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1 PROCEEDINGS
2 MS. STEIBER: Okay. I'm sorry. Tell me again how
3 you had heard of Madoff before.

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4 MR. HEDGES: Well, by way of background, I began
5 investigating hedge funds in the early 1990s as an outgrowth
6 of my family's investing activity in hedge funds, which began
7 in the late '80s, and we had a number of hedge fund manager
8 relationships. This was in the early '90s, at a time when
9 there is a very small universe of hedge fund managers. Some
10 people estimate 6- to 800 hedge fund managers were in
11 business -- you know -- I mean, '92-93 time period.

12 So the universe of managers that one would call on
13 or with diligence and resource was extraordinarily small and,
14 of course, because I was building a business on advising
15 families on how to invest successfully with hedge fund
16 managers, my job was effectively to create a due diligence
17 process for hedge funds and to go out and improve that
18 process by evaluating hundreds of managers and given the
19 timing of when I started, I got to know the vast majority of
20 the people running hedge funds. Certainly well over half if
21 not two-thirds or three-quarters of the managers I knew in
22 those early years of the modern-day hedge fund industry, and
23 Madoff was a manager who subsequently I had heard of quite
24 frequently, but never had the opportunity to meet until 1997
25 when a private banking client of mine took me in to meet him

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1 in hopes that I would approve an investment for a fund that
2 we were co-managing and also approve an investment for their
3 other clients, which I failed to do. I did not approve the
4 investment.

5 MS. STEIBER: And when you're looking at all of
6 these different hedge fund managers, did you have a standard
7 due diligence process that you went through?

8 MR. HEDGES: We did, and the due diligence process
9 is obviously -- as all these processes, even to this day, it
10 is constantly being informed by due -- the best practices and
11 new standards and new instruments and new securities and new
12 offerings in the marketplace, but we have always worked hard
13 to be at the forefront of codifying the hedge fund due
14 diligence process.

15 I've written and my firm has authored probably
16 scores of white papers or research papers on hedge fund
17 strategies. I've written a book called Hedges on Hedge
18 Funds. I used to host educational conferences and publish
19 newsletters. I maintained sort of the earliest hedge fund
20 indices and a number of things.

21 But yes, we have a standard due diligence process
22 that looks at a whole spectrum of front offices and back
23 offices.

24 MS. STEIBER: Okay. And did you say that you --
25 This is a question. Did you say that you were

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1 still waiting for someone to provide you with a document to
2 look at?

3 MR. HEDGES: I have it.

4 MS. STEIBER: Oh, okay. Could you just go through
5 what your standard process is and then talk about how Madoff
6 was triggering red flags to you, if he was, as you went
7 through your process?

8 MR. HEDGES: Sure. Well, essentially, we have a
9 summary sheet on the due diligence questionnaire, and
10 this -- and I'm referring to the due diligence questionnaire

11 which was really the template that we used in 1997, at the
12 time of my visit with Madoff. It would be different today.

13 But essentially, it details the firm, the contact
14 information, the source of referral, the form, the date, the
15 time, the place of the meeting, the principals that were
16 seen, the assets under management that the firm had.

17 The assets under management at Madoff, according to
18 my experience, was also a very closely-veiled secret. No one
19 ever had real perspective that I know of on the actual assets
20 under management.

21 I can remember years and years of people whispering
22 it's possible that Madoff's asset center management are
23 x billions of dollars or x-plus \$2 billion, and there was
24 never any ability to get visibility on that -- which I think
25 was a red flag.

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1 we looked at the inception of the business, the
2 product lines, the different types of funds or separate
3 accounts or other investment vehicles that are offered, the
4 stated investment philosophy, the peer group and competition,
5 others that are admired, and those were just general
6 30,000-foot questions.

