PRIVATE FUND INVESTOR DUE DILIGENCE: EVIDENCE FROM 1995 TO 2015

WULF A. KAAL*

Abstract

The importance of private fund investor due diligence in the investment allocation process, capital formation, and private fund litigation has reached unprecedented levels and is increasing further. To provide the industry with data, data trend analyses, and guidance on applicable legal standards, the author examines two datasets: (1) private investment fund advisers' SEC Form ADV II filings from 2007 to 2014 (N=100392), and (2) the publicly available litigation record pertaining to private fund investor due diligence from 1995 to 2015 (N=572). After highlighting important changes in the quality and quantity of private fund investor due diligence in SEC Form ADV Part II, the author evaluates the corresponding litigation record and analyzes expert guidance on applicable best practices.

* Associate Professor, University of Saint Thomas School of Law (Minneapolis). The author would like to thank the many practitioners who contributed to this article. Special thanks go to Tom Joyce, Steve Adams, and Bentley Anderson as well as anonymous representatives of the private investment fund industry and its lobby groups. Special thanks also go to research librarian Nick Farris for his invaluable support.

Table of Contents

I. Introduction

Private fund investor due diligence[1] is becoming an increasingly important part of the capital formation and allocation

[1] Private fund IDD can most generally be defined as a process for the identification of investment managers and asset allocation to such managers for investments, in combination with the ongoing monitoring of investment managers' operations and management to ensure that investors' interests are protected. *See* RANDY SHAIN, HEDGE FUND DUE DILIGENCE: PROFESSIONAL TOOLS TO INVESTIGATE HEDGE FUND MANAGERS 9–10 (2008). Private fund IDD also provides a comprehensive analysis and understanding of the potential operational and financial risks involved with investing with a specific manager. *See, e.g.*, BOB KERN, U.S. BANCORP FUND SERVICES, LLC, A GUIDE TO HEDGE FUND INVESTOR DUE DILIGENCE 1 (2009), http://www.usbfs.com/usbfs/documents/2013/white-papers/USBFS%20Guide%20to%20Investor%20Due%20Diligence_2010.pdf [https://perma.cc/97P5-MHHD] ("As investors, particularly institutional investors, begin conducting formal due diligence assessments of administration operations prior to placing assets with funds, management companies must augment their purely asset management focus with comprehensive compliance programs and be aware of all red flags including perceived conflict of internal administration services, valuation conflicts of interest, or affiliated prime brokerage arrangements."); PWC, ATTRACTING PENSION PLAN ASSETS: WHAT ALTERNATIVE INVESTMENT MANAGERS NEED TO KNOW 1 (2012), https://www.pwc.com/us/en/alternative-investment/assets/pwc.hedge-fund-due-diligence.pdf [https://perma.cc/WF6J-L4ZT] ("While plan sponsors continue to be attracted to the performance characteristics of alternative investments, they also are seeking increased levels of information on their operational complexities in order to address the total risk (investment and operational) funds pose to pension assets."). *See*

process. Investor due diligence (IDD) is a core function of the proliferating private investment fund industry. The private investment fund industry has been growing significantly since the early 2000s.[2] The changing demands by institutional investors have had an astounding impact for alternative investments,[3] precipitating growth to $2.63 trillion assets under management (AUM) at the end of 2013.[4] Between 2013 and 2015, the private fund industry grew by 26%, increasing from just above $2 trillion AUM in 2013 to $2.7 trillion AUM through 2015.[5] Traditional alternative investments, such as

---

generally RAJIV JAITLY, PRACTICAL OPERATIONAL DUE DILIGENCE ON HEDGE FUNDS: PROCESSES, PROCEDURES, AND CASE STUDIES (2016).

[2] *See* Rene M. Stulz, *Hedge Funds: Past, Present, and Future*, 21 J. ECON. PERSP. 175, 184 (2007) (explaining the growth, risk and performance of hedge funds from the early 1990s to the mid 2000s).

[3] CHRISTINA FAST & EMILY ROBERTS, DEUTSCHE BANK, TWELFTH ANNUAL ALTERNATIVE INVESTMENT SURVEY 12 (2014), https://www.managedfunds.org/wp-content/uploads/2014/04/2014-Deutsche-Bank-AIS.pdf [https://perma.cc/PD59-7TA6] ("The tremendous growth in the volume of alternative assets has been largely driven by institutional investors looking to incorporate both true alpha and return stream diversification into the core of their portfolios."); GRANT THORNTON, 2014 HEDGE FUNDS UPDATE: NEW REGULATIONS AND SHIFT TO INSTITUTIONAL MONEY CHALLENGE SMALLER FIRMS 3 (2014), https://www.grantthornton.com/~/media/content-page-files/financial-services/pdfs/2014/AM/140212-FIS-Asset-Management-Report-140227FIN.ashx [https://perma.cc/73UC-5PAQ] ("The lag is not surprising, given the approach of many hedge funds that makes them attractive to institutional investors. Hedge funds emphasize absolute return, offering reduced volatility over long time horizons but, as in the current environment, lower returns in a bull market.").

[4] CITI INV'R SERVS., OPPORTUNITIES AND CHALLENGES FOR HEDGE FUNDS IN THE COMING ERA OF OPTIMIZATION PART 1 4 (2014), http://www.citibank.com/icg/global_markets/prime_finance/docs/Opportunities_and_Challenges_for_Hedge_Funds_in_the_Coming_Era_of_Optimization.pdf [https://perma.cc/SXP4-X4D5] ("By 2018, we forecast core hedge fund industry AUM to rise to $4.81 trillion-an increase of 81% from the $2.63 trillion noted at the end of 2013.").

[5] *Hedge Fund Industry—Assets Under Management*, BARCLAYHEDGE http://www.barclayhedge.com/research/indices/ghs/mum/Hedge_Fund.html [https://perma.cc/8KFE-RVZ3] (listing the annual hedge fund industry AUM from 1997 to 2010 and quarterly hedge fund industry AUM beginning in 2011).

hedge funds and private equity,[6] have grown twice as fast as traditional investment, such as mutual funds and closed-end funds.[7]

While some studies identify due diligence as an important source of alpha for private funds,[8] sophisticated investors, especially since the financial crisis of 2008–09, place an extra emphasis on due diligence before making an investment decision.[9]

The private fund industry has incrementally improved due diligence standards and requirements in the aftermath of the financial

---

[6] Pooneh Baghai et al., *The $64 Trillion Question: Convergence in Asset Management*, MCKINSEY & CO. 5, 11 (2014), www.mckinsey.com/industries/private-equity-and-principal-investors/our-insights/the-64-trillion-question [https://perma.cc/MG88-E2Z3] ("We include assets held by hedge funds, private-equity firms, and real assets (in agriculture, commodities, energy, infrastructure, and real estate) held by financial investors.").

[7] *Id.* at 6 ex. 1 ("Alternative investments have grown twice as fast as traditional investments since 2005.") Numerous analysts expect this growth to continue in the foreseeable future. *See generally* GBENGA BABARINDE ET AL., STRATEGY&, ALTERNATIVE INVESTMENTS: IT'S TIME TO PAY ATTENTION 4 (2015), http://www.strategyand.pwc.com/media/file/Alternative-investments.pdf [https://perma.cc/7WQD-WN6Q] ("The players that approach these choices wisely will be well positioned to profit in a marketplace that we expect to grow from US$10 trillion in assets today to $18.1 trillion by 2020.").

[8] Stephen J. Brown et al., *Hedge Fund Due Diligence: A Source of Alpha in a Hedge Fund Portfolio Strategy*, 6 J. INV. MGMT. 23 (2008), joim.com/wp-content/uploads/emember/downloads/p0253.pdf [https://perma.cc/UQ38-ZTE7] ("Due diligence is an important source of alpha in a well designed hedge fund portfolio strategy. . . . [E]ffective due diligence is an expensive concern. This implies that there is a strong competitive advantage to those funds of funds sufficiently large to absorb this fixed and necessary cost. The consequent economies of scale that we document in funds of funds are quite substantial and support the proposition that due diligence is a source of alpha in hedge fund investment."); Olivier Gottschalg & Bernd Kreuter, *Quantitative Private Equity Fund Due Diligence: Possible Selection Criteria and their Efficiency* 1 (Nov. 7, 2006) (unpublished working paper), http://ssrn.com/abstract=942991 [https://perma.cc/8V83-TVPX].

[9] William E. Donnelly, *The Heightened Importance of Thorough Due Diligence in the Current Market Environment*, PRACTICAL COMPLIANCE & RISK MGMT. FOR THE SEC. INDUS. 13, 16–17 (2009), www.leclairryan.com/files/Uploads/Documents/Donnelly_PCRM_04-09.pdf [https://perma.cc/8MR5-3VDQ] ("The trilogy of high-profile Ponzi schemes described above has underlined the critical importance of effective investment due diligence. As the Stanford case illustrates, due diligence is also critically important for financial advisers who are considering changing firms.").

crisis of 2008–09.[10] Before the financial crisis of 2008–09, investment advisers and managers usually performed at least part of their due diligence by starting with the Alternative Investment Management Association (AIMA) or Managed Funds Association (MFA) due diligence questionnaires and edited the templates to suit their circumstances.[11] The old versions of those questionnaires were often used in an attempt to avoid investors' questions challenging the manager on possible weaknesses in their controls.[12] In the aftermath of the financial crisis of 2008–09 and other associated crises including the Madoff scandal, investors, at least relatively sophisticated investors, no longer accepted the slanted phrasing of the due diligence

---

[10] *Id*. at 13 ("Although commentators have identified a broad range of causes that undoubtedly contributed to the current financial crisis, the failure of many financial intermediaries, including broker-dealers, banks, pension fund trustees and investment advisers (and, in some instances, their lawyers) to perform adequate due diligence was undoubtedly one very important factor. The lack of adequate due diligence has been a particularly serious failing with regard to the several enormous Ponzi schemes that have been uncovered as a result of the current crisis."); Jason Scharfman, *Evaluating Trends in Funds of Hedge Funds Operational Due Diligence*, *in* RECONSIDERING FUNDS OF HEDGE FUNDS 17, xxix (Abstract) (Greg N. Gregoriou ed., 2013) ("Post-2008 FoHFs have also broadened the scope of their operational due diligence reviews.").

[11] *See* MANAGED FUNDS ASS'N, SOUND PRACTICES FOR HEDGE FUND MANAGERS, Appendix II (2007), http://www.managedfunds.org/wp-content/uploads/2011/06/Sound-Practices-2007.pdf [https://perma.cc/5MGL-84JQ] [hereinafter SOUND PRACTICES] (showing a pre-2008 example of the Model Due Diligence Questionnaire prepared and published by the Managed Funds Association); Jennifer Banzaca, *Legal, Operational and Risk Considerations for Institutional Investors When Performing Due Diligence on Hedge Fund Service Providers*, 3 HEDGE FUND L. REP. (2010).

[12] *See* MANAGED FUNDS ASS'N, MODEL DUE DILIGENCE QUESTIONNAIRE FOR HEDGE FUND INVESTORS 1 (2011), http://www.managedfunds.org/wp-content/uploads/2011/06/Due-Dilligence-Questionnaire.pdf [https://perma.cc/5MGL-84JQ] [hereinafter MODEL DUE DILIGENCE QUESTIONNAIRE] ("In addition, a Hedge Fund Manager may choose not to respond to a particular question in light of confidentiality concerns. Any information provided in this questionnaire by a Hedge Fund Manager is current only as of the date this questionnaire is completed and the Hedge Fund Manager has no obligation to update or supplement any of the answers given, and assumes no responsibility for the accuracy of the answers provided after the date the questionnaire is completed.").

questionnaires and their answers.[13] As a result, the questionnaires became more rigorous.[14]

Since 2010, IDD has also become an increasingly litigated issue in the capital formation and allocation process.[15] In lock step with the growth of the private investment fund industry, private fund IDD litigation has increased significantly since the financial crisis of 2008–09.[16] Courts in the early 2010s started to set out private fund

---

[13] Cecilia C. Lee, *Reframing Complexity: Hedge Fund Policy Paradigm for the Way Forward*, 9 BROOK. J. CORP. FIN. & COM. L. 478, 515 (2015) ("Industry bodies, such as the UK-based, Alternative Investment Management Association (AIMA) and U.S.-based Managed Funds Association (MFA), have also been quick to act in order to minimize the glare of regulation by establishing best practices for its members and actively participating in the policy discussions."); Press Release, Managed Funds Ass'n, Managed Funds Association Takes Steps to Restore Investor Confidence with Enhanced Best Practices & Investor Due Diligence Recommendations (Mar. 31, 2009), http://www.businesswire.com/news/home/20090331006134/en/Managed-Funds-Association-Takes-Steps-Restore-InvestorVKyU8Th0y70 [https://perma.cc/9NUY-KEHS] ("MFA has a decade-long tradition of robust *Sound Practices*. Today, more than ever before, investors will benefit from our due diligence questionnaire as they undertake robust diligence when considering an investment in a hedge fund. Investors can also benefit from reviewing the recommendations in *Sound Practices* as they consider operational, governance and other matters as part of their diligence when making an investment [sic]. . .").

[14] Rules Implementing Amendments to the Investment Advisers Act of 1940, 76 Fed. Reg. 42,950, 42,969 (July 19, 2011) (acknowledging that by 2011 hedge funds disclosures to the SEC "required information. . . similar to, and at times less extensive than, the information that investors in hedge funds and other private funds commonly receive in response to due diligence questionnaires or in offering documents."); Eze Castle Integration, *Global Hedge Fund Technology Benchmark Study 2014*, HEDGEFUND J. (Jan. 7, 2015), http://www.thehedgefundjournal.com/node/9871 [https://perma.cc/6XWD-GLRC] ("Due diligence questionnaires (DDQs) are no longer "check the box" forms; they are now detailed examinations of business processes, infrastructure and application sets that require firms to spend time completing and explaining how they function on a day-to-day basis."); *see also* Press Release, Alt. Inv. Mgmt. Ass'n, AIMA Updates Due Diligence Questionnaire for Selecting a Fund of Hedge Funds Manager (June 3, 2015), https://www.aima.org/en/media/press-releases.cfm/id/9FBE0326-2A33-446C-ABDF17CF4F8CD56C [https://perma.cc/Q42J-2Y3M].

