therefore, costly activity, characterized by a lot of real and metaphorical shoe leather expended in visiting hedge funds around the country. Each visit entailed running through long lists of carefully constructed questions designed to catch lies and inconsistencies while harvesting as much useful information as possible. The gum-shoe tactics also included physical auditing of the workplace, or “kicking the tires” by inspecting the workplace, its people and practices in order to identify any “canaries that had stopped singing in the coal mine,” the “red flags,” the “gut-feelings”—indeed, anything that seemed odd or out of place.

However, spoiling this picture of the dedicated sleuth are the more banker-like salaries that hedge fund analysts are paid rather than the workmanlike wages of detectives. These high costs, long hours, and tedium are not sufficient to give due diligence its reputation as the least-loved subdiscipline. What guarantees its place in analyst ignominy are the lead shoes—not gum shoes—that are a standard part of the attire and signify the doom-laden mission of the wearer. For unlike the detective, who starts with the knowledge that there was a crime, the due diligence analyst begins and ends with no crime while having the certainty of its future possibility. The task is summed up by Cowper’s dictum that “the absence of proof is not a proof of absence.” A clean bill of health can never be determined. Fraud is probably the most alarming event that can befall a hedge fund and a hedge fund investor. Fraud not only taints the investment, but it poses real liabilities to the investor. Beyond the real liability and real monetary loss, there is also a range of collateral damage that can be sustained, including loss of job and undermining of the business franchise of the investor. It is a minefield, where after deploying every reasonable means of detection, one must proceed, with the suspicion that some mines must remain undetected. And, the situation can get immeasurably worse. A fraud, may never come to light or may surface enough to produce a lawsuit and civil or criminal fraud charges—charges that must be proven to a sufficient degree, which is a process that can take years.

In the long run, due diligence takes the prize as the most dreaded advisory service because of its poor cost–benefit ratio. The certainty of high cost and the uncertainty of results entail a potential negative payoff for those who undertake it. So, why is it there? Two reasons: Due diligence alone can immunize its purchasers from being charged with negligence in the event of a fraud, and there is no better alternative. Moreover, in the hedge fund world, there is no equivalent to the broker research that is the backbone of information for equity investors. The restrictions on hedge fund advertising, too, mean that the equivalent coverage for mutual funds that companies such as Morningstar provide is not available for hedge funds. Due diligence is the meat and potatoes of hedge fund research. It is almost the only way to get detailed information about hedge funds.

With these impressions in hand, I set off on what became the long road that led to this book about fraud. However, there were several important waypoints along that road that put fraud last—not first—in the series of investigations that resulted.

My prior experience in the management of research—including a 50-person research team in Tokyo at the height of the “bubble” years—made me very conscious of research overheads, and desirous of ways to reduce them without diminishing
the results. The principal means to accomplish this was through a combination of automation and unbundling of the analyst skill set. For this reason, the labor intensiveness of due diligence felt like a problem begging for a solution. Due diligence, however, had a more serious problem than its cost structure. Its most serious flaw was its lack of clear efficacy. While it protected its users from charges of negligence, it had no assessible track record of catching criminals or preventing previously honest people from becoming criminals.

My hopes for improving the cost–benefit of due diligence became stuck on the benefits side of the equation because it did not appear to have an objective measure of performance and had no obvious way to measure improvement. Instead, it was like a variant of Monopoly’s “Get out of Jail Free” card—to be presented when things went wrong. (This was not to deny or denigrate the usefulness of due diligence as a means of gathering information about hedge funds.)

THE SUCCESS OF FAILURE

Having reached this first twist in the road, I put due diligence aside and focused on the circumstances that made due diligence a necessity in the first place. This shifted the investigation from the question of “What’s wrong with due diligence?” to that of “What’s wrong with hedge funds that they need due diligence?” In turning this question over, it gradually transformed into a more basic question: “Why do hedge funds fail?”

The hedge fund industry had long been prone to periodic “die-offs” where as many as 15–30 percent of all funds cease trading for a variety of reasons. Some, including the biggest and most successful, suddenly “implode” or “blow-up,” losing a majority of their net asset value in a matter of days, or hours. Others voluntarily return investor funds and go out of business when they sense a lack of opportunity. Many suffer severe redemptions that force them to shut down, while a small number suffer the “unkindest cut” and fall victims to fraud.