7 our diligence process goes into a great deal of
8 detail, first of all, pertaining to ownership of the
9 organization and background. we look at the business
10 strategy, not just the investment strategy, but the business
11 strategy, that the manager's implementing the business
12 structure, including associated entities, obviously the
13 relationship with the specialist business, the broker-dealer
14 business would have been key with Madoff, the ownership of

15 those businesses, the billing rights and control, the general
16 partner, the various directors, officers, staff, their
17 respective backgrounds, tenures and responsibilities, whether
18 or not there are key personnel appointed and the roles of the
19 board of directors, advisory committees, chief investment
20 officers, CFO, marketing contacts, portfolio managers,
21 analysts, traders, marketing and client service personnel,
22 compliance, operations, administration personnel, other
23 professionals and non-professionals.

24 MS. STEIBER: And why is that important to you?

25 MR. HEDGES: Systems professionals, as well as the

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1 principals. We look at the financial objectives of the
2 principals and the other professionals. We look at the key
3 employment contracts provisions with key personnel, as well.
4 We look at the business involvement of other key personnel.

5 So, for instance, in the situation of Madoff, if he
6 was running an asset management business, but also running a
7 broker-dealer, then that would represent another key business
8 involvement of him.

9 MS. STEIBER: Now, what informed --

10 MR. HEDGES: Key personnel and provisions with that
11 possibility, turnover of professionals and who and why they
12 have left the organization, whether or not they're replaced,
13 the whole criminal regulatory complaints, pending or settled,
14 for or against any employee or principal of the firm, and
15 that's just -- that's Section 1 of about eight sections
16 pertaining to in this case Ownership, Organization, and
17 Background.

25 strategy or any other driver, such as volatility. This is

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1 obviously another substantial red flag for us in looking at
2 Madoff where we saw consistency of returns that was not in
3 keeping with the type of strategy that we understood him to
4 be implementing because we felt that there were -- that the
5 track record did not correlate to what we saw as either
6 market factors, volatility factors, or other exogenous
7 factors that would have otherwise affected the track record
8 one way or another.

9 So, for instance, we look at the context of the
10 record, the business environment. We also look at -- you
11 know, the way in which the record is being developed from a
12 corporate perspective, as well. Is it an owner-employee
13 situation, is it a large asset management firm, a
14 big -- small asset management firm, how much money is being
15 managed, how many other strategies are being employed, the
16 relative returns, how the manager's style, strategy or
17 methodology has changed over the course of time, just the
18 performance record based on the current process, or is it
19 something that's evolved.

20 We look at the greatest successes and failures. We
21 discuss market conditions that are most conducive to success
22 or least conducive to success, targeted and expected rates of
23 returns, is this strategy best for and most likely cases, and
24 then we look at the decision-making process, various aspects
25 of how security choices are made, attributes or factors and

1 internal processes for overseeing the investment of capital.

2 MS. STEIBER: Okay. Now, as far as when you're
3 analyzing this, did you need anyone else? Did you need,
4 like, a team of experts, a computer program, or is it just
5 you use -- you know, your background and experience or were
6 just things so obvious with Madoff that you didn't need to go
7 through any kind of analysis? You know, do you have a
8 background?

9 what I'm trying to get at, what expertise do you
10 have or anyone on your team -- you know, normally in order to
11 do a due diligence process? Was that necessary in this case
12 in order to identify that there were red flags with Madoff?
13 Do you have a CPA? Do you have --

14 Does that make any sense?

15 MR. HEDGES: Yes, I understand your question. I
16 want to give you a thoughtful answer, though.

17 I believe that -- you know, I'm in business because
18 I do professional due diligence as a fiduciary on behalf of
19 clients and as such, I'm held to a standard and I have to
20 have a process, which is -- you know, some of what you're
21 hearing me talk about.

22 Your question, though, really is do you have to be
23 a Jim Hedges --

24 MS. STEIBER: Yes.

25 MR. HEDGES: -- expert fiduciary in the hedge fund

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1 business to have seen red flags or to conduct effective due
2 diligence on the Madoff asset management firm.

