Hedge Funds Are Victims, Raising Further Questions

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The collapse of Bernard L. Madoff's firm surprised many on Wall Street. Mr. Madoff had been a major trader.

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Frauds on Wall Street aren't unheard of. But a $50 billion

Ponzi scheme, one that prosecutors say struck at boldface names on several continents, is a bombshell by any standard.

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The case against Bernard L. Madoff, the respected longtime trader accused of running one of the biggest frauds in Wall Street history, has been Topic A in the investor community. But close behind is a heated discussion of how the sordid drama will affect the already-battered community of hedge funds and other investment firms — many of which invested with Mr. Madoff.

Mr. Madoff's case could hardly have come at a worse time for hedge funds. The whipsawing markets and suddenly unfriendly lenders have already taken their toll on high financiers, and many have already suffered what amounts to runs on the bank by investors clamoring to withdraw their investments.

"It can't help but have the effect of further chipping away at the confidence that the investor community has in the hedge fund industry," said Ralph L. Schlosstein, the chief executive of Highview Investment Group, a money management firm and a former president of BlackRock. "But like many things that come at moments of fragility, its impact is magnified."

The collapse of Mr. Madoff's firm took the vast majority of investors by surprise. Mr. Madoff, once the largest market maker on the Nasdaq stock market, was known for his modest demeanor and, perhaps more important, his steady and overwhelmingly positive returns. That in turn appears to have attracted scores of investors, from Palm Beach country clubs to Manhattan social circles.

It is difficult to map out the swath of damage that the Madoff firm's collapse is likely to cut through the hedge fund industry, not to mention a wide range of other investors. But among its biggest investors were funds of funds, firms that invest in several hedge funds and are nominally among the most sophisticated judges of character in the industry. Because Mr. Madoff reported consistently positive returns for more than a decade — some say impossibly so — he drew vast amounts of business from them.

Now, the collateral damage is likely to add to the chaos that has already been ravaging hedge funds. Spooked by losses and forced to raise cash quickly as the financial crisis ballooned, investors have sought to pull out their money from hedge funds, causing serious pain, and even some forced closures. A growing list of large, well-known firms have sought to block redemption requests in an effort to stem a mass exodus of investors who now desperately want to get into cash.

In a letter sent Friday, the Citadel Investment Group said it was halting redemptions at its two largest hedge funds through March 31.

Confidence will only weaken further with the Madoff firm scandal, intensifying pain for the industry.

"If you couple this with the deleveraging already, this means one thing: more redemptions," said Campbell R. Harvey, a professor at the Fuqua School of Business at Duke University.

The losses from the Madoff firm will also raise more questions about how well funds of funds perform due diligence, a concern already magnified by losses in the hedge fund industry.

"Funds of funds that invested in Madoff will get a double whammy," said Whitney Tilson, who runs the T2 Partners hedge fund. "Not only will they have to take a loss, but they are going to have to do an awful lot of explaining for how they ever got fooled here."

Indeed, while many investors are asking how regulators could have missed a towering Ponzi scheme, some are beginning to question the whole process of due diligence. Several potential investors had raised questions about Mr. Madoff's claims of steady returns over the years, but regulators apparently took few steps to investigate.

"Where were the auditors?" asked Bill Grayson, the president of Falcon Point Capital, a hedge fund based in San Francisco. "Where was his chief compliance officer? Where was the S.E.C.?"

Already under heightened scrutiny, the collapse of the Madoff firm is likely to propel calls for greater regulation of the hedge fund industry, beyond the current optional registration with the Securities and Exchange Commission.

What's more, many investors in hedge funds are likely to ask tougher questions of the managers of these firms. Executives who are loath to disclose their investment strategies — instead running a "black box" model, as Mr. Madoff infamously did — will probably come under increased pressure to open the lid on their operations, at least a little bit.

"I suspect that many investors are going to start asking many more questions of their managers," Mr. Tilson said. "They will be much less tolerant of black box managers."

Still, some disagree that Mr. Madoff's arrest will lead to widespread contagion throughout the industry. Mr. Tilson argued that most investors would see the case as an unusual circumstance whose breadth and brazenness is unlikely to be duplicated. "This is not a Lehman Brothers," he said.

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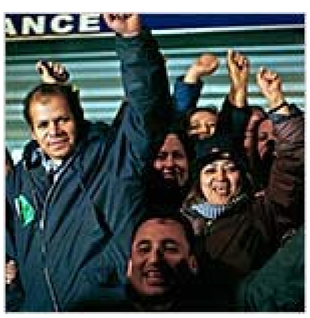

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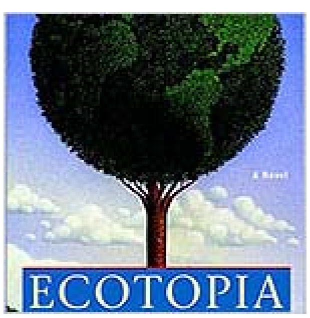

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