This periodically churning sea of birth and death can cause a high degree of instability in an institutional investor’s hedge fund portfolio. At one time I had likened it to stably managing a college football team when every year all of your seniors depart and there is a new intake of freshman. The hedge fund “bench” is similar in turnover, but it occurs in a more chaotic pattern, both with respect to the timing of arrivals and departures and the near randomness in the composition of the individuals that depart.

In the past, the subject of fraud and that of fund failure was often conflated, causing much confusion as to whether evil was widespread in the “hedge-sphere” or was it mostly the benign failures of largely honest folks. The broad study of failure was intended to answer these questions by examining the causes and frequencies of failure attributable to all causes and evaluated over all years.

Earlier in my career, as an index provider, I observed similar cycles of creation and destruction in the form of new companies entering and existing companies exiting an index during an index recomposition. In most cases, the companies leaving the index are those that have experienced a reduction in market cap while those coming in have had growth in market cap. To a great extent, the exiting and entering refreshes the success content of the index by rescreening for size. In a growing market and
economy, stocks that cease to grow will eventually be flushed out of an index. Like scenes edited from a film, they end up on the cutting-room floor and are lost to index consciousness.

I had a hunch that while indexes illustrated the mechanics of success, the data of these exited “defunct” companies might be the best source for understanding failure, and, with a little bit of hunting around, I was able to find some index vendors that had and would share these data. Years later, thinking about the failure of hedge funds, I recalled the defunct data and acquired some that I recompiled into a database of failed hedge funds—and then structured that into what might be called a “failed funds index.”

What was most surprising about this strange index was that no one, including quants, had an intuitive picture of how such a hedge fund failure index should look:

The surprising result was that the performance of the “failed funds index” looked a lot like that of the normal “live” hedge fund index, except that the performance was somewhat lower. If true, this implied that failure looked like success, only less so. Success and failure, as far as hedge funds were concerned, were not apples and oranges, but perhaps, first-rate apples and second-rate apples. Several months of more detailed analysis followed, breaking down the failed funds into subgroups having common causes of failure. In medicine, the procedures used for deceased subjects are different from those used in normal practice. It is much the same with
dead funds. Their description and analysis require special forms of data. Normal funds data are continuous (runs from the beginning to the end) for any time period examined:

![Five Normal Funds NAV Monthly, Rebased to 1.0](image1)

Sometimes a new fund is added to the index and starts to contribute its performance in the midst of a period, as per “Series 5” below:

![Five Normal Funds NAV, Including One with a Later Start Date](image2)

Sometimes, an existing fund experiences a performance blow-up and “dies,” as shown again in Series 5:

![Five Normal Funds NAV, Including One with a Later Start Date](image3)
In a database (or index) comprised of only dead funds, the performance data for each fund may begin and end at a different point in time, making the data discontinuous both within and across series. This means that it is not possible to vertically align all of the data to calculate averages. And, without this cross-sectional comparison, it is not easy to determine common characteristics between the time series. Moreover, the immediate period leading up to the “death event” may express unique behavior that would be lost in averaging it in with normal funds. The same is true at the start of the fund’s life, its “birth” and the period immediately following the birth:

I constructed two purpose-built sets of data to adjust for these dead fund attributes. One was referred to as “end-adjusted data” and the other as “start-adjusted data.” As their names suggest, these data sets recompiled the dead funds
values so that either their start points or end points line up vertically (coincidentally). The data in this form facilitated detailed examination of the various patterns of deaths or births. The drawback of this method was the loss of the characteristics of the actual time period; but, if one’s intention is to study death, a death is a death is a death, to paraphrase Gertrude Stein. They are more comparable in place rather than in time:

In the first case, it meant that one could compare all of the dead funds at the time they were, say, 11 months old, or, as in the second case, all funds in the six months before they died. With the second set I could, for example pose the question, “For all funds that appeared to die in a catastrophic collapse in returns, what was going on one month earlier or one year earlier?” Or, with the start-aligned data, “How many funds died at different ages in their lifespan, rather than in different months of the year or different years?”
Ultimately, this work resulted in comparative summary statistics of average fund life and allowed grouping of performance for subgroups that seemed to have died for similar reasons.

The foregoing analysis eventually led to the central conclusion that the majority of hedge funds expired as a result of a shortage of capital (a condition I call “capital insufficiency”). This main cause of fund death seemed to explain the relatively good aggregate performance of failed funds already seen in the failed funds index referred to earlier. The insufficiency of capital could have been due to slightly worse performance that had the effect of diverting capital to other funds, or, perhaps, the fund never attracted sufficient capital in the first place. Equally, the lack of capital could have been due to weak marketing (the corollary being firms that raise large amounts of money because of good marketing, but have lackluster performance.)