[15] *See infra* Part III.

[16] *See infra* Figure 3 (depicting the duplication of "due diligence" cases from 2004 to 2005, and the exponential growth of them over the next five years).

IDD standards and provided guidance on the requirements and limits.[17] The increasing due diligence litigation record underscores the heightened importance of due diligence in the capital formation and allocation process.

Little to no guidance exists on applicable standards for IDD.[18] Despite the increasing relevance of IDD in the capital formation and allocation process, and IDD litigation, the industry is mostly left to its own devices to ensure adequate due diligence standards apply. Available resources describe best practices but do not sufficiently outline the legal requirements pertaining to private investment fund due diligence.[19] The available case law only marginally provides relevant guidance on private fund IDD.[20]

This article provides the first comprehensive study on the changing private fund IDD landscape. To provide the industry with adequate guidance on private fund IDD, the author examines private investment funds' SEC Form ADV II filings[21] from 2007 to 2014

---

[17] *See infra* Part III.B.1–2.

[18] *See* Part IV (stating that this article is the first study to address the lack of guidance on private fund IDD in the United States).

[19] *See* ALT. INV. MGMT. ASS'N, AIMA'S ILLUSTRATIVE QUESTIONNAIRE FOR DUE DILIGENCE OF THE 1.2 FUND, Sept. 2015, http://www.onepointwo.com/documents/The%201.2%20Fund%20-%20AIMA%20DDQ.pdf [https://perma.cc/3SV6-ETPZ] [hereinafter AIMA'S ILLUSTRATIVE QUESTIONNAIRE] (illustrating a tool available to investors when considering hedge fund manager and a hedge fund); MODEL DUE DILIGENCE QUESTIONNAIRE, *supra* note 12.

[20] *See* discussion *infra* Part III.B.1. (describing various legal standards, from contract, corporate, and common law, under which courts have evaluated private fund IDD).

[21] U.S. SEC. & EXCH. COMM'N, FORM ADV UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION, https://www.sec.gov/about/forms/formadv-part2.pdf [https://perma.cc/WK77-D9AA]. Any reference to Form ADV II filings means "Part 2A" of Form ADV, or the "brochure," as it was formerly frequently referred to. Form ADV Part 2A is not a marketing document in the private fund world—instead, it is a required disclosure document, and the imperative for a private fund manager is to keep the narrative language as high-level, summary, and as non-committal as possible, because a material omission and/or misstatement in that section could lead to a serious charge of violating the securities laws. As a result, managers try to simplify their disclosures to the greatest extent possible, and they are generally not making representations regarding the extent of their diligence regarding selecting investments. Several examples of private investment funds' Part 2A exist where Part 2A relates to an incredibly complex business

(N=100392) and the publicly available litigation record pertaining to private fund IDD from 1995 to 2015 (N=572). After highlighting important changes in the quality and quantity of private fund IDD in SEC Form ADV Part II, the author summarizes and illustrates the litigation record on private investment fund due diligence from 1995 to 2015, breaking down individual expert testimony provided by due diligence experts in courts and evaluating expert guidance on applicable IDD best practices.

To preview findings, the author provides evidence that from 2007 to 2014 an increasing number of SEC Form ADV II filers deemed IDD worth mentioning in their filings and an increasing number of SEC From ADV II filers qualitatively intensified their due diligence disclosures in Form ADV II brochure filings. More specifically, an increasing number of SEC Form ADV II brochure filers have included IDD disclosures since 2010.[22] However, the number of filers who include those disclosures remained relatively consistent between 2012 and 2014.[23] The intensity of IDD mentioning relative to total SEC Form ADV II brochure filings, however, has increased substantially; the due diligence count exceeded the total ADV II filings for the first time in 2014.[24] The data suggests that SEC Form ADV II brochure filers take IDD disclosures in Form ADV II much more seriously since 2010, and even more seriously since

---

managed through multiple advisers and multiple separate strategies and funds, and yet the entire document is typically relatively short, and it sticks to just the information expressly required by the instructions to Part 2A. Even for fund of fund (FoF) managers, Part 2A is not likely to be treated as a marketing document, other than perhaps where the FoF interests themselves are distributed to true retail investors. Accordingly, FoF managers are themselves likely to have an important incentive to minimize how they describe their investment and other processes. In addition, as with all other private fund managers, any reference by a FoF (or any other manager, for that matter) to that firm's investment process is regularly going to be offset by a (probably lengthy) disclaimer in the Part 2A regarding, inter alia, how errors in investment selection can still occur, that the manager's investment-selection process is not foolproof, and that poor performance and other issues can still occur that will result in the loss of the investor's capital.

[22] *See infra* Figure 1 (illustrating the relationship between the overall count of Form ADV II brochure filings between 2007 and 2014 and Form ADV II brochure filings that mention IDD at least once).

[23] *See* discussion *infra* Part III.A.

[24] *See* discussion *infra* Part III.A.

2012.[25] Filers appear to see a need to increase the quantity of IDD disclosures in Form ADV II.

The data on case law between 1995 and 2015 suggests that private fund IDD has reached new and lasting prominence in the court system.[26] The increasing caseload on private fund IDD since 2005 could suggest that applicable legal standards need to be further clarified to protect investors. Madoff-related cases in the aftermath of the discovery of the Madoff Ponzi scheme in 2008 help explain the significant increase in the prevalence and importance of private fund IDD after 2009.[27]

This article has four parts. Following this Introduction, Part II defines private fund IDD as used in this article and describes the scope and applicable criteria. Part III describes the methodology, coding, data, and trends in data, and evaluates policy implications of this study in two data categories: (1) private investment fund advisers' SEC Form ADV II filings from 2007 to 2014 (N=100392), and (2) the publicly available litigation record pertaining to private fund IDD from 1995 to 2015 (N=572). Part III provides a synthesis of case law and summarizes core holdings and applicable legal standards pertaining to private fund IDD. Part IV ends with a discussion of key findings and an evaluation of the implications of the data for policy.

II. Private Fund Investor Due Diligence

Private fund IDD is associated with a broad array of activities and definitions.[28] Private fund IDD can be defined most generally as a process for the identification of investment managers' asset allocations for investments, and ongoing monitoring of investment managers' operations and management, to ensure investors' interests are protected.[29] Private fund IDD also provides a comprehensive analysis

---

[25] *See* discussion *infra* Part III.A.

[26] *See infra* Figure 3 (discussing the author's data findings from Westlaw searches on private fund IDD case law).

[27] *See* discussion *infra* Part III.B.3 (discussing the courts' reaction to the Madoff scandal).

[28] *See* SHAIN, *supra* note 1, at 9–10 (discussing the scope of due diligence requirements).

[29] *See* JAITLY, *supra* note 1, at 4–5 (explaining the need for operational due diligence and investment due diligence to be done in tandem).

and understanding of the potential operational and financial risks involved with investing with a specific manager.[30]

For purposes of this article, multiple meanings may be associated with the general term due diligence and private fund IDD specifically. Possible meanings of the term due diligence include: (1) the due diligence Limited Partners (e.g., pension funds) perform on prospective private fund managers to determine whether or not to invest; (2) the due diligence performed by specialty financial advisors and fund-of-fund managers on prospective private funds they are recommending to others or investing in to assemble their own portfolio; and (3) the due diligence performed by private fund managers on their own investments.

IDD can be contrasted with operational due diligence. Financial due diligence is the review and monitoring private investment funds with respect to financial risk.[31] By contrast, operational risk is defined broadly, and includes risks associated with: operations, accounting, compliance, valuation, audit, reporting, and the oversight of personnel.[32] The purpose of operational due diligence is to review and monitor funds with respect to operational risk and may include: risk management procedures, style and strategy, analysis of a fund's infrastructure, back office procedures, peer comparisons, and financial statements, among other items.[33] Legal and regulatory

---

[30] *See e.g.*, KERN, *supra* note 1; PWC, ATTRACTING PENSION PLAN ASSETS: WHAT ALTERNATIVE INVESTMENT MANAGERS NEED TO KNOW 3–7 (2012), https://www.pwc.com/us/en/alternative-investment/assets/pwc.hedge-fund-due-diligence.pdf [https://perma.cc/P9GG-GZWY] (advising investors on how to address due diligence concerns).

[31] *See* JAITLY, *supra* note 1, at 4–5 (providing an overview of the due diligence associated with investment activity).

[32] INT'L ASS'N OF FIN. ENG'RS, REPORT OF THE OPERATIONAL RISK COMMITTEE: EVALUATING OPERATIONAL RISK CONTROLS 5 (2001), http://www.iaqf.org/dev/files/Evaluating%20Operational%20Risk%20Controls%20-%20White%20Paper.pdf [https://perma.cc/2DFN-UUGX] ("A useful starting point for defining operational risk is the concept of 'losses caused by problems with people, processes, technology, or external events.' Within these broad constraints, there is nonetheless ambiguity. There is room for debate about whether nonmonetary losses should be taken into consideration by risk managers. While nonfinancial losses such as reputational damage can negatively impact a firm, they are difficult to quantify or cannot be quantified at all.").

[33] *See e.g.*, DEUTSCHE BANK GLOBAL PRIME FINANCE, THIRD ANNUAL OPERATIONAL DUE DILIGENCE SURVEY 13 (2014), https://www.

problems are also indicators of operational risk, and operational risk increases as potential conflicts of interest between managers and investors increase.[34] Operational due diligence practices are not currently harmonized in the private investment fund industry, but operational due diligence templates, such as the AIMA model document, are used frequently by industry participants.[35] In contrast, while investment due diligence may start with the same set of basic questions, it is almost always an idiosyncratic process, because it is focused on the subject manager's investment process, which typically is unique to that manager.[36]

It is also important to distinguish operational due diligence with respect to different types of funds. For example, the operational due diligence review of a venture capital fund is very different than that of a private equity fund, which in turn is different than that of an actively traded private fund.[37] Each of these areas is quite different, and raises unique and substantive concerns and issues.

---

managedfunds.org/wp-content/uploads/2014/07/Third-Annual-Deutsche-Bank-Operational-Due-Diligence-Survey-Summer-2014.pdf [https://perma.cc/WM82-22KS]; DEUTSCHE BANK HEDGE FUND CONSULTING, A STUDY OF INVESTOR OPERATIONAL DUE DILIGENCE (ODD) 15 (2012), https://www.db.com/unitedkingdom/docs/Deutsche_Bank_ODD_Study_FINAL_(22.10.12).pdf [https://perma.cc/9TBX-EFUN] (providing a list of operational due diligence meeting documents).

[34] Brown et al., *supra* note 8, at 2 (explaining that operational risk associated with conflicts of interest both within the fund and external to the fund can lead to underperformance of the fund).

[35] *See* discussion *infra* pp. 58–59 (describing the standard private fund IDD industry practices, as stipulated in the author's examined litigation record); *see also* sources cited *infra* note 245 (suggesting questionnaires as tools for managing due diligence).

[36] *See* KERN, *supra* note 1 (advising managers as to how to comply with IDD based on their own investment strategies).

[37] *See* CORGENTUM, PRIVATE EQUITY OPERATIONAL DUE DILIGENCE TRENDS—NAVIGATING THE PATH FORWARD 8 (2012), http://www.corgentum.com/pdf/Corgentum_Private_Equity_Operational_Due_Diligence_Trends_Study.pdf [https://perma.cc/CZB4-77U3] (describing the differing focuses of private equity investors and hedge fund investors relating to operational due diligence); MODEL DUE DILIGENCE QUESTIONNAIRE, *supra* note 12.

Private fund IDD encompasses several core subjects.[38] Some of the core factors considered in private funds' IDD include the qualitative and quantitative examination of: investment strategies, business structure, valuation policies and procedures, operations, private fund managers, personnel, alignment of interests, conflicts of interest, risk management, compliance, investment terms, criminal-civil and regulatory actions, and competitive advantage, among other items.[39] The Managed Funds Association (MFA) has summarized core due diligence content in its widely used due diligence questionnaire.[40] The questionnaire lists the following items, among others, as core investment due diligence: Investment Manager Entities and Organizational Structure, Personnel, Compliance System and Registrations with Regulatory Authorities, Legal Proceedings, Infrastructure and Controls, Business Continuity, Vehicles Managed, Conflicts of Interest, Fund Investment Approach, Fund Capital and Investor Base, Fund Terms, Performance History, Risk Management, Valuation, Fund Service Providers, and Investor Communications.[41] Similarly, AIMA provides guidance on private fund IDD.[42] The AIMA

---

[38] *See* MODEL DUE DILIGENCE QUESTIONNAIRE, *supra* note 12 (listing topics related to due diligence); PREQIN, KEY DUE DILIGENCE CONSIDERATIONS FOR PRIVATE EQUITY INVESTORS 2 (2014), https://www.preqin.com/docs/reports/Preqin-Special-Report-Due-Diligence-Private-Equity-Investors-Jul-14.pdf [https://perma.cc/ZZE2-RMFZ] ("This report seeks to provide an insight into the key questions investment professionals should ask themselves during initial fund screening and due diligence: What key indicators are there that a fund will successfully raise capital? What key indicators are there that a fund will outperform its peers? How does an investor gain access to the best fund offerings?"); U.S. SEC. & EXCH. COMM'N, OFFICE OF COMPLIANCE INSPECTIONS & EXAMINATIONS, INVESTMENT ADVISER DUE DILIGENCE PROCESSES FOR SELECTING ALTERNATIVE INVESTMENTS AND THEIR RESPECTIVE MANAGERS, 4 NATIONAL EXAM PROGRAM RISK ALERT 2 (2014), https://www.sec.gov/about/offices/ocie/adviser-due-diligence-alternative-investments.pdf [https://perma.cc/JG5E-FP6C] [hereinafter DUE DILIGENCE PROCESSES FOR SELECTING ALTERNATIVE INVESTMENTS].