3 MS. STEIBER: Right.

4 MR. HEDGES: And I believe that I think it is fair
5 to say that there are enough red flags that I came across
6 that would even alert the lay person to the potential for the
7 Madoff track record being too good to be true, and I say that
8 with great consideration because I want to be very sensitive
9 to victims in this situation who are not experts, but I
10 believe that the due diligence red flags were there that were
11 sufficient to give people pause, whether or not they were
12 professionals or not.

13 MS. STEIBER: And do you have an idea of why you
14 think people went ahead and invested anyway, even with these
15 obvious red flags?

16 MR. HEDGES: Well, first and foremost is that some
17 people did not do due diligence. Secondly, others, I believe
18 in this situation, allowed another party's due diligence to
19 be a substitute of their own, and in allowing someone else's
20 due diligence to be a substitute for their own, they
21 abdicated the responsibility for the decision.

22 I think other investors relied upon the confidence
23 that they placed personally in Madoff, somebody that they
24 knew or held in esteem because of possibly knowing other
25 investors or hearing of his track record from a source that

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1 they viewed as credible, and I think that in time a fair
2 degree of responsibility for the situation will be laid at
3 the feet of the feeder funds and other intermediaries,
4 whether they're private bankers, marketers, hedge funds, Fund
5 to funds, or feeder funds, who should have, in my estimation,
6 known better.

7 MS. STEIBER: I know in this case, did you have
8 anyone else with you that you brought some type of -- like I
9 said, I don't know if you're a CPA, but a CPA or someone else
10 that has certain expertise in with you?

11 MR. HEDGES: Well, there are two parts of your
12 question. Am I a CPA? No. Did I bring a CPA with me? No.

13 I was accompanied by, I believe, two
14 representatives from the private bank that I was working with
15 and I know one for sure, and I think there was another
16 gentleman there, and I can't remember if he met us before or
17 after or if he was there the whole meeting. I just don't
18 simply recall.

19 MS. STEIBER: And do you remember if they felt the
20 same way that you did after the meeting, based on all the
21 open questions, or did they have a different feeling after
22 the meeting?

23 MR. HEDGES: I would characterize it that the
24 private bank was desirous of my approving an investment
25 because they felt that the opportunity was appropriate for

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1 our funds and their clientele and that I was being brought in
2 to sign off on this opportunity as a formality, and it's also
3 my belief that, at the end of the process, whether or not
4 they were convinced is immaterial because I had the authority
5 to veto the investment and I did.

6 MS. STEIBER: I guess what I'm trying to get at is
7 something similar to the earlier question, which is -- you
8 know, did you need a specific background in hedge funds in
9 order to -- you know, have recognized the red flags or were
10 these -- you know, bankers or bank-related people, were

11 they -- did they also -- were the red flags to them pretty
12 obvious? So I guess it's kind of going after the same point
13 we were talking about earlier.

14 But -- you know, we're going to speak to them, but
15 if they had said something to you, like that meeting was
16 really strange in our experience or something like that? You
17 said it was very atypical for you.

18 MR. HEDGES: Yeah. I don't know. I can't opine
19 upon what they were thinking at the time. It was a different
20 dynamic that you have to understand.

21 I was being brought in to opine and approve
22 something that they wanted to get done. So, in theory, I
23 was -- I would be remiss in not suggesting that they wanted
24 to make this investment. They sourced this opportunity and
25 this relationship. So -- you know, I would presume that they

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1 had made a conclusion that it was an appropriate investment.

2 MS. STEIBER: And we were talking a little bit
3 about audited financials, and I think you said that normally
4 in your due diligence process, you'd request audited
5 financials, but Madoff made it clear that he wouldn't provide
6 those --

7 MR. HEDGES: That's correct.

8 MS. STEIBER: -- is that correct? And when in the
9 process do you usually get audited financial statements? Or
10 does it just vary?

11 MR. HEDGES: It does vary, and when I --

12 I would -- you know, I have countless numbers of
13 additional pages -- you know, half a dozen additional pages

14 of issues that I go through in terms of a due diligence
15 process which I've not -- you know, read through for you.