At the opposite end of the spectrum were a relatively small number of funds that died as a result of fraud. It was a comforting observation that crime did not appear to be a dominant factor in the failures (number of failures, rather than value of failures).

CREDIT IS THE PROBABILITY OF FAILURE

Having arrived at a peak of sorts, where the terrain of fund failure could be seen within its context, I reached another of those turns in the road where the research changed direction. Having started on the problem of due diligence a year or so earlier, the research had been transformed into an analysis of fund failure. Now enough perspective had been obtained to turn the question of failure on its head and ask, “If one knew the historic probability of failure due to any and all causes, did this not equate with a generic definition of hedge fund credit?”

There had never been a great need for hedge fund credit ratings. The funds were not issuers of debt (though some did distribute financial instruments and some of these either used credit or were themselves rated), nor was their equity acquired, except in rare circumstances. However, given the sums of money they controlled, their privacy-seeking business operations, their power in the hands of few people, limited regulatory scrutiny, no share price, and not a great deal of public domain information, some measure of their probability of failure would be a valuable tool to have as a parallel check on the health and safety of the funds.

One further reason for interest in hedge fund credit was the growth in demand for insuring hedge fund risks. Some hedge funds themselves were reportedly seeking to insure against so-called “rogue traders,” and it might not be long before hedge fund investors might wish to insure against hedge fund failures due to a variety of causes. While this might not free the investors of the obligation to carry out due diligence, it might help to limit the exposure to any residual risks that remained after due diligence. And, as a practical point, I was still hoping to find a way to reduce the labor intensiveness of due diligence, which made it slow and expensive.

As both the number of hedge funds and hedge fund investors increased toward 10,000, the number of funds for which investors might want due diligence was in the hundreds and this had to be repeated at least once a year if not two or more times. If one analyst could hypothetically perform due diligence on five funds per week, and that is optimistic to be repeated week after week, it might work out to
some 15 per month and around 150 per year. If each fund is seen twice a year, it would equate with covering 75 funds per analyst. (In reality, the limit is more like 50.) This would mean that providing due diligence coverage of just 10 percent of the funds universe would require 20 full-time analysts. This still does not solve the problem of clients wanting due diligence on some of the other 9,000 funds. Even another 1,000 to 2,000 funds covered would increase the number of analysts to 40 to 60. While it is certainly possible to manage this many analysts, the logistical problems increase geometrically and the ability to provide the coverage says nothing about the costs of doing so, which also increase at a linear rate.

For these reasons, great appeal was found in any research that could be “machine-driven” — as is much of the performance and risk analysis. In an effort to do just that, the ongoing investigation moved on to another track, pursuing a more automated calculation of hedge fund credit as the statistic for the probability of fund failure.

The credit phase of the project began with the supposition that if cash insufficiency was the prime cause of hedge fund failure, then a model of cash sufficiency was, to a large extent, a model of hedge fund credit, the probability that a hedge fund would fail. This work was eventually implemented as a computer program.

The key to the credit model is the fact that it combines hedge fund cash flows with performance, creating a larger picture of the forces operating on a given fund than performance alone. This helped to balance one of the conflicts faced by fund managers and indirectly by investors, which is the trade-off between cash under management, which earns a small but stable fee, and cash earned through positive performance, which earns a greater fee but is unstable.

Where the credit model (shown in the following figure on page xviii) becomes subtle and complex in its workings is in breaking down its basic elements and in the interaction between these elements, including:

**Income Sources**
- **Management fee income.** A function of funds under management and the level of the fee charged.
- **Actual performance fee income.** A function of performance, fee level, and high-water mark, all of which had to be calculated separately for each tranche of investor cash invested at a given point in time.
- **Option value of expected income.** The model also calculated the implied “in-the-money” or “out-of-the-money” option value of a performance fee during the interval prior to its next payment date. This model calculated the amount of money in each tranche of assets under management (AUM) that was currently above the high-water mark times the amount of time left until the performance fee was earned.

**Costs**
- **Fund manager overheads (“burn rate”).** Could vary considerably from one type of operation to another, including numbers of staff and offices and locations.