[39] *See generally* GREG N. GREGORIOU, FUNDS OF HEDGE FUNDS: PERFORMANCE, ASSESSMENT, DIVERSIFICATION, AND STATISTICAL PROPERTIES 392–98 (2006) (describing widespread use of the term "due diligence" and the multitude of contexts in which the term is employed).

[40] MODEL DUE DILIGENCE QUESTIONNAIRE, *supra* note 12 (listing topics related to due diligence).

[41] *Id*.

[42] The AIMA's Illustrative Questionnaire for Due Diligence (DDQ) is only available to AIMA members. *See* Press Release, *supra* note 14.

standards are substantially similar to the MFA, but differ in certain aspects.[43]

The U.S. Securities and Exchange Commission (SEC) has taken an increasing interest in private fund IDD, noting both the growth of alternative fund industry and increasing recommendations of investment advisers of alternative investments.[44] The SEC mentions practices including: "(i) the use of separate accounts to gain full transparency and control; (ii) the use of transparency reports issued by independent fund administrators and risk aggregators; (iii) the verification of relationships with critical service providers; (iv) the confirmation of existence of assets; (v) routinely conducting onsite reviews; (vi) the increased emphasis on operational due diligence; and (vii) having independent providers conduct comprehensive background checks."[45] Despite a number of enforcement actions that deal with misrepresentation in relation to due diligence,[46] the SEC has not taken a rigid enforcement position on the effectiveness or ineffectiveness of due diligence industry practices.[47] Instead, the SEC has merely acknowledged the increasingly robust due diligence practices post-financial crisis of 2008–09.[48]

Since the financial crisis, courts have faced an unprecedented wave of litigation in which investors sue private funds for their alleged lack of competent due diligence practices.[49] Many of the cases originate from investor losses caused by investment managers

---

[43] For example, the MFA standards focus more heavily on investment manager activity, while the AIMA standards emphasize asset data and investment strategy. *Compare* MODEL DUE DILIGENCE QUESTIONNAIRE, *supra* note 12, *with* AIMA'S ILLUSTRATIVE QUESTIONNAIRE, *supra* note 19.

[44] DUE DILIGENCE PROCESSES FOR SELECTING ALTERNATIVE INVESTMENTS, *supra* note 38, at 1 (indicating that investment adviser recommendations have increased in the last six years and assets under management for global alternative investments have grown at a five-year rate of more than seven times that of traditional asset classes).

[45] *Id*.

[46] *See, e.g.*, Hennessee Group LLC, Investment Advisers Act Release No. 2871, 2009 WL 1077451, at *2 (Apr. 22, 2009) ("With regard to Bayou, Hennessee Group, at Gradante's direction, did not perform several key elements of its advertised due diligence practices.").

[47] *See* DUE DILIGENCE PROCESSES FOR SELECTING ALTERNATIVE INVESTMENTS, *supra* note 38, at 2 n.8.

[48] *See generally id.* at 2–6 (documenting changes in due diligence practices).

[49] *See* discussion *infra* Part III.B (documenting a variety of actions against private funds).

investing in Ponzi schemes or other fraudulent investments.[50] Courts have begun to set out some of the outer limits of acceptable due diligence practices in relation to private funds and private fund advisors. Plaintiffs in such cases have made due diligence related claims under the following causes of action: securities fraud and/or breach of contract (if defendant had not engaged in any kind of due diligence);[51] lack of due diligence as breach of fiduciary duties;[52] lack of due diligence as misrepresentation;[53] contractual and common law

---

[50] Many of the cases dealt with hedge funds with a "fund of funds" strategy making investments in the following fraudulent investment schemes: The Cosmo funds, the Nadel funds, Bernard Madoff Investment Management, and the Bayou Hedge Fund Group. *See* Kevin McCoy, *Ex-convict Charged in Ponzi Scheme*, USA TODAY (Jan. 30, 2009), http://usatoday30.usatoday.com/money/markets/2009-01-27-ny-ponzi-arrest_N.htm [https://perma.cc/SYP5-5VML]; *Con of the Century*, THE ECONOMIST (Dec. 18, 2008), http://www.economist.com/node/12818310 [https://perma.cc/DN5F-F6UE] (discussing the cause and effect of the Bernard Madoff Ponzi scheme); Gretchen Morgenson et al., *Clues to a Hedge Fund's Collapse*, N.Y. TIMES (Sept. 17, 2005), http://www.nytimes.com/2005/09/17/business/clues-to-a-hedge-funds-collapse.html?_r=0 [https://perma.cc/4EM5-B2QN].

[51] *See, e.g.*, S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 112 (2d Cir. 2009) (holding that the defendant advisor group was not liable for fraud or negligence because there was no proof that the advisors knew that the hedge fund was involved in a Ponzi scheme); Matana v. Merkin, No. 13 Civ. 1534 (PAE), 2014 WL 426857, at *3 (S.D.N.Y. Feb. 4, 2014) (determining that an investor's claim of fraud by the fund manager was not supported, because although failure to disclose unknown facts might be irresponsible, it did not show fraudulent intent); S. Cherry St., LLC v. Hennessee Grp. LLC (*In re* Bayou Hedge Fund Litig.), 534 F. Supp. 2d 405, 416 (S.D.N.Y. 2007) (holding that defendants were not liable for fraud for failure to conduct adequate due diligence).

[52] *See, e.g.*, *Matana*, 2014 WL 426857, at *3 (holding that a fund manager did not breach his fiduciary duty to the investor by failing to disclose or learn facts about the Madoff scheme); CMMF, LLC v. J.P. Morgan Inv. Mgmt., Inc., 992 N.Y.S.2d 158 (N.Y. Sup. Ct. 2013) (holding that the investment advisor was not liable for breach of fiduciary duties in purchasing and holding certain risky funds during the 2007 Housing Crisis).

[53] *See, e.g.*, R.W. Grand Lodge of Free & Accepted Masons of Pa. v. Meridian Capital Partners, Inc. (*In re* Meridian Funds Grp. Sec. & Emp. Ret. Income Sec. Act Litig.), No. 09-CV-7099 (TPG), 2015 WL 1258380, at *1 (S.D.N.Y. Mar. 13, 2015) (asserting that defendants secured plaintiff's investment through fraudulent action related to the Madoff scheme); Elendow Fund, LLC v. Rye Select Broad Mkt. XI Fund (*In re* Tremont Sec. Law, State Law, & Ins. Litig.), No. 08 Civ. 11117, 2013 WL 5179064, at *1 (S.D.N.Y. Sept. 16, 2013)

duties defendants owed to plaintiffs;[54] due diligence as a fiduciary duty;[55] SEC enforcement actions;[56] failure to monitor;[57] and securities fraud as a result of lacking due diligence.[58]

---

aff'd. Elendow Fund, LLC v. Rye Inv. Mgmt., 588 F. App'x 27 (2d Cir. 2014) (alleging defendant misrepresented the due diligence it performed on fund managers, and that it was induced to invest by certain representations that proved to be false); Schwarz v. ThinkStrategy Capital Mgmt. LLC, No. 09 Civ. 9346 (PAE), 2012 WL 2026365, at *1 (S.D.N.Y. May 31, 2012) (holding that the defendant was liable for fraud in misrepresenting the extent of its due diligence in connection with the hedge funds in which the defendant invested); *In re* J.P. Jeanneret Assocs., Inc., 769 F. Supp. 2d 340, 355 (S.D.N.Y. 2011) (stating that investors sufficiently asserted claims against investment advisor for fraud involving investments that turned out to be part of a Ponzi scheme; *In re* Optimal U.S. Litig., 813 F. Supp. 2d 351, 358 (S.D.N.Y. 2011) (asserting that defendants failed to conduct adequate due diligence regarding Madoff, ignored red flags, and made misstatements and omissions in connection with the sale of Optimal shares); Schwarz v. ThinkStrategy Capital Mgmt. LLC, 797 F. Supp. 2d 439, 442–43 (S.D.N.Y. 2011) (alleging that defendants misrepresented the scope and nature of due diligence conducted on potential investments and the process by which investment decisions were made); *In re* Beacon Assocs. Litig., 745 F. Supp. 2d 386, 413–14 (S.D.N.Y. 2010) (finding that plaintiffs sufficiently alleged that defendants had knowledge that public statements regarding a feeder fund were not accurate, and ultimately did nothing to address the risks); Cambridge Place Inv. Mgmt. v. Morgan Stanley & Co., No. SUCV2010--2741-BLS1, 2012 WL 5351233, at *1 (Mass. Super. Oct. 2, 2012) (alleging that defendants made misleading statements in their offers to sell residential mortgage-backed securities, in violation of the Massachusetts Uniform Securities Act); FutureSelect Portfolio Mgmt., Inc. v. Tremont Grp. Holdings, Inc., 309 P.3d 555, 557, 565 (Wash. Ct. App. 2013) (finding that the plaintiffs' allegations regarding losses suffered from a Ponzi scheme were sufficient to state claims of securities fraud and negligent misrepresentation).

[54] *See, e.g.*, Sapirstein-Stone-Weiss Found. v. Merkin, 950 F. Supp. 2d 621, 624 (S.D.N.Y. 2013) (alleging that an advisor's failure to conduct due diligence in connection with a hedge fund's investments with Madoff violated common law and contractual duties owed to plaintiffs).

[55] *See, e.g.*, Hunnicutt & Co. v. Thinkstrategy Capital Mgmt., LLC, 910 N.Y.S.2d 762 (N.Y. Sup. Ct. 2010) (finding that the advisor was liable for breach of fiduciary duty in failing to conduct due diligence).

[56] *See, e.g.*, SEC v. Quan, Civ. No. 11-723 ADM/JSM, 2013 WL 5566252, at *35 (D. Minn. Oct. 8, 2013) (holding that there were genuine issues of fact surrounding whether due diligence representations made in flipbooks and private placement memoranda were fraudulent).

Plaintiffs will often set out specific industry practices (or lack thereof) as evidence that the fund failed to perform proper due diligence.[59] Common allegations of due diligence violations include failure to: (1) collect information about fund managers;[60] (2) assess the fund's experience, credibility, and transparency;[61] (3) interview hedge fund personnel from the top down;[62] (4) study individual positions in regard to its off-balance sheet transactions;[63] (5) review audited financial statements, check on references, confirm the prime banking relationship, and verify the auditor;[64] (6) monitor an investment once it is made, and perform ongoing and continuous quantitative and

---

[57] *See, e.g.*, Metro. Life Ins. Co. v. Tremont Grp. Holdings, Inc., C.A. No. 7092-VCP, 2012 WL 6632681, at *65–67 (Del. Ch. Dec. 20, 2012) (determining that the plaintiffs had pleaded facts sufficient to show fraud, as defendants made false statements regarding its due diligence and monitoring practices, received millions in fees, and had an interest in deceiving the investors).

[58] *See, e.g.*, S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 99 (2d Cir. 2009) (alleging that defendants committed securities violations in failing to learn and disclose that a hedge fund that plaintiff invested in was involved in a Ponzi Scheme); Matana v. Merkin, No. 13 Civ. 1534 (PAE), 2014 WL 426857, at *9–15 (S.D.N.Y. Feb. 4, 2014) (determining that defendant did not commit fraud by failing to disclose or learn facts about the Madoff Ponzi Scheme); Prickett v. N.Y. Life Ins. Co., 896 F. Supp. 2d 236 (S.D.N.Y. 2012) (holding that policyholder's fraud claim failed because there was no sufficient evidence showing that defendants acted with scienter in failing to conduct due diligence).

[59] *See* cases cited *infra* notes 60–73.

[60] *See S. Cherry St.,* 573 F. Supp. 3d at 98; Schwarz v. ThinkStrategy Capital Mgmt. LLC, No. 09 Civ. 9346 (PAE), 2012 WL 2026365, at *4 (S.D.N.Y. May 31, 2012).

[61] *See S. Cherry St.*, 573 F. Supp. 3d at 100; *Schwarz,* 2012 WL 2026365, at *24–25 ("[H]edge fund due diligence . . . ordinarily entailed inquiries to verify: (1) the backgrounds of sub-funds' managers and other key personnel; (2) that the sub-funds were audited; (3) that the sub-funds' service providers were reputable; and (4) that their technology and infrastructure . . . were satisfactory.").

[62] *See S. Cherry St.*, 573 F. Supp. 3d at 100.

[63] *See In re* Bayou Hedge Fund Litig., 534 F. Supp. 2d 405, 409 (S.D.N.Y. 2007), *aff'd S. Cherry St.*, 573 F.3d 98 (2009).

[64] *See S. Cherry St.*, 573 F.3d at 100–01; *In re* Optimal U.S. Litig. 813 F. Supp. 2d 351, 382–83 (S.D.N.Y. 2011).

qualitative analysis;[65] (7) take steps to prove accounting firm actually exists;[66] (8) save on due diligence costs by not providing those services at all;[67] (9) analyze publicly available Form ADV and other publicly available fund documentation;[68] (10) audit or assess relevant audited

---

[65] *See S. Cherry St.,* 573 F.3d at 104 (alleging that the defendant promised in writing to perform extensive pre- and post-recommendation ongoing due diligence); *Schwarz,* 2012 WL 2026365, at *3 ("Kapur also stated that he would hold an in-person meeting with potential sub-fund managers before investing in any fund, 'that assets under management would be independently verified, [and] that due diligence was an ongoing process that would continue even after money had been invested in the sub-fund."); Pension Comm. of Univ. of Montreal Pension Plan v. Banc of Am. Secs. LLC, 691 F. Supp. 2d 448, 459–60 (S.D.N.Y. 2010) (arguing that the defendant did not perform adequate qualitative analysis of financial instruments and portfolios).