16 MS. STEIBER: Right.

17 MR. HEDGES: And what I would like to convey is
18 that the way in which a due diligence process occurs, from my
19 perspective, is that there's an iterative dialogue over the
20 course of numerous visits with an open and cooperative
21 manager and team.

22 Hang on for me just one second.

23 So the fact that this is conducted as what I would
24 characterize as an iterative multi-phased process means that
25 we do not go in, like -- if you will, a box-checking

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1 consultant and ask question 1, 2, 3, down to question 653,
2 and then get all the answers and then have a yes or no answer
3 on making an investment.

4 we have a dialogue with the manager where we hit on
5 key elements and we find out where the manager is interested
6 in talking in an initial meeting, and we see that over the
7 course of time, we extract more and more information.

8 In the case of meeting Madoff, the initial meeting
9 led to my hitting a roadblock in so many instances that I had
10 no interest in continuing to ask about this business strategy
11 or his -- you know, his pricing policy for his broker-dealer
12 or his -- you know, whatever other issues might have come up
13 later.

14 MS. STEIBER: Okay. Now, as part of an investment
15 strategy, he was -- I'm sure he was talking about his
16 investment strategy and you said that was some type of a red
17 flag for you.

18 Could you say why it was a red flag for you? Was
19 it just -- you said the consistency of the returns or was
20 there something else about his investment strategy?

21 MR. HEDGES: Well, I remember making the comment
22 where I said, "I'm here to ask the stupid questions," which
23 was intended to be a self-deprecating way of relieving the
24 tension in a one-way dialogue to invite him to explain to me
25 simplistically the way in which he made money, and I remember

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1 also saying very specifically, "I don't get it. You're going
2 to have to do this again like in the first grade. I'm
3 sorry," and I found that -- and -- you know, by the way,
4 again these were disingenuous comments inasmuch as I did
5 understand what he was saying, but it did not make sense to
6 me what he was saying.

7 MS. STEIBER: Now why? Because of your knowledge
8 of the options market or was there something else?

9 MR. HEDGES: Well, yeah, because of my knowledge of
10 the potential for conflicts of interest between the two
11 businesses, and to a -- you know, lesser degree my knowledge
12 of the options market.

13 MS. STEIBER: Do you usually -- what do you usually
14 do when somebody gives you an investment strategy? Do you
15 take them at their word or do you go back, and -- is there
16 any -- I mean, is there any way that you can check if they're
17 really following the investment strategy they claim to be
18 following in a normal situation?

19 MR. HEDGES: Absolutely. I have a saying that you
20 can never have enough friends in low places. And what I mean

21 by that is when I invest with managers, I try to get to know
22 people throughout all aspects of the organization. Knowing
23 the head of a \$10 billion hedge fund is useful and helpful in
24 terms of access to information and attention for my clients
25 and things of that nature, but it's not to say that that

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1 individual's the person's responsible for making sure that
2 the K-1s, which are income tax reporting documents, get out
3 on the time -- in a timely fashion.

4 So I believe it's important to know individuals in
5 all aspects of the business. That's why I had previously
6 mentioned in this call meeting CFOs, back office people,
7 traders, analysts, et. cetera, because they give you
8 perspective on the business that you don't get from just
9 meeting the boss.

10 MS. STEIBER: Okay. Another question that's a
11 little off topic, as far as the SEC, when you're conducting
12 due diligence, do you look to see -- you know, if they're
13 registered with the SEC? Is that something that's important
14 to you?

15 MR. HEDGES: Well --

16 MS. STEIBER: For a hedge fund?

17 MR. HEDGES: -- if they're registered with the SEC,
18 it's important to me as pertains to baseline disclosures and
19 regulatory infractions or other issues that may have arisen
20 in the past.

21 MS. STEIBER: So is that something you weigh,
22 whether or not they have some regulatory infractions?

23 MR. HEDGES: I want to understand it, yes.

24 MS. STEIBER: And in this case, was that something

25 that you looked at? He was regulated by the SEC or the NASD

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1 at the time or anyone else? Was that something you
2 considered, do you remember?