**Other**
- **Lock-up period.** The cushioning effect of investor capital that could not be redeemed.
- **Accumulated earnings.** The flexibility afforded by having financial reserves.
- **Redemptions.** Investor withdrawals of cash.
- **Redemption cascade.** Occurs where redemptions reach a critical level, triggering an unstoppable outflow of assets.
- **Balance equations.** Several summations that netted out positive and negative values at different levels.
- **Credit.** Pegged to one of the balance level equations.

Schematic Diagram of the Principal Elements in the Hedge Fund Credit Model
The credit model made it possible to run an automated calculation over the data for hundreds or thousands of funds, revealing many of the internal value dynamics that were never before visible. The underlying data could be added at any time and by people other than analysts and they could be aggregated at many more levels than just performance and risk. As the model ran, it also generated large quantities of intermediate data that could go into a database and be used for further analysis, such as estimating new subscriptions and redemptions.

**BAITING FRAUD**

With the completion of the hedge fund credit model, there was an integrated analytical tool that could describe all of the general forms of hedge fund failure that had been witnessed to date, with the single exception of fraud. While one of the least frequent causes of failure, fraud seemed different from all of the other causes, and its analysis also appeared to be less amenable to quantitative methods. For this reason, it was left out of the previous work, and for the same reason it was the last aspect of fund failure to be tackled.

The first phase of the fraud research consisted of little more than creating files for every case that could be found. However, the first discovery was that relatively few cases could be found. While there is much talk about hedge funds and fraud, the examples quoted are usually the same handful. Prior to the recent case of Bernie Madoff, the most famous hedge fund scandal cited was Long-Term Capital Management (LTCM), which went under in September 1998. This was the classic and, perhaps, the first termed a “systemic risk” to the global financial system. The trouble with LTCM as an example is that fraud was never charged. It was certainly a failure, a “blow-up,” and involved more than a small amount of naiveté and some degree of negligence—but not fraud. So, the biggest and best example, the most oft-quoted, is no example at all. Uncharacteristically, LTCM was also bailed-out by a consortium of large banks, which later reaped a large profit as a result.

Other big cases spoken of around the water cooler included: Askin/Granite (1994), Berger/Manhattan (2000), Smirlock/Laser (2000), Natale/Cambridge (2000), Lauer/Lancer (2003), Strafaci/Lipper (2003), Bayou (2003), and Amerindo (2008). With additional effort, a few others could be dredged from the collective memory, such as Yagalla–Ashbury, Hoover, Hegarty–Hyannis, Amaranth, and Millennium. After collecting this “low-hanging fruit,” one is struck by the fact that there are not that many and that the majority are so recent that few have completed the legal process and had final judgment rendered. And, prior to the mid-1990s, the archives are pretty bare. All of this was puzzling after starting this book with the misconception that hundreds of cases and case documents existed going back decades.

It was little short of a disaster to find that comprehensive documentation of hedge fund frauds were either nonexistent or just were very hard to come by. Most frustrating was the fact that no complete authoritative list of cases had ever been compiled. As a result, one never knew how many cases there really were or when you were finished searching for new ones. There seemed no alternative to hunting for needles in a haystack.
The U.S. Securities and Exchange Commission (SEC) Web site (www.sec.gov) contains thousands of enforcement actions, but they are not categorized to identify hedge funds. If you go through the cases one by one, you can find the keywords “hedge fund” in the text of some, which, once compiled, does produce a decent list of hedge fund frauds. However, the vast majority of these SEC cases do not involve hedge funds, but rather corporations and corporate executives, brokers, accountants, and mutual or fixed income fund managers as well as individuals purporting to be such.

The case universe was substantially further expanded with the inclusion of commodity trading advisers (CTAs) and commodity pool operators (CPOs), which again meant screening all of the CFTC enforcement actions for other key phrases. A third major source of cases is newspaper archives, especially for cases where the two main regulators (SEC, CFTC) were not involved. These included both private actions and those pursued by state and federal law enforcement. Finding cases at the state level, for example those private actions that are filed in state or county courts and cases filed by state regulators in state courts, may be found by checking each state’s court records, but some are certain to be missed, either because of a lack of available records or just the inability to mount a complete search.

Once there was a near complete list of cases, each case was dissected into its component data, and the storyline of each fraud was worked out, including the principal actors and actions. There were often substantial differences in documentation and detail available.