[66] *See S. Cherry St.,* 573 F.3d at 102–03 ("Despite the fact that HHCO had 'stopped auditing Bayou Fund in 1998, and never audited any of the Bayou Family Funds once they were established in 2003, Hennessee Group represented to South Cherry that Bayou [Accredited], and the Bayou Family Funds, were audited by HHCO."); *In re* Meridian Funds Grp. Sec. & Emp. Ret. Income Sec. Act (ERISA) Litig., No. 09-CV-7099 TPG, 2015 WL 1258380, at *4 (S.D.N.Y. Mar. 13, 2015) ("BMIS employed an obscure auditing firm with only three employees. Such a tiny firm could not have adequately audited a firm like BMIS, managing billions of dollars."); SEC v. Quan, No. Civ. 11-723 ADM/JSM, 2014 WL 4670923, at *9–10 (D. Minn. Sept. 19, 2014) (alleging that the defendant never retained a major accounting firm despite its PPMs that represented that investments would be protected by a major accounting firm to examine the books of any intermediary); *Schwarz*, 2012 WL 2026365, at 10–11* (alleging how the Hedge Fund company failed to verify the auditor for several funds); *In re* Bernard L. Madoff Inv. Sec. LLC, 515 B.R. 117, 134 (Bankr. S.D.N.Y. 2014) (observing that that the defendant ignored warnings of industry professionals who asserted that the defendant's failure to use a large, public accounting firm was a "potential red flag").

[67] *See S. Cherry St.,* 573 F.3d 98 at 100–01.

[68] *See* Matana v. Merkin, No. 13 Civ. 1534 (PAE), 2014 WL 426857, at *4 (S.D.N.Y. Feb. 4, 2014) (arguing that fraudulent intent could be inferred from the defendant's failure to check Madoff's publicly available Form ADV); *In re* Tremont Sec. Law, State Law, & Ins. Litig., No. 08 Civ. 11117, 2013 WL 5179064, at *7 (S.D.N.Y. Sept. 16, 2013) *aff'd.* Elendow Fund, LLC v. Rye Inv. Mgmt., 588 F. App'x 27 (2d Cir. 2014) (alleging defendant's Form ADV contained specific, false statements concerning its due-diligence program, including statements that defendant "engaged with custodians on a daily basis, monitored their securities holdings, asset mix and adherence to investment

financial statements;[69] (11) use a private investigator to perform internal background checks and reference checks on prospective sub-fund managers;[70] (12) conduct in-person interviews of sub-fund managers;[71] (13) inquire about fund controls;[72] and (14) analyze projections, royalty arrangements, and license agreements.[73]

---

guidelines, and used its own proprietary software to continually evaluate managers' performance") (internal quotes omitted).

[69] *See S. Cherry St.,* 573 F.3d at 100–01; *Schwarz*, 2012 WL 2026365, at *7 ("The files similarly lacked evidence that ThinkStrategy had conducted site visits or in-person interviews with sub-fund managers."); Schwarz v. ThinkStrategy Capital Mgmt. LLC, 797 F. Supp. 2d 439, 445 (S.D.N.Y. 2011) (observing that while the defendants represented to the plaintiffs that they invested only in audited sub-funds, the defendants invested in some sub-funds that were not audited); *In re Optimal U.S. Litig.,* 813 F. Supp. 2d at 359 (alleging that the internal quantitative due diligence software showed that Madoff's returns could not be replicated and were mathematically implausible, and that Madoff did not have independent auditors); *In re* Bayou Hedge Fund Litig., 534 F. Supp. 2d 405, 410 (S.D.N.Y. 2007) *aff'd S. Cherry St.*, 573 F.3d 98 (2009) (alleging that even if the defendant employed an independent accountant, there were not sufficient audited financial statements to recommend the fund).

[70] *See Schwarz,* 2012 WL 2026365, at *7.

[71] *See id.*

[72] *See id*. (alleging that the defendant did not investigate the fund's internal controls, over which an inexperienced fund manager had centralized control and sole signing authority over fund disbursements); *In re* Beacon Associates Litig., 745 F. Supp. 2d 386, 420 (S.D.N.Y. 2010) (discussing the defendant's failure to comply with the investment strategy they purported to follow, and decision to invest in Madoff, despite knowledge that Madoff did not comply with that strategy); Cambridge Place Inv. Mgmt., Inc. v. Morgan Stanley & Co., No. CIV.A. 10-2741-BLS1, 2012 WL 5351233, at *2 (Mass. Super. Sept. 28, 2012) ("Underwriting financial institutions that profited from the securitizations sought increasing volumes of mortgage loans from the originators who, exercising their increased bargaining power, demanded that the underwriters limit their quality control reviews to a smaller percentage of loans.").

[73] *See* Baker v. Goldman Sachs & Co., 949 F. Supp. 2d 298, 309 (D. Mass. 2013) (admitting that Goldman did not get adequate information regarding revenues and organic growth, and did not receive its royalty arrangements or license agreements).

III. Data & Trends

To comprehensively assess the evolution of private fund IDD standards over the past twenty years, and to provide the industry and investors with guidance, the author surveyed multiple data sources. Data sources examined for this study include: (1) private investment funds' SEC Form ADV II filings from 2007 to 2014 (N=100392) (the offering brochures provided to investors that discuss fund strategy and governance), (2) the publicly available litigation record pertaining to private fund IDD from 1995 to 2015 (N=572) (taken both from published and unpublished judicial opinions and their litigation dockets as provided by Bloomberg and Pacer), and (3) expert testimony (as surveyed from Westlaw's Expert Testimony database). The author examines each data source and highlights commonalities, knock-on effects, and possible causes for trends and changes in trends.

A. SEC Form ADV Part II: 2007 to 2014

Investment advisers are required by the SEC to register with the SEC and state securities authorities.[74] SEC Form ADV II is a uniform SEC form. Part I of SEC Form ADV II requires the investment adviser to disclose information about its business, ownership, clients, employees, business practices, affiliations, and any disciplinary events of the adviser or its employees.[75] The SEC reviews the information in ADV II to process investment adviser registrations and to conduct its regulatory and examination programs.[76] Since 2011, the SEC has required investment advisers that file ADV II to prepare narrative brochures containing information regarding the educational and business background of management and key advisory personnel of the adviser, disciplinary information, the types of advisory services offered, the adviser's fee schedule, and conflicts of interest.[77] The

---

[74] *Fast Answers—Form ADV*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/answers/formadv.htm [https://perma.cc/EF29-NTH4] (last updated Mar. 11, 2011) (explaining the registration process).

[75] U.S. SEC. & EXCH. COMM'N, OMB NO. 3235-0049, FORM ADV (2011) [hereinafter FORM ADV]. Investment adviser filings of ADV II Part 1 are available to the public on the SEC's Investment Adviser Public Disclosure (IAPD) website at www.adviserinfo.sec.gov.

[76] *Fast Answers—Form ADV*, *supra* note 74 (explains the review process).

[77] FORM ADV, *supra* note 75 (requiring investment advisors to report information such as that enumerated by the author).

narrative brochure is a core disclosure document investment advisers make available to their clients.[78] Upon filing, the investment adviser's SEC Form ADV II is available to the public on the IAPD website.[79]

Year	Form ADVII Filings	Mention DD	DD Counts	Ratio 1	Ratio 2
2007	1123	159	257	0.14158504	0.228851291
2008	2109	353	683	0.167377904	0.323850166
2009	2940	477	998	0.162244898	0.339455782
2010	3024	571	1383	0.188822751	0.45734127
2011	21685	5843	14816	0.269448928	0.683237261
2012	27320	7862	20828	0.287774524	0.762371889
2013	20256	7198	20031	0.355351501	0.98889218
2014	21935	7869	22573	0.358741737	1.029085936

Ratio 1: ADV II Filings/Filings Mentioning DD; Ratio 2: ADV II Filings/DD Counts

Table 1—SEC Form ADV II filings from 2007 to 2014 (N=100392). The author filed a Freedom of Information Act request with the SEC and obtained all available SEC Form ADV Part II brochure filings between years 2007 and 2014. "DD Counts" means total mentions of "due diligence" within Form ADV II filings. "Filings Mentioning DD" means the total number of filings in which "due diligence" appears at least once. The author completed the Form ADV II search using Adobe Acrobat Pro IX's Advanced Search function. The displayed ratios were generated by dividing total number of ADV II filings per year by "Filings Mentioning DD" and "DD Counts" from 2007 to 2014.

Table 1 shows the SEC Form ADV II filings from 2007 to 2014. After 2010, a noticeable increase in filings—from 3,024 filings in 2010 to 21,685 filings in 2011—is accompanied by a corresponding increase in filings mentioning IDD and an increase in the due diligence counts in such filings. While the overall filings between 2012 and 2013 depreciated, the ratio of due diligence counts is only marginally affected (depreciating from 20,828 to 20,031) and filings that mention due diligence decreased (depreciating from 7,862 to 7,198) in relation to the overall filing depreciation. This can be interpreted as a

---

[78] *Fast Answers—Form ADV*, *supra* note 74 (explaining the use of the disclosed information).

[79] INV. ADVISOR PUB. DISCLOSURE, http://www.adviserinfo.sec.gov [https://perma.cc/CWE6-LUZ3] (providing investment advisers' SEC Form ADV II filings).

heightened emphasis by filing companies on IDD explanations both with regards to the overall period from 2007 to 2014, and especially during 2012 and 2013.

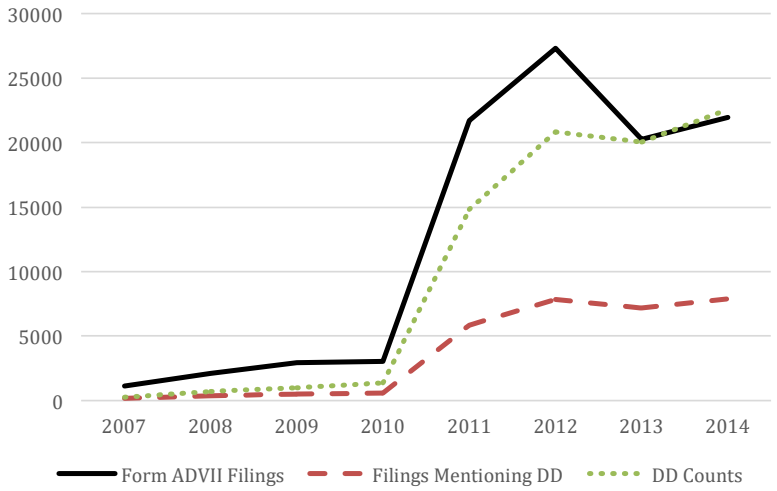

Figure 1—SEC Form ADV II filings from 2007 to 2014 (N=100392) compared with SEC Form ADV II Filings Mentioning Due Diligence Once and Form ADV II Due Diligence Counts from 2007 to 2014. The author filed a Freedom of Information Act request with the SEC and obtained all available SEC Form ADV Part II brochure filings between 2007 and 2014. "DD Counts" means total mentions of "due diligence" within Form ADV II filings. "Filings Mentioning DD" means the total number of filings in which "due diligence" appears once. The author completed the Form ADV II search using Adobe Acrobat Pro IX. The displayed ratios were generated by dividing the total number of ADV II filings per year by "Filings Mentioning DD" and "DD Counts" from 2007 to 2014.

Figure 1 illustrates the relationship between the overall count of Form ADV II brochure filings between 2007 and 2014 and Form ADV II brochure filings that mention IDD at least once. Figure 1 also sets this relationship in contrast with the quantitative mentioning of due diligence filings between 2007 and 2014. The pre-2010 Form ADV II brochure filings are miniscule, and due diligence does not play a significant role in the pre-2010 Form ADV II disclosures. While an increasing number of ADV II brochure filers included IDD disclosures since 2010, the number of filers who include those disclosures has

remained relatively consistent between 2012 and 2014. The intensity of IDD mentioning relative to total Form ADV II brochure filings, however, has increased substantially, and the due diligence count exceeds the total ADV II filings for the first time in 2014. The data suggests that Form ADV II brochure filers have taken IDD disclosures in Form ADV II much more seriously since the year 2010 and especially since 2012. Filers appear to see a need for increased IDD disclosures in Form ADV II between 2011 and 2014.