3 MR. HEDGES: I -- as I sit here today, I don't
4 believe he was registered with the SEC in 1997.

5 MS. STEIBER: Well, his BD. His advisory business,
6 no. But the fact that he had a BD that was regulated by the
7 SEC, was that something you --

8 MR. HEDGES: It was generally my recollection that
9 he was regulated by the NASD, and so I -- I don't think I was
10 aware that he was regulated at that time by the SEC. I
11 believe it was later that I had learned that he had had some
12 degree of review by the SEC, but I don't have a great deal of
13 perspective on what that was or when it occurred exactly in
14 the context of time because once I made my decision this was
15 not the guy for us, then -- you know, the degree of attention
16 and bandwidth that I gave Madoff was really reserved to the
17 curiosity of hearing who was investing with him or how big
18 his asset base was swelling.

19 MS. STEIBER: Right. And did you -- I have a
20 couple of questions about the SEC involvement.

21 So have you had any thoughts, I mean, since this
22 broke, about why you think that the SEC hadn't detected this
23 before?

24 MR. HEDGES: I think that there was a preponderance
25 of suspicion among hedge fund industry insiders that

1 something was awry at Madoff Securities, and I -- I would
2 be -- even though I have gotten a high degree of public
3 attention for having opined upon Madoff in what was,
4 relatively speaking, a long time ago, I believe that many
5 others arrived at similar conclusions as I did in 1997.

6 I also understand that there, I believe, was a
7 culture around protecting this individual and his firm that I
8 found when I spoke to members of the press about his firm.

9 MS. STEIBER: Could you explain that a little bit
10 more? -- the culture of protecting him by whom?

11 MR. HEDGES: I had expressed doubts about his
12 trading strategy to members of the press generically over the
13 course of the years, not -- not -- not regularly, not
14 consistently, not often, but when it came up, I would say
15 I've never liked what was going on there. I've always felt
16 something rotten in the State of Denmark when it comes to
17 Bernie Madoff, and I found that no one in the press was
18 willing to pick up the ball and write a story about somebody
19 who they -- for some reason or another, chose to -- chose to
20 stand down from doing rigorous research and diligence and
21 potentially unearthing an unpleasant story.

22 MS. STEIBER: And through the years when you
23 were -- you know, making this statement, did you read
24 articles, or did -- I guess there were a couple of articles
25 out, I think, after 2001 about Madoff's firm that cast

1 suspicions on his -- the success of his trading strategy.

2 Did you read those? Were you aware of that or had

3 you heard of Markopolos?

4 MR. HEDGES: I -- I have -- I was not familiar with
5 him, but I was aware of certain articles that had been
6 written.

7 I mean, as I said, I think it's important that you
8 keep in mind that -- that among hedge fund industry insiders,
9 I believe that there was a fairly prevalent concern as to
10 what actually went on at Madoff, which is not to presume that
11 people thought he was running a \$50 billion Ponzi scheme.

12 MS. STEIBER: Okay.

13 MR. HEDGES: You know, it's an enormous void that
14 one has to jump across to make that -- that connection, but
15 that did you really know what was going on, is it the kind of
16 firm that gives you access to the information that would make
17 it through a sophisticated diligence process?

18 One of the first articles I did was with -- I can't
19 remember if it was CNN or Fortune, but irrespective, it
20 was -- it was early in the process, and I -- I said to the
21 reporter, "what is probably most telling is which investors
22 were not at Madoff Securities," and I made the point that
23 Harvard and Yale and Stanford, Stanford's Endowment and the
24 University of Texas and the Virginia State Retirement System,
25 VRS, and other big pensions, endowments, private foundations

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1 that are renowned for the sophistication of their investment
2 strategy and asset allocation and due diligence were not
3 investors, and I think that that is quite telling.

4 It's not just Jim Hedges. There were lots of other
5 people out there that controlled or were gatekeepers or
6 otherwise had access to allocate capital that stayed away

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7 because they felt something was inappropriate.