The intention at the outset was to publish every known case, though this proved to be an unrealistic goal given the high proportion of cases that have not yet been decided. A further reason for 100 cases is that it is generally considered to be a minimally sufficient set for statistical analysis. Lastly, it has established the history of the crime from its earliest days, the most difficult part to document.

The final leg of this journey involved the compilation of aggregate statistics of the full set of cases and an analysis of this aggregated data in order to put the cases into subgroups based on type. And there it ends.

The work stands as a substantial casebook, a near-complete historical record, a quarry of facts, figures, plots, people, and punishments. It is the first extensive book wholly dedicated to this subject and provides the first comprehensive attempt to draw conclusions as to the nature of fraud in the hedge fund industry, its reasons, its methods, the outcomes, and some insights into ways to prevent, or predict, the crime in advance.

This book is devoted to the subject of hedge fund fraud. Its purpose is educational and its structure follows its purpose. The method is scientific in three senses: fact-based, comparatively organized, and statistically meaningful. While the subject dictates that it is also substantially concerned with legal matters, this book is not intended to be about the law or for the purpose of training lawyers. Instead, the educational message has been directed to the investment community, those who seek to risk their capital on a rational basis and want to better understand some of the outer reaches of what constitutes rational risk.

The book is divided into two parts. The first is a broad appraisal of the context of fraud and hedge funds. The second is a compendium of 100 cases, each laid out in an identical format for comparison.
Part One, Life, Death, and Degeneration, consists of three introductory chapters providing general explanation of the subject matter and approach.

Part Two, Cases and Conclusions, consists of Chapters 4 and 5. Chapter 4, the heart of the book, features the casebook—100 chronologically arranged case studies beginning with the first known case. Each case involves a hedge fund participant and a formal allegation of fraud. All cases have been disposed within U.S. jurisdictions: civil, criminal, or administrative. An identical page format of facts, charts, tables, and summarized texts has been employed for each case in order to facilitate case comparisons. Chapter 5 follows with an analysis and functional grouping of cases.
Part of the strategy in choosing this topic was to select an “unloved” area of research, where there was freedom to pursue the subject over a long period in an uncompetitive environment. Careful selection paid off to such an extent that, not only were curious observers almost entirely absent, but even friends and family appeared to be calling less often. The normal look of interest one gets when you say you are writing a book soon evaporated when you explained that it was about hedge fund fraud, and hedge fund death. (Some of my best friends are hedge fund managers.)

As a consequence, the writing of this book proved to be a fairly solitary endeavor. That, in turn, makes the job of writing an acknowledgments page a simpler task than usual. There is no need for a Stadium of Heroes or Hall of Fame. In their place, a Bench of Acknowledgment will do to say thanks to those that suffered and sweated alongside me.

In the genesis of the idea and its circuitous evolution, I received a great deal of support and encouragement from Simon Ruddick. His long-term interest in unique data and the interface of qualitative–quantitative information were shared subjects over many years, as was my excursion into hedge fund life and death. Thanks, pal.

My lawyer, Karen Frank, was instrumental in putting me together with the folks at John Wiley & Sons and getting me established as a writer.

My wife, Shoko, not the long-suffering type by nature, had to make major adjustments in her life to put up with the difficult person she married, a forbearance pushed to the limit during the long years it took to research and write this book. She also knows that I’d be lying if I said I will not do it again.

My editors at Wiley were the magic that transformed my files into a commercial book. I would especially like to thank Tim Burgard and Stacey Rivera for their tireless efforts and apologize for my excessive questions.

The last one on this little bench of acknowledgment is my lovely little nephew “Bertie,” who kept me company, watched over my shoulder, stretched and yawned, and hopped about in the sheer pleasure of living.
Introduction

Hedge Fund Fraud and “the Appliance of Science”

The available means for dealing with hedge fund fraud have been relatively unproductive, unscientific, expensive, and time consuming. There is now a basis for altering and improving the current practice to make it more productive, more scientific, less costly, and more expeditious.

The current discipline—a combination of investor due diligence, law enforcement, and judicial procedure—has not served anyone well. Yet there are no credible alternatives. Given the small number of hedge funds that were operating until recent times, hedge fund fraud had been too infrequent a crime to justify compiling specific class data from which statistical inferences could be drawn regarding actual rates of risk. Moreover, even within the larger case set of all investment fund frauds, where a sufficient body of statistical data exists, the approach has been no different because of the legalistic bias of the regulators and the securities statutes they administer.