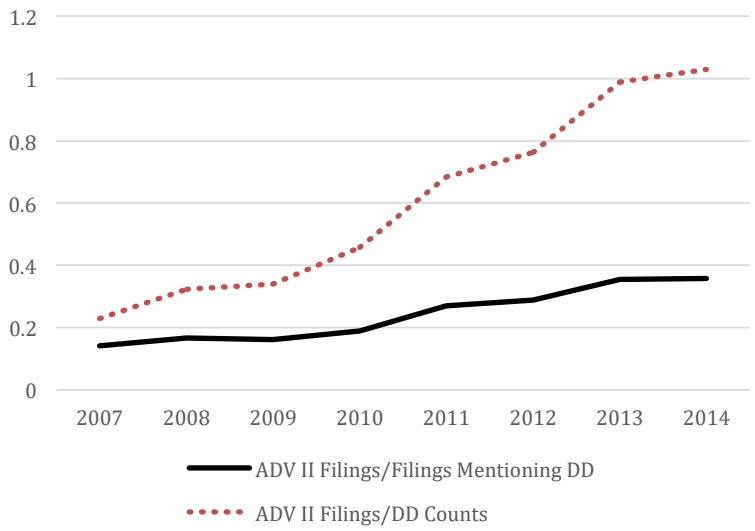

Figure 2—Ratio of Form ADV II Filings/ Form ADV II Filings Mentioning Due Diligence and Ratio of Form ADV II Filings/ Form ADV II Due Diligence Counts from 2007 to 2014 (N=100392). The author filed a Freedom of Information Act request with the SEC and obtained all available SEC Form ADV Part II brochure filings between years 2007 and 2014. "DD Counts" means total mentions of "due diligence" within Form ADV II filings. "Filings Mentioning DD" means the total number of filings in which "due diligence" appears once. The author completed the Form ADV II search using Adobe Acrobat Pro IX. The displayed ratios were generated by dividing the total number of ADV II filings per year by "Filings Mentioning DD" and "DD Counts" from 2007 to 2014.

Figure 2 shows that between 2007 and 2014 the overall amount of Form ADV II brochure filings in relation to due diligence mentioning therein is increasing at a significant rate. Figure 2

demonstrates that both the overall intensity of IDD mentioning in Form ADV II brochure filings increased substantially, but also that the quantity of Form ADV II brochure filings with at least one reference to IDD is increasing. In sum, Figure 2 demonstrates that from 2007 to 2014 an increasing number of ADV II filers deem IDD worth mentioning, and an increasing number of ADV II filers qualitatively increased their due diligence disclosures in Form ADV II brochure filings.

The data analysis in Figures 1 and 2 is limited by multiple possible meanings of the term due diligence.[80] An evaluation of the three disparate respective meanings of the term due diligence in the Form ADV II brochure filings would require a full contextual search and separate evaluation of each term in the respective context in the entire Form ADV II brochure filings dataset.

B. Litigation Record: 1995 to 2015

To assess the legal standards applied to private fund IDD, the author used Westlaw searches of published and unpublished cases occurring at both the federal and state level. Litigation research requires an in-depth evaluation of case dockets rather than published judicial decisions.[81] The author's quantitative coding took account of

---

[80] *See* discussion *supra* Part II.

[81] Margo Schlanger & Denise Lieberman, *Using Court Records for Research, Teaching, and Policymaking: The Civil Rights Litigation Clearinghouse*, 75 U.M.K.C. L. REV. 155, 163 (2006) ("[O]pinions do not tell the entire story of a litigation. Opinions are, rather, snapshots of the case at one particular point in time. That point may be a particularly crucial one, but it may not."). For similar approaches, see, e.g., James D. Cox et al., *There are Plaintiffs and . . . There are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 VAND. L. REV. 355, 358 (2008) ("In this Article, we examine the impact of the PSLRA and, more particularly, the impact of the type of lead plaintiff on the size of settlements in securities fraud class actions."); Jessica M. Erickson, *Over Litigating Corporate Fraud: An Empirical Examination*, 97 IOWA L. REV. 49, 58 (2011) ("I first used the Dockets database in Westlaw to identify the shareholder derivative suits . . . I then accessed the entire case records for these suits . . . ."); David A. Hoffman et al., *Docketology, District Courts, and Doctrine*, 85 WASH. U. L. REV. 681, 684 (2007) ("We suggest an alternative story, which is not ruled out by the data, and hypothesize that trial court opinion writing is motivated by the fear of reversal."); Margo Schlanger, *Inmate Litigation*, 116 HARV. L. REV. 1555, 1562 (2003) ("I begin, in Part I, by looking at the cases in the courthouse, focusing by necessity on federal

published and unpublished judicial decisions, and provides a more in-depth analysis by consulting the dockets associated with the respective decisions. After providing visualizations of how many court cases were mentioning both private funds and due diligence practices (N=672), the author hand-selected cases that involved lawsuits against private funds that had substantial content in which the court evaluated due diligence (N=36). Selected cases were then evaluated for both content, the complaints' causes of action, and jurisdiction of filing.

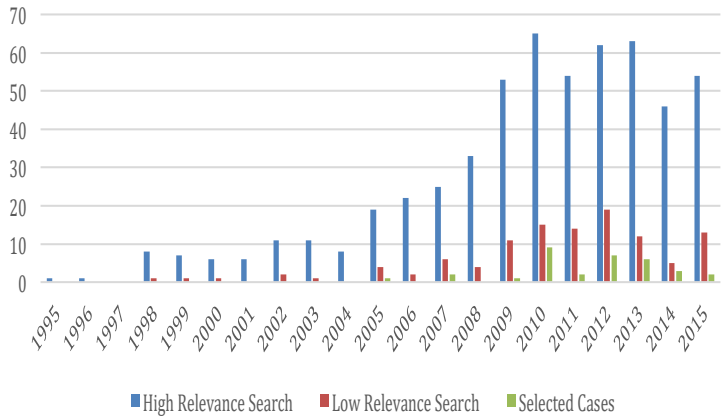

Figure 3—Private Fund IDD Cases - Westlaw Search on Case Law between 1995 and 2015. The Broad Measure/Low Relevance is a Westlaw search of all cases that include private fund, "due diligence," and the following search parameters: adv: ("hedge fund" "private fund" "private equity") AND "due diligence" filed between 1995 and 2015 (N=572). The Narrow Measure/High Relevance is a Westlaw search of all cases that included "private fund" and "due diligence" in the same paragraph (N=118). The Narrow Measure/High Relevance Search on Westlaw had the following search parameters: adv: "due diligence" /p ("private fund" "private equity" "hedge fund") filed

---

filings . . . In Part II, I continue the examination of the inmate docket, looking at the outcomes of the cases . . . ."); Ronald F. Wright, *Trial Distortion and the End of Innocence in Federal Criminal Justice*, 154 U. PA. L. REV. 79, 83 (2005) (developing a 'trial distortion' theory based on case data).

between 1995 and 2015. "Selected cases" refers to the cases that were hand-selected for highly relevant content and analysis (N=32).[82]

Figure 3 shows that the legal decisions involving private fund due diligence have substantially increased since 2005, but especially since 2008. Cases involving IDD in the broad, narrow, and selected case categories all consistently increased overall, with a slight lapse in 2014. Overall, the data on case law between 1995 and 2015 suggests that private fund IDD has reached new and lasting prominence in the court system. The increasing caseload on private fund IDD since 2005 could suggest that applicable legal standards need to be clarified to protect investors.

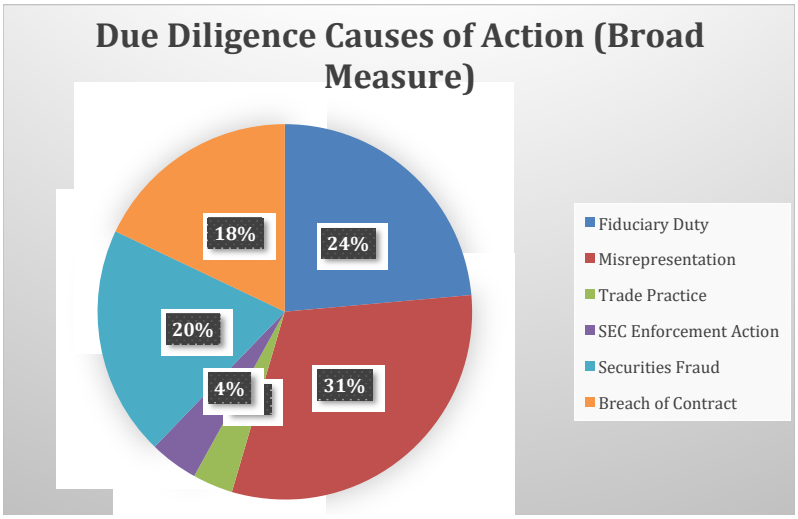

Figure 4a—IDD Causes of Action Based on Westlaw Search on Federal Case Law between 1995 and 2015. Broad Measure is a Westlaw search of all cases that include private fund, "due diligence," and the following causes of action: Search adv: ("hedge fund" "private fund" "private equity") AND "due diligence" (N=572).

[82] "Selected Cases" are the small sub-set of hand-selected cases that dealt specifically with private fund due diligence in which the court devotes substantial time to evaluating due diligence practices (two or more paragraphs). See list of cases in Appendix A.

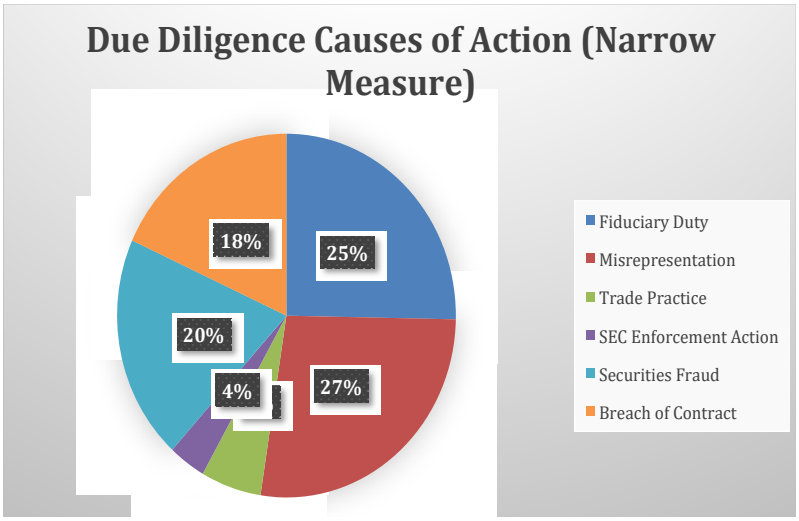

Figure 4b—IDD Causes of Action Based on Westlaw Search on Federal Case Law between 1995 and 2015. Narrow Measure is a Westlaw search of all cases that include private fund and "due diligence" in the same paragraph and the following causes of action (Fiduciary Duty, Misrepresentation, Trade Practices, Securities Fraud, Breach of Contract). Search: adv: "due diligence" /p ("private fund" "private equity" "hedge fund") (N=118).

Figures 4a and 4b show that the largest categories of causes of action for IDD from 1995 to 2015 involved in order of preference: (1) misrepresentation, (2) fiduciary duties, (3) securities fraud, and (4) breach of contract. These categories and the order of preference are consistent across broad and narrow search methods.

Unlike Figure 4, in the hand-selected sample of cases in Figure 5, the leading causes of action were by order of preference: (1) fiduciary duty, (2) negligent misrepresentation, (3) breach of contract.

Figure 5—Causes of Action in Hand-Selected Cases (N=32) from 1995 to 2015. After completing searches on Westlaw for cases dealing with due diligence and private funds in both a narrow and broad relevance search from 1995 to 2015, the author hand-selected cases (N=32) with highly relevant content and analysis. After the sample selection, the author obtained the dockets on Bloomberg for the selected cases. Figure 5 displays the causes of action listed in the respective plaintiff's complaint against the private fund adviser defendants. Because cases in the hand-selected subsample involved multiple causes of action, the breakdown of causes of action exceeds the total of thirty-two cases.

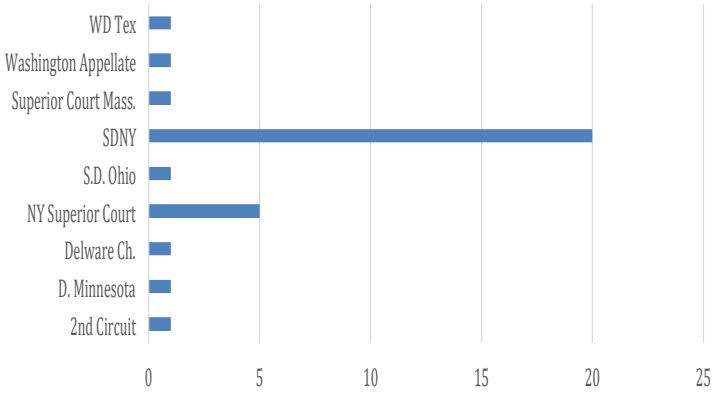

Figure 6—Courts' Jurisdiction and Geographic Location in Hand-Selected Cases (N=32) from 1995 to 2015. After completing searches on Westlaw for cases dealing with due diligence and private funds in both a narrow and broad relevance search from 1995 to 2015, the author hand-selected cases (N=32) with highly relevant content and analysis. Figure 6 shows the jurisdictions/courts where the respective actions were filed.

Figure 6 shows that the overwhelming majority of case law in the hand-selected subsample (N=32) originates in the Southern District of New York.

1. Legal Standards

Figure 3 indicates that the litigation record of private fund IDD has most substantially increased between 2005 and 2015. While some courts in that period found that a complete lack of IDD can amount to securities fraud and/or breach of contract,[83] and lack of IDD

[83] *See* S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 114 (2d Cir. 2009); Matana v. Merkin, No. 13 Civ. 1534 (PAE), 2014 WL 426857, at *4 (S.D.N.Y. Feb. 4, 2014) (finding the defendant had no duty to monitor or investigate Madoff's public filings such that a failure to do so would give rise to an inference of fraudulent intent); *In re* Bayou Hedge Fund Litig., 534 F. Supp. 2d 405, 416 (S.D.N.Y. 2007) ("Even South Cherry's alternative allegation that Hennessee Group failed to perform due diligence commensurate with industry standards is inadequate to plead scienter.").

can be a breach of fiduciary duties,[84] the majority of courts evaluate issues pertaining to private fund IDD in the context of misrepresentation.[85] Other issues regarding IDD evaluated by courts involved: the contractual and common law duties due diligence defendants owed to plaintiffs,[86] failure to monitor,[87] and securities

---

[84] *See Matana*, 2014 WL 426857, at *3; CMMF, LLC v. J.P. Morgan Inv. Mgmt., Inc., 992 N.Y.S.2d 158, at 23–24 (N.Y. Sup. Ct. Aug. 21, 2013); Hunnicutt & Co. v. Thinkstrategy Capital Mgmt., LLC, 910 N.Y.S.2d 762, at *5 (N.Y. Sup. Ct. Apr. 27, 2010) (finding that plaintiffs sufficiently alleged a breach of fiduciary duty for failure to exercise due diligence in connection with the defendant's investment in a Ponzi scheme, where an internet search would have revealed sufficient information to put the defendants on notice that further due diligence was required).