8 MS. STEIBER: I did read that article and we've
9 heard something similar to that from a few other people.

10 And were you surprised that, at the end when this
11 came out, the SEC or the NASD, FINRA, didn't detect what was
12 going on?

13 MR. HEDGES: Yes.

14 MS. STEIBER: Why?

15 MR. HEDGES: Because to me it was very obvious that
16 there were problems and it was very much a part of the
17 industry discourse that certain investors had cause for
18 concern about that organization.

19 MS. STEIBER: And what would you have expected
20 regulators to have done to have detected the fraud, if you
21 ever thought about it? Wasn't there -- wasn't there an
22 examination process? Would you have thought -- you know, if
23 you're familiar with the examination process, would have
24 shown regulators that he was committing fraud of some sort?
25 If you haven't thought about it -- you know, don't worry

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1 about it.

2 MR. HEDGES: It's really difficult to opine upon
3 the -- the problems with the regulatory process in this
4 situation without discussing broader regulatory reform and
5 the need for both resources as well as sophistication at the
6 investigator level.

7 MS. STEIBER: Okay. So let's talk about maybe
8 first the sophistication at the regulatory level. What are
9 your thoughts about that?

10 MR. HEDGES: Well, the SEC and the self-regulating
11 organizations are, by and large, staffed with traditionally
12 junior people conducting investigations, at least that has
13 always been my experience, and I have been -- you know,
14 reviewed or audited by both the SEC and the CFTC and the NAS
15 and -- you know, the various organizations that touch my
16 firm, and usually, I would say out of meeting a couple of
17 dozen of these individuals over the years, I would -- I would
18 venture a guess to say that one of them comes to mind who was
19 the Miami Field Office head was over the age of 40. I
20 suspect that the average age of the other investigators that
21 were -- that have been in my office was probably 32 years
22 old.

23 MS. STEIBER: And so what would be your
24 recommendation? Is it a matter of -- you know, years, or
25 age -- a matter of certain type of industry experience?

24

1 MR. HEDGES: I think that -- that a certain degree
2 of -- of education and credentialing and breadth of
3 understanding of strategies would be helpful.

4 My own experience has been one of frustration with
5 at times junior investigators who do not understand my
6 business. When I was running a Fund to funds business, I
7 often found that investigators would ask me for my -- my
8 trade confirms on the second or third day of a visit, for
9 instance, and I would say, "We're in the fund of hedge fund
10 business. We invest with hedge fund managers that have
11 private placement documents offered under Reg. D. We don't
12 have trade confirms here. We have neither brokerage accounts
13 or trade confirms nor all the other litany of things that go

14 along with that sort of business."

15 MS. STEIBER: So you felt like they had --

16 MR. HEDGES: I felt like I was dealing with, in
17 that particular example, an investigator who was working off
18 of a rote formulaic process that he did not understand
19 because if he had understood the process, he wouldn't have
20 asked a Fund to funds manager for trade confirms.

21 So this is not to pick on or -- overly focus on one
22 young investigator, but I do think it's endemic of a
23 system-wide dynamic. Too many advisors, not enough
24 investigators and not enough education or sophistication or
25 tenure with many of the investigators that are in the field.

25

1 MS. STEIBER: And what's your feeling about hedge
2 fund regulation?

3 MR. HEDGES: I'm pro hedge fund regulation, and I
4 have always been very active both with -- both in the press
5 and in my writings, as well as -- you know, otherwise in
6 favor of hedge fund regulation.

7 I've participated in both rounds of SEC Roundtables
8 on Hedge Fund Regulation conducted by Chairman Donaldson,
9 and -- you know, I -- believe that thoughtful, judicious
10 regulation is important.

11 I also want to make a point that is not meant to be
12 a caveat or to otherwise negate what I've just said, but it
13 is very true that if somebody is intent on conducting a
14 fraud, it's hard to prevent people from stealing one's money.
15 I mean, there's a difference between proper regulation and
16 governance for an industry versus the one manager who