There is now the prospect of a more scientific methodology for better understanding and controlling this crime, which brings it in line with other applied sciences such as criminal forensics, actuarial science, investment finance and risk control and is also the logic used by most institutional investors in managing their portfolios. The first step in this transition has been taken in this book by compiling a sufficient statistical history of the occurrence of the crime within the narrower hedge fund case set. For the first time, a more scientific approach to hedge fund fraud analysis can take place with the expected result—a more effective means of dealing with the crime.

FINANCE IS SCIENCE

Most of today’s institutional investment is undertaken on a substantially scientific basis. Despite the evidence of recent market crashes and the malfunctioning of large swathes of the economy and financial system, most institutional investors employ some form of logical or empirical analysis to determine when and how to invest. Most of these analyses could also be described as the “scientific method,” or its quasi-scientific form. (There are also large areas of pseudoscience and nonscience coexisting and interacting daily with the more rational methods.)

These analytic approaches have increasingly accommodated differences between normal market behaviors, such as exist within a “normal distribution” of probabilities, and exceptional market behaviors, often referred to as “events,” sometimes more specifically as “bubbles” and more popularly as “crashes.” There is generally an
accurate perception, too, that these exceptional periods are discontinuous with normal periods when the normal rules do not seem to apply. However, even these nonnormal market periods are examined with the same scientific lens that is applied to the normal behaviors.

For investors, nonnormal conditions can mean excess returns but more often result in substantial losses. This is also true for hedge fund investors, but much less so for a variety of reasons:

- Many hedge funds hedge event risks.
- In their hedging of normal risks most hedge funds operate at lower volatility than the markets (though their leverage may just as often make them more vulnerable to certain market factors).
- Some hedge funds specifically engage in strategies that profit from events.
- Some macro funds correctly call the coming crashes and short the markets instead of going to cash.

Nevertheless, many hedge funds will suffer heavier losses when markets “tank.” Also, because hedge fund hedging is more complicated than long-only investing, some hedge funds simply get their risk management wrong (“model risk”) and suffer catastrophic loss (“blow-up”). Also, because at any given time, a large number of hedge funds are young funds with limited capital, including some with decent performance, they still fail to raise sufficient capital, or they have overheads too high to be profitable and have to close their business. Finally, a portion of funds close down for a variety of other reasons, anything from disagreement among the partners, loss of a major investor, merger or acquisition, or just a long spell of subpar performance.

Thus, despite their superior performance, large numbers of hedge funds shut down all the time. During periods of market upheaval, the numbers can rise to 15 percent per annum or more of all funds.

All of the negative outcomes in the life of hedge funds are contained within the same continuum of risk assessment. When funds close down for business reasons, it is an event that breaches the logical–scientific environment within which investment operates—but just barely. Most funds that close down have not had enormous losses, and many others are very small funds with few, if any, outside investors. Even in the extreme circumstances of a fund “blow-up,” it is viewed in the same way that a market-crash would be—an investment loss under nonnormal conditions.

These boundary cases that result in funds closing down are “one-zero” or life and death events, and they are provided for in the investment contracts, articles, and other corporate founding documents.

**FRAUD IS LAW**

When there is a suspicion of fraud in a hedge fund, and that suspicion leads to charges or investigation, then the entire edifice of logical–scientific method falls away. The investor no longer has any calculations to make (unless they invest in legal
outcomes). Nor, once the matter enters the legal system, will there be a quantifiable chance of determining whether a fraud actually took place.

Scientific Method: Logic and Law

Once the fraud enters the legal system, the pattern of events that follows is what is sensible and efficacious for the legal system.

Science, Math, and Logic vs. Law, Order, and Society

What is lost in this breach of science is the opportunity to determine what did take place and, perhaps more importantly, how to reduce its occurrence.
INTRODUCTION

This takes us back to the beginning of the process, to the initial vetting of funds, the due diligence procedure. Ideally, due diligence should be a scientific method to determine the probability of fraud, but it is not. Instead, it is a legal strategy to avoid a charge of negligence. How would you get to the moon if your process for getting there was designed to protect you from being charged with not getting there? And, as an alternative, if you ended up in Philadelphia as a result of a plea bargain?

Scientific Method vs. Legal Method

In science, there is a demonstrable relationship between cause and effect that cannot be altered. In the law, things may start out aiming for a cause–effect relationship, but pragmatic decisions will often alter this in such a way as to obscure the relationship.

Science vs. Law