[85] *See In re* Meridian Funds Grp. Sec. & Employee Ret. Income Sec. Act (ERISA) Litig., No. 09-CV-7099 TPG, 2015 WL 1258380, at *6 (S.D.N.Y. Mar. 13, 2015); *In re* Tremont Sec. Law, State Law, & Ins. Litig., No. 08 Civ. 11117, 2013 WL 5179064, at *8 (S.D.N.Y. Sept. 16, 2013) *aff'd.* Elendow Fund, LLC v. Rye Inv. Mgmt., 588 F. App'x 27 (2d Cir. 2014); Schwarz v. ThinkStrategy Capital Mgmt., No. 09 Civ. 9346 (PAE), 2012 WL 2026365, at *15 (S.D.N.Y. May 31, 2012) (holding that the defendants had a fiduciary duty to plaintiffs that required them to give correct information as to their due diligence practices); *In re* Optimal U.S. Litig., 813 F. Supp. 2d 351, 365–66 (S.D.N.Y. 2011); Schwarz v. ThinkStrategy Capital Mgmt., 797 F. Supp. 2d 439, 447 (S.D.N.Y. 2011) ("Plaintiffs have adduced evidence from which a reasonable trier of fact might conclude that defendant Kapur's statements to plaintiffs on behalf of ThinkStrategy regarding its due diligence and investment processes were false when made, that he knew at the time that they were false, and that he made the representations not believing or intending that ThinkStrategy would perform due diligence and make its future investment decisions in conformity with those representations."); *In re* J.P. Jeanneret Assocs., 769 F. Supp. 2d 340, 358 (S.D.N.Y. 2011) ("Both the fact of the misrepresentation about performing due diligence and its materiality to a reasonable investor are patent."); *In re* Beacon Associates Litig., 745 F. Supp. 2d 386, 412 (S.D.N.Y. 2010) ("[W]hen a business promises to conduct due diligence, but is incompetent or mismanaged and fails to uphold its promise, an aggrieved investor's remedy lies in a breach of contract action rather than a federal securities fraud action."); FutureSelect Portfolio Mgmt. v. Tremont Grp. Holdings, 309 P.3d 555, 566 (Wash. App. 2013).

[86] *See, e.g.*, Sapirstein-Stone-Weiss Found. v. Merkin, 950 F. Supp. 2d 621, 624–25 (S.D.N.Y. 2013) (alleging the defendant's failure to conduct due diligence on investments with Madoff was unreasonable and violated the contractual and common law duties Defendants owed to Plaintiffs).

[87] *See, e.g.*, Metro. Life Ins. Co. v. Tremont Grp. Holdings, Inc., No. Civ.A. 7092-VCP, 2012 WL 6632681, at *15 (Del. Ch. Dec. 20, 2012) (alleging facts

fraud.[88] The SEC in its enforcement actions also had to address whether due diligence representations in private placement memoranda and flipbooks were fraudulent.[89]

Successful lawsuits in the context of lacking IDD typically require a complete lack of due diligence despite explicit promises to perform such due diligence.[90] Promising to conduct due diligence and then failing to conduct any (except in isolated incidents), is actionable misrepresentation.[91] Relying solely on an investment or fund representation and not actually performing due diligence is sufficient to present an issue of fact to a jury for fraud.[92] A jury might reasonably find that a defendant's representations were knowingly false and that the defendant acted intentionally and/or recklessly in making those false statements in order to induce plaintiffs to invest, in cases where the fund manager, after representing to clients he conducted due diligence, failed to: (1) use an investigative firm to conduct a

---

sufficient to support an inference of breach of duty for failure to analyze, evaluate, and monitor Madoff investments).

[88] *See, e.g.*, *S. Cherry St.*, 573 F.3d at 103; *Matana*, 2014 WL 426857, at *4; Prickett v. N.Y. Life Ins. Co., 896 F. Supp. 2d 236, 246 (S.D.N.Y. 2012); *Metro. Life Ins. Co.*, 2012 WL 6632681, at *17.

[89] *See* SEC v. Quan, Civ. No. 11-723 ADM/JSM, 2013 WL 5566252, at *13 (D. Minn. Oct. 8, 2013) (denying the defendant's motions for summary judgment on due diligence representations). Although not specifically studied in this paper, one should note the SEC administrative (i.e. non-criminal) actions against funds for due diligence violations. *E.g.*, *In re* Hennessee Group LLC, Investment Advisers Act Release No. 2871, 95 SEC Docket 2049, 2009 WL 1077451 at *5–6 (Apr. 22, 2009) (finding breach of fiduciary duties to clients for defendant's failure to perform two elements of the due diligence evaluation that it had told its clients and prospective clients that it would do).

[90] *See Sapirstein-Stone-Weiss Found.*, 950 F. Supp. 2d at 621; *Schwartz*, 2012 WL 2026365, at *1; *In re* Beacon Assocs. Litig., 745 F. Supp. 2d 386 (S.D.N.Y. 2010); Cambridge Place Inv. Mgmt., Inc. v. Morgan Stanley & Co., Inc., Nos. 10-2741-BLS1, 11-4605-BLS1, 2012 WL 5351233 (Mass. Sup. Ct. Sept. 28, 2012).

[91] *See Schwarz*, 2012 WL 2026365, at *15 (S.D.N.Y. May 31, 2012) (finding the defendants had a fiduciary to plaintiffs to give them the correct information regarding the defendant's due diligence practices).

[92] *See e.g.*, *Sapirstein-Stone-Weiss Found.*, 950 F. Supp. 2d at 625 ("[A]dmitted failure to conduct any due diligence of Madoff whatsoever not only violates Defendants' covenant to exercise reasonable care in selecting third-party investment managers, but also establishes that Defendants' alleged omissions and representations in the Offering Memoranda and Quarterly Letters were made with full knowledge of their falsity.").

background check on any prospective sub-fund or sub-fund manager, (2) speak to anyone other than the fund director to verify biographical data, or (3) invest in funds that were audited.[93]

For example, "knowledge that [an advisor] had stopped performing due diligence, coupled with fact that" an owner simultaneously admitted that a consulting firm "was unable to replicate" the investment company's "results on its own rendered [the firm's] prior promise to supervise clients' investments materially misleading".[94] Knowledge of lacking due diligence creates the "duty to update and/or correct prior representations" of due diligence.[95] Further, an allegation that "defendants ignored their own stated practices as they sought increasing volumes of mortgage loans and acceded to the originators' demands for limited quality control" is sufficient to withstand a motion to dismiss with respect to the defendants' due diligence.[96]

Cases dealing with due diligence as securities fraud often hinge on scienter, "the lack of diligence, constructive fraud, or unreasonable or negligent conduct of the defendant."[97] Courts hold that the lack of due diligence, beyond merely being negligent or just professionally incompetent, must be intentional or highly reckless.[98] In lieu of intent, a defendant is required to show reckless disregard for the truth in order for the plaintiff to successfully plead securities fraud.[99]

---

[93] *See Schwarz,* 2012 WL 2026365, at *3–10 (elaborating that plaintiff repeatedly asked defendant about its due diligence practices and was induced to invest, and encouraged family members to do the same, based on defendant's representations, which were knowingly false).

[94] *In re Beacon Assocs. Litig*., 745 F. Supp. 2d at 415.

[95] *Id.* ("losses from fraud were within the zone of risk concealed by the failure to disclose that no due diligence was performed" on the investment company).

[96] *Cambridge Place Inv. Mgmt., Inc*., 2012 WL 5351233, at *21.

[97] Margot A. Metzner, *The Due Diligence Requirement for Plaintiffs Under Rule 10b-5*, 1975 DUKE L.J. 753, 758 (1975) (internal quotations omitted) (citation omitted).

[98] *See S. Cherry St., LLC v. Hennessee Grp., LLC*, 573 F.3d 98, 109 (2d Cir. 2009) ("Every Court of Appeals that has considered the issue has held that a plaintiff may meet the scienter requirement' for civil liability under § 10(b) and Rule 10b-5 'by showing that the defendant acted [either] intentionally or recklessly. . . ." (quoting Tellabs, Inc. v. Makor Issues & Rights, LTD, 551 U.S. 308 (2007)) (internal quotations omitted).

[99] *Id*. ("By reckless disregard for the truth, we mean 'conscious recklessness—*i.e.*, a state of mind *approximating actual intent,* and *not merely a heightened form of negligence,*' . . . In elaborating as to what may constitute

Defendants have "a duty to use reasonable care in conducting financial due diligence consistent with standards of care in the profession."[100] Defendants have been held to have been negligent for not adequately analyzing revenue, reviewing license agreements, scrubbing projections, and assessing accounting issues.[101] While irresponsible, the lack of checking public documentation on an investment is insufficient to plead fraudulent intent,[102] and "[failing] to perform due diligence commensurate with industry standards is inadequate to plead scienter."[103]

Fiduciary duty obligations are another core area in private fund IDD litigation.[104] Failure to supervise and direct investment of assets in accordance with an investment plan's investment policy, and offering memoranda or quarterly letters with misrepresentations of due diligence processes can demonstrate a failure to exercise reasonable care and sufficient to plead breach of fiduciary duty.[105] Finally, as a

---

recklessness in the context of a private securities fraud action, we have referred to conduct that 'at the least . . . is highly unreasonable and which represents an extreme departure from the standards of ordinary care to the extent that *the danger was either known to the defendant or so obvious that the defendant must have been aware of it* . . . .'") (citation omitted).

[100] Baker v. Goldman Sachs & Co., 949 F. Supp. 2d 298, 314 (D. Mass. 2013).

[101] *Id*. at 314.

[102] Matana v. Merkin, No. 13 Civ. 1534 (PAE), 2014 WL 426857, at *3 (S.D.N.Y. Feb. 4, 2014) ("Merkin may well have been irresponsible or slipshod if he did not attempt to learn what was in Madoff's Form ADV; but irresponsibility does not equate to fraudulent intent.").

[103] *In re* Bayou Hedge Fund Litig., 534 F. Supp. 2d 405, 416 (S.D.N.Y. 2007) ("Even South Cherry's alternative allegation that Hennessee Group failed to perform due diligence commensurate with industry standards is inadequate to plead scienter.").

[104] Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 Wash. U.L.Q. 1017, 1017–18 (2005) (noting that "renewed attention to the long-recognized problems of enforcing fiduciary obligations in mutual funds" combined with "high investor expectations of care and loyalty" have made fiduciary duties a major topic of litigation). *See generally* ZACHARY G. NEWMAN & JONATHAN M. PROMAN, HAHN & HESSEN, I'VE BEEN SUED FOR *WHAT?*—FIDUCIARY DUTY CLAIMS AGAINST HEDGE FUND MANAGERS AND HOW TO AVOID THEM (2013), http://www.martindale.com/matter/asr-1951004.Sued.pdf [https://perma.cc/E9JZ-F7BG] (discussing basics of fiduciary duties).

[105] *See* Hunnicutt & Co. v. Thinkstrategy Capital Mgmt., LLC, 910 N.Y.S.2d 762, slip op. at 4 (N.Y. Sup. Ct. Apr. 27, 2010) (holding that the allegations

contractual matter, due diligence promises (in a brochure, website, contract with investors, etc.) must be in writing in order for them to be enforceable.[106]

2. Core Cases

Several core cases highlight the evolving legal standards applicable to private fund IDD. Figures 4a and b, and Figure 5 show that from 2005 to 2015, the majority of the available litigation record in the context of IDD pertained to allegations of misrepresentation.[107] Courts have found that a complete lack of promised IDD can amount to fraud.[108] For instance, in *Schwarz*, the plaintiffs contended that the defendants misrepresented the nature and extent of IDD conducted on the sub-funds designated for investors. [109] Investments in seven of those sub-funds turned out to be entirely worthless, as these seven sub-funds were revealed as fraudulent.[110] The defendants' due diligence activities and stipulations scrutinized by the court included: (1) performance of background and reference checks on prospective sub-fund managers; (2) in-person interviews of sub-fund managers; (3) investments only in audited sub-funds; and (4) investments only in sub-funds with reputable service providers.[111] The defendant's extensive failures to perform due diligence[112] resulted in the defendant

---

sufficiently stated a breach of fiduciary duty for failure to exercise due diligence in connection with an investment in a Ponzi scheme).

[106] *See* S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 108 (2d Cir. 2009) (affirming that the plaintiff's contract claim was barred by the Statute of Frauds).

[107] For list of relevant cases, see note 53.

[108] *See* Sapirstein-Stone-Weiss Found. v. Merkin, 950 F. Supp. 2d 621, 628 (S.D.N.Y. 2013) (finding that the plaintiff's allegation that the defendants "failed to heed various 'red flags,'" in addition to its allegation that defendants made knowing and intentional misrepresentations about plaintiff's investments was sufficient to plead scienter); *Schwarz*, 2012 WL 2026365, at *15 (finding that each false representation alleged by plaintiffs independently supported a finding of fraud).

[109] *Schwarz*, 2012 WL 2026365, at *17 (finding that plaintiffs sufficiently alleged that the defendants made false and fraudulent statements regarding due diligence, in breach of their fiduciary duty to their investors).

[110] *Id.* at *6.

[111] *Id*. at *7.

[112] *Id*. at *10–11 (describing the defendant's due diligence failures, which included, among many other things, failing to perform background checks on

missing a significant red flag—that one fund had never before been audited.[113] Further, the court found that the defendant did not perform any of the aforementioned four specific tasks it had represented to the plaintiffs.[114]

However, unlike in *South Cherry Street* or *Mantana*, the court found sufficient intent for fraud, because the lack of due diligence was not just a result of incompetence and/ or based on hindsight speculation on failure to carry out industry practices, but involved the defendants knowingly making false due diligence representations.[115] Beyond promising due diligence, the defendant said they had accomplished due diligence and only invested in "audited sub-funds," a representation they knew was not true at the time they made it.[116]

Many plaintiffs have brought cases under the theory that lack of due diligence can constitute securities fraud.[117] Generally, courts have not looked upon this cause of action favorably.[118] In *In re Bayou Hedge Fund Litigation* and its companion appeal *South Cherry Street,* both the Southern District of New York and Second Circuit Court of Appeals directly addressed a claim that a lack of due diligence

---

officers, investigate service providers, verify assets under management, verify the fund's auditor and administrator, notice discrepancies in financial reports, and verify information provided by the fund).

[113] *Id*. at *11.

[114] *Id*. at *13 (finding that the evidence established that the defendant made knowingly false representations regarding its due-diligence on prospective and current sub-funds).

[115] *See supra* notes 102–03 and accompanying text.

[116] *Schwarz*, 2012 WL 2026365, at *15.

[117] *See, e.g.*, S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 111 (2d Cir. 2009) (clarifying the how a lack of due diligence can relate to scienter); Matana v. Merkin, No. 13 CIV. 1534 (PAE), 2014 WL 426857, at *4 (S.D.N.Y. Feb. 4, 2014) (holding that irresponsible due diligence does not equate to fraudulent intent or scienter); *In re* Bayou Hedge Fund Litig., 534 F. Supp. 2d 405, 416 (S.D.N.Y. 2007) (holding that a failure to perform due diligence to industry standard is not adequate to plead scienter).

[118] *See S. Cherry St., LLC,* 573 F.3d at 100 ("[C]ourt dismissed the securities fraud claim on the ground that the Amended Complaint (or 'Complaint') failed to plead scienter in the manner required by the Private Securities Litigation Reform Act of 1995."); *In re Bayou Hedge Fund Litig.,* 534 F. Supp. 2d at 414 ("While Fed.R.Civ.P. 9(b) states that 'malice, intent, knowledge or other conditions of mind' may be 'averred generally,' the PSLRA and long-standing law in this Circuit impose more stringent requirements for pleading securities fraud.").

satisfied the scienter required to prove securities fraud.[119] This line of lawsuits originated from investors that sued their specialist hedge fund adviser for recommending investments in Bayou Accredited, private pooled investment funds that turned out to be a massive fraud and collapsed in 2005.[120] Prior to recommending such a fund to investors for investment, the hedge fund investment advisor advertised its patented due diligence process that included the following five levels of scrutiny:

> (1) collection of information about the fund's manager; (2) assessment of the fund's 'Experience,' 'Credibility,' and 'Transparency'; (3) interviews of hedge fund '[p]ersonnel from the top down' at the fund's offices to give HG a sense of 'overall professionalism, attitude and depth of organization'; (4) study of the fund's '[i]ndividual positions,' with an emphasis on its long, short, cash, and derivative positions, as well as any '[o]ff balance sheet transactions'; and (5) review of 'audited financial statements,' checks of the fund's key personnel's references, confirmation of the fund's prime banking relationship, and measures to 'Verify Auditor'.[121]

Additionally, defendant Hennessee Group represented that after investors' decided to invest in a given fund, defendant would place equal importance on monitoring and on-going due diligence of that fund.[122] The Second Circuit in *South Cherry Street* held that lack of due diligence was insufficient to plead securities fraud and, as a contractual matter, due diligence promises by defendant had to be

---

[119] *S. Cherry St., LLC,* 573 F.3d at 108–10, 113 (comparing different definitions of scienter and stating "the factual allegations in the Complaint do not give rise to a strong inference that the alleged failure to conduct due diligence was indicative of an intent to defraud"); *In re Bayou Hedge Fund Litig.*, 534 F. Supp. 2d at 416.

[120] *S. Cherry St., LLC,* 573 F.3d at 102 ("As revealed in a September 2005 SEC report and an SEC action against the Bayou funds' principals, Bayou Accredited was part of a Ponzi scheme."); *In re Bayou Hedge Fund Litig.*, 534 F. Supp. 2d at 407 ("According to the Complaint, South Cherry's investment came at the recommendation of Hennessee Group, an investment advisor specializing in hedge funds.").

[121] *S. Cherry St., LLC,* 573 F.3d at 100–01.

[122] *Id*. at 101.

provided in writing in order for them to be enforceable.[123] *South Cherry Street* would provide the template for future cases involving Madoff; while it was likely that the defendant fund was at the very least incompetent and negligent, the plaintiff was required to provide evidence that the fund knew or was grossly reckless in making due diligence reputations to survive leading on securities fraud.[124]

Beyond civil suits, the SEC has also brought criminal and administrative actions with assessing fraud allegations associated with lacking IDD.[125] In *SEC v. Quan*, the court determined whether the defendant's due diligence representations in the defendant's private placement memoranda and flipbooks were fraudulent.[126] Because the defendant failed to contact retailers to verify the existence of the underlying receivables and did not inspect the merchandise collateral, the SEC alleged that the promised due diligence had not been performed.[127] The defendants advanced novel arguments for why their due diligence representations were not fraudulent: first, that the statements were "mere puffery" and not representations, and second, that some basic review was carried out.[128] The court rejected both arguments, finding that a reasonable investor might have relied on the statements, and the basic "review" of information provided by the fraudulent fund itself was insufficient in light of their previous

---

[123] *Id*. at 115.
[124] *Id*. at 110.
[125] *See, e.g.*, SEC v. Quan, No. 11 Civ. 723, 2013 WL 5566252, at *12 (D. Minn. Oct. 8, 2013).
[126] *Id*. ("The [private placement memoranda] stated, in pertinent part: As an example of the procedures Acorn will follow with respect to structuring Acorn Financed Note transactions, Acorn has informed the Company [i.e., SCAF, LLC] that it intends generally to undertake the following procedures with respect to each Distribution Company and related transactions: perform ongoing quantitative and qualitative analysis or similar protracted procedure to determine the fair market value of underlying assets of the short-term commercial credit market and the financial conditions of the borrowers and its customers. . . . The flipbooks stated that Acorn would perform 'Full Due Diligence on Borrower prior to commitment,' and that due diligence would include an inventory summary analysis, periodic asset appraisals of the borrower, on-site field examinations, and an accounts receivable aging summary and analysis.").
[127] *Id*.
[128] *Id*.

representations.[129] The determination of whether the defendants' due diligence with respect to the quality, existence, and quantity of the merchandise and receivables satisfied the funds' due diligence representations was held to be a fact issue for the jury.[130]

In a case involving allegations of insufficient IDD, *Fraternity Fund*, hedge fund investors brought an action against the defendants' limited liability companies' issuing funds, and their principals, alleging violation of federal and state securities law, and state common law.[131] The plaintiffs alleged that the Beacon Hill defendants misrepresented in due diligence questionnaires that Beacon Hill used repurchase agreement prices to value the securities in the hedge funds the investors had bought whereas in reality the Beacon Hill defendants had used their own allegedly fraudulent prices.[132] The court found that using repurchase agreement prices, while technically correct, was nevertheless misleading.[133] *Fraternity Fund* adds to the long list of cases in which due diligence documents and practices are often used to build cases for misrepresentation, if not securities fraud cases.

3. Impact of the Madoff Ponzi Scheme

The post-2009 increase in the caseload pertaining to private investment fund due diligence is partly explained by the Bernard L. Madoff Securities Ponzi scandal. Figures 1 and 2 demonstrate that private fund IDD has experienced a remarkable transformation in post-2009 SEC Form ADV II filings. Correspondingly, Figure 3 shows that

---

[129] *Id.* at *12–13 (finding that the level of due diligence provided was sufficient to raise a question for a jury to decide).

[130] *Id*. at *13 ("Accordingly, the Quans' motions for summary judgment on the due diligence representations are denied.").

[131] Fraternity Fund Ltd. v. Beacon Hill Asset Mgmt. LLC, 376 F. Supp. 2d 385, 390–92 (S.D.N.Y. 2005).

[132] *Id*. at 400 (explaining that investors would have reasonably inferred independent pricing).

[133] *Id*. at 401 ("Stating that repo prices were used when, in fact, they were used in an inconsequential way, might be technically correct but nevertheless misleading. Indeed, the alleged misstatements were given in response to the question, 'How do you mark the liquid positions in your portfolio?' Defendants responded that Beacon Hill 'utiliz[ed] prices received from the repo market.' It did not qualify this response by disclosing that repo prices were used in an insignificant manner. An investor reasonably would have understood the statement to mean that Beacon Hill valued the securities based upon prices from the repo market.") (citations omitted).

after 2009, the amount of litigated cases has increased significantly. Madoff-related cases in the aftermath of the discovery of the Madoff Ponzi scheme in 2008 help explain part of the significant increase in the prevalence and importance of private fund IDD after 2009.[134]

The Madoff fraud was one of the most ruthless Ponzi schemes in the history of securities fraud.[135] After several decades of fraudulent activities, the Madoff fraud was finally unveiled in December of 2008 and has been litigated since 2010.[136] Bernard L. Madoff founded Investment Securities LLC in 1960, and over several decades the firm gained an excellent reputation for generating safe and stable returns, even during volatile and bear market periods.[137] During this time, many of his assets under management came from other hedge funds

---

[134] A number of post-2009 cases deal with the Madoff feeder funds. *See e.g.*, S. Cherry St., LLC v. Hennesee Grp. LLC, 573 F.3d 98, 99–100 (2d Cir. 2009) (indicating defendant Hennessee's involvement in investing plaintiff's funds in a Ponzi scheme); Matana v. Merkin, No. 13 Civ. 1534 (PAE), 2014 WL 426857, at *1 (S.D.N.Y. Feb. 4, 2014) (arising out of Madoff's investment scheme); Sapirstein-Stone-Weiss Found. v. Merkin, 950 F. Supp. 2d 621, 624 (S.D.N.Y. 2013) (assessing defendants' investment of plaintiffs' funds in Madoff's Ponzi scheme); *In re* Beacon Assocs. Litig., 745 F. Supp. 2d 386, 394 (S.D.N.Y. 2010) (discussing the role of Beacon Fund as a feeder fund for Madoff); Anwar v. Fairfield Greenwich Ltd., 728 F. Supp. 2d 372, 388 (S.D.N.Y. 2010) (acknowledging Fairfield Greenwich Group's funds position as feeder funds for Madoff's scheme); FutureSelect Portfolio Mgmt., Inc. v. Tremont Grp. Holdings, Inc., 309 P.3d 555, 561 (Wash. Ct. App. 2013) (describing defendant Tremont's role in providing access to Madoff's feeder funds).

[135] GREGG BARAK, THEFT OF A NATION: WALL STREET LOOTING AND FEDERAL REGULATORY COLLUDING 25 (2012) ("Comparatively, Madoff's Ponzi scheme was unique in the annals of Ponzi schemes. Its longevity, size, and global reach make similar Ponzi schemes highly unlikely in the future.").

[136] *See* Press Release, Sec. & Exch. Comm'n, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme (Dec. 11, 2008), https://www.sec.gov/ news/press/2008/2008-293.htm [https://perma.cc/27LX-AD4Q] (announcing that the SEC filed charges for securities fraud against Madoff and his investment firm).

[137] *See The Madoff Investment Securities Fraud: Regulatory and Oversight Concerns and the Need for Reform: Hearing Before the S. Comm. On Banking, Hous., and Urban Affairs*, 111st Cong. 2 (2009) (statement of Sen. Dodd) [hereinafter *Madoff Hearing*] (discussing the growth of Madoff's company and its reputation prior to the discovery of the firm's fraudulent dealings).

that engaged in a "fund of funds" strategy.[138] Such funds selected the very best funds using their skilled due diligence and investment analysis practices and then in return charged their investors standard private fund fee structures (2/20).[139] In reality, most of these funds were depositing the vast majority of their capital into Madoff's black box of a fund.[140] Fund managers were incentivized to invest in this manner because Madoff charged notoriously low fees for the hedge fund business (charging only transaction fees rather than fees based on AUM), and generated very conservative but consistent returns.[141] Despite his sterling reputation in the industry, including a chairmanship of NASDAQ, some observers doubted whether the returns were possible.[142] Multiple SEC investigations were launched on various issues with the Madoff's fund.[143] The investigations failed

---

[138] *See* DIANA B. HENRIQUES, THE WIZARD OF LIES: BERNIE MADOFF AND THE DEATH OF TRUST 58 (2012) ("This made Chais the forerunner of the hundreds of entrepreneurs who would create and peddle private funds designed solely to carry other people's money to Madoff's door. Chais set up the first formal 'feeder fund.' A feeder fund is simply a fund that raises money from investors and puts it into one or more other funds.").

[139] *See id*. at 127 ("Other fledgling financial advisers were soon investing their pension fund clients' money with Madoff through Ivy, which collected substantial fees in exchange for its advice and due-diligence examinations.").

[140] Despite the due diligence that the "feeder" funds promised to investors, Madoff refused to provide them with any information whatsoever about his investment strategy. *See id.* at 199, 211 ("He reminds them once again that he shouldn't even have to submit to these due-diligence quizzes . . . . a few elite hedge funds had sheepishly disclosed to investors that, for all their preening claims about careful due diligence, they had been ripped off.").

[141] *Id*. at 123 ("Madoff would let his feeder funds reap the huge management fees while he got only the trading commissions.").

[142] *See id*. at 373 ("'[M]any banks, industry advisors and insiders who made an effort to conduct reasonable due diligence flatly refused to deal with BLMIS and Madoff because they had seriously concerns their [investment advisory] business were not legitimate.'"); *Madoff Hearing*, *supra* note 137 at 1 (statement of Sen. Dodd) ("In 2001, Barron's reported some experts doubted [Madoff's] methodology and were troubled by his secrecy . . . . In 2005, derivatives expert Harry Markopoulos . . . identified numerous red flags: returns that were too good to be true consistent gains over 10 percent every year, in bull and bear markets alike; investment strategies that could not produce stated returns.").

[143] *Madoff Hearing*, *supra* note 137, at 3 ("In 2006, following the SEC examination, the Madoff brokerage firm also registered as an investment

to turn up evidence of the criminality behind the fund.[144] Instead the investigation focused on technicalities like registering as an investment advisor.[145] Finally, in 2008, after running out of cash to pay redemptions in the midst of the financial crisis, Madoff admitted to top employees the entire investment advisory business was a fraud, calling it "one big lie" and a "giant Ponzi Scheme."[146]

A plethora of lawsuits followed this admission, many of which pitted investors against the "fund of funds" hedge funds that promised due diligence and ongoing monitoring but delivered multi-billion dollar loses.[147] Madoff's unique reliance on large feeder funds created a massive industry for IDD lawsuits.[148] The feeder funds had collected high advisory fees as due diligence experts, but caused large numbers of investors to lose their investments as a result of the Madoff fraud.[149] The investors' lawsuits often point out that appropriate elementary due diligence—the kind that prevented some large banks and investment firms dealing with Madoff—would have picked up the massive red

---

banker-an investment adviser, excuse me. Yet somehow regulators missed a massive fraud.")

[144] U.S. SEC. & EXCH. COMM'N, OFFICE OF INSPECTOR GENERAL, OIG-509, INVESTIGATION OF THE FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME (2009).

[145] *Id.*

[146] *See* Press Release, Sec. & Exch. Comm'n, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme (Dec. 11, 2008), https://www.sec.gov/news/press/2008/2008-293.htm [https://perma.cc/27LX-AD4Q] (quoting Madoff's description of his scheme).

[147] Sapirstein-Stone-Weiss Found. v. Merkin, 950 F. Supp. 2d 621, 624 (S.D.N.Y. 2013); *In re* Optimal U.S. Litig., 813 F. Supp. 2d 351, 365–66 (S.D.N.Y. 2011); Metro. Life Ins. Co. v. Tremont Grp. Holdings, Inc., No. 7092-VCP, 2012 WL 6632681, at *16–17 (Del. Ch. Dec. 20, 2012).

[148] S. Cherry St., LLC v. Hennesee Grp. LLC, 573 F.3d 98, 99–100 (2d Cir. 2009) (indicating defendant Hennessee's involvement in investing plaintiff's funds in a Ponzi scheme); Matana v. Merkin, No. 13 Civ. 1534 (PAE), 2014 WL 426857, at *1 (S.D.N.Y. Feb. 4, 2014) (arising out of Madoff's investment scheme); *Sapirstein*, 950 F. Supp. 2d at 624 (S.D.N.Y. 2013); *In re* Beacon Assocs. Litig., 745 F. Supp. 2d 386, 394 (S.D.N.Y. 2010) (discussing the role of Beacon Fund as a feeder fund for Madoff); Anwar v. Fairfield Greenwich Ltd., 728 F. Supp. 2d 372, 388 (S.D.N.Y. 2010) (acknowledging Fairfield Greenwich Group's funds position as feeder funds for Madoff's scheme); FutureSelect Portfolio Mgmt., Inc. v. Tremont Grp. Holdings, Inc., 309 P.3d 555, 561 (Wash. Ct. App. 2013) (describing defendant Tremont's role in providing access to Madoff's feeder funds).

[149] *See* cases cited *supra* note 147.

flags surrounding Madoff's secretive and bizarre business practices.[150] Such red flags included: Madoff's business practice of acting as a highly irregular combination of investment advisor, broker, and custodian;[151] lack of independent auditors; refusal to provide independent verification of executed trades;[152] concealment of his advisory business from the investment community generally and from the SEC;[153] decision not to charge an investment management fee;[154] inability to replicate returns that were mathematically implausible;[155] and entering into contracts not executed by the correct parties.[156]

In *Matana v. Merkin*,[157] one of several major cases in the context of the Madoff fraud,[158] the court had a similar problem to *South Cherry Street*, mainly it had to decide if a lack of due diligence can amount to securities fraud in the right circumstances. The plaintiffs

---

[150] *See* cases cited *supra* note 148.

[151] *In re Optimal U.S. Litig.*, 813 F.Supp.2d at 359 (showing how Madoff acted in multiple capacities, which the Court saw as a red flag).

[152] *Id*.

[153] *Id*. at 358.

[154] *Id*.

[155] *Id*. at 359.

[156] *Id*.

[157] No. 13 CIV. 1534 (PAE), 2014 WL 426857, at *1 (S.D.N.Y. Feb. 4, 2014).

[158] *See generally In re* Bernard L. Madoff Inv. Sec. LLC, No. 08-99000 (SMB), 2015 WL 4734749 (Bankr. S.D.N.Y. Aug. 11, 2015) (mentioning various major Madoff cases); *In re* Meridian Funds Grp. Sec. & Employee Ret. Income Sec. Act (ERISA) Litig., No. 09-CV-7099 TPG, 2015 WL 1258380 (S.D.N.Y. Mar. 13, 2015); *In re* Tremont Sec. Law, State Law, & Ins. Litig., No. 08 CIV. 11117, 2013 WL 5179064 (S.D.N.Y. 2013) No. 08 Civ. 11117, 2013 WL 5179064, at *1 (S.D.N.Y. Sept. 16, 2013) *aff'd.* Elendow Fund, LLC v. Rye Inv. Mgmt., 588 F. App'x 27 (2d Cir. 2014); Sapirstein-Stone-Weiss Found. v. Merkin, 950 F. Supp. 2d 621 (S.D.N.Y. June 11, 2013); Prickett v. New York Life Ins. Co., 896 F. Supp. 2d 236, 240 (S.D.N.Y. 2012); *In re* Austin Capital Mgmt., Ltd., Sec. & Emp. Ret. Income Sec. Act (ERISA) Litig., No. 09 M.D. 2075, 2012 WL 6644623, at *1 (S.D.N.Y. Dec. 21, 2012); *In re Optimal U.S. Litig.*, 813 F.Supp.2d 351; *In re* J.P. Jeanneret Assocs., Inc., 769 F. Supp. 2d 340 (S.D.N.Y. 2011); *In re* Beacon Assocs. Litig., 745 F. Supp. 2d 386 (S.D.N.Y. 2010); Anwar v. Fairfield Greenwich Ltd., 728 F. Supp. 2d 372, 388 (S.D.N.Y. 2010); *In re* Bernard L. Madoff Inv. Sec. *LLC*, 515 B.R. 117 (Bankr. S.D.N.Y. 2014); Metro. Life Ins. Co. v. Tremont Grp. Holdings, Inc., No. CIV.A. 7092-VCP, 2012 WL 6632681 (Del. Ch. Dec. 20, 2012); FutureSelect Portfolio Mgmt., Inc. v. Tremont Grp. Holdings, Inc., 309 P.3d 555 (Wash. App. Ct. 2013); Hecht *ex rel.* Andover Assocs., LLC v. Andover Assoc. Mgmt. Corp., 910 N.Y.S.2d 405 (N.Y. Sup. Ct. 2010).

in *Matana* alleged that such a lack of basic due diligence activities, such as failure to analyze Form ADV, which is public information, led the fund to invest in the clearly fraudulent Madoff fund.[159] By failing to investigate such basic information, the plaintiffs alleged Merkin "had to know" that Madoff was engaging in fraud.[160] While the court suggested such due diligence behavior or lack thereof was "irresponsible or slipshod," such irresponsibility did not equate to fraudulent intent.[161]

In *Sapirstein*, another Madoff-related case involving fraud allegations associated with a feeder fund promising but not delivering on due diligence obligations, the court was tasked with analyzing whether defendants supervised and directed the respective fund assets in accordance with the investment policy of the investors' plan.[162] The *Sapirstein* court held that sufficient intent for fraud existed when not only did the defendant's fail to pick up red flags, but overtly misrepresented and misstated information that they knew was not true based on their interactions with Madoff's business practices.[163] For example, despite telling clients that Morgan Stanley was serving as a custodian for the fund's investments in their offering materials, they were well aware that Madoff was clearing and settling his own supposed trades and acted as his own custodian for all transactions.[164] Unlike in *South Cherry Street* or *Matana*, the fund did not only act negligently or have a bad due diligence practice, it knew at the time it was making the representations that they were untrue based on previous business interactions with Madoff.[165]

One of the largest combined actions against Madoff feeder funds, *In re J.P. Jeanneret Associates, Inc.*, involved investors going after Jeanneret Associates, a Madoff sub-feeder fund.[166] Ivy Asset Management and Jeanneret Associates had entered a relationship in

---

[159] *Matana*, 2014 WL 426857 at *4.
[160] *Id*.
[161] *Id*. (finding the actions of the funds irresponsible but declared that no fraudulent intent existed).
[162] *Sapirstein-Stone-Weiss Found.*, 950 F. Supp. 2d at 624–25.
[163] *Id*. at 628 (explaining fraudulent activity being conducted by fund operators).
[164] *Id*. (exemplifying how easily fraud was carried out even though the companies knew the manner in which Madoff conducted his business).
[165] *Id*. (declaring that the fund had clear knowledge that it was conducting fraud).
[166] *In re* J.P. Jeanneret Assos., Inc., 769 F. Supp. 2d 340, 346 (S.D.N.Y. 2011).

which Jeanneret would take investor funds, deposit it with Ivy, who would in turn invest in Madoff in return for half of Jeanneret's advisory fee.[167] Ivy, which had originally invested its own hedge fund client's money with Madoff, had noticed major inconsistencies and red flags in Madoff's strategy.[168] Despite withdrawing most of their own money in the fund as a result of these red flags, Ivy's management team continued to take money from sub-funds for Madoff's fund.[169] However, Ivy eventually revealed to Jeanneret that they could perform no due diligence on Madoff, because his self-executing trades and paranoia about access made it impossible to actually assess the fund in a professional fashion.[170] However, sub-funds like Jeanneret continued to assure clients in offering memoranda that Ivy was their "Investment Advisor" and would be applying rigorous due diligence on any investment manager it invested with.[171] In a claim for securities fraud, the court found that Jeanneret had sufficient scienter for securities fraud, considering Jeanneret had actual knowledge that no due diligence was being performed despite promising investors that Ivy was carrying out rigorous due diligence processes on all securities it invested in.[172] Claims that involve investors using hindsight to second guess the due diligence practice often fail (even in the face of clearly

---

[167] *Id.* at 349.

[168] *Id.* at 350 ("Internal memos written by Ivy employees at or about this time urged that Ivy 'explore this further' and noted that Ivy had 'inability to make sense of Madoff's strategy' because 'his trades for our accounts are inconsistent with the independent information that is available to us.'").

[169] *Id.* at 352 (recounting how, in late 2000, Ivy withdrew its entire proprietary investment in Madoff, and chose not to inform Jeanneret that it had done so).

[170] *Id.* ("In fact, according to testimony given by Simon, Ivy stopped making due diligence visits to Madoff, because it did not feel welcome after it had withdrawn its proprietary funds from Madoff. . . . Ivy apparently did not reveal its withdrawal from Madoff, or its advice to its own clients to do so, at that time.") (citations omitted).

[171] *Id.* at 352–53 ("Like its predecessor, this OM designated Ivy as the "Investment Advisor." The 2003 OM listed the same responsibilities for Ivy as Investment Advisor that were listed in the 1991 OM-providing due diligence research with respect to potential investment managers, making recommendations to JPJA regarding which investment managers should select for investing Income Plus assets, and monitoring performance of investment managers that are managing Income Plus assets.").

[172] *Id.* at 357 (concluding that JPJA delegated the due diligence function to Ivy, was subsequently aware that Ivy was unable to perform due diligence on Madoff, and did nothing about it).

incompetent management), as seen in *South Cherry Street*,[173] but it has been held that funds that promise due diligence and yet have no intention of actually carrying it out are violating federal securities laws rather than breaching basic contracts.[174]

A companion case dealing with Ivy, Jeanneret and Beacon Associates (all Madoff feeder funds), *In re Beacon Associates Litigation*,[175] similarly found the plaintiffs stated a claim for securities fraud.[176] The court evaluated the following due diligence-related activities: (1) monitoring the performance of investments and their adherence to stated investment strategies and objectives, (2) making specific promises to perform a particular act in the future while secretly intending not to perform that act, (3) failing to update or correct statements on due diligence.[177] The court held that the defendant's knowledge about advisor's stopping due diligence performance rendered defendant's prior promise to supervise clients' investments materially misleading.[178] Furthermore, knowledge about advisor's stopping due diligence performance created a duty to update and/or correct prior representations regarding due diligence.[179]

In another Madoff-related case, *Metropolitan Life Insurance Co.*, the limited partner insurance carriers filed action against the partnership (Tremont Opportunity Fund III, a "fund of funds") that in turn invested in Rye Select Market Prime Fund, a major Madoff feeder fund. Tremont advertised to investors, in both their PPM and website, that they engaged in a "rigid due diligence and selection process" when selecting funds for investments.[180] Due to the existence of an

---

[173] 573 F.3d 98, 114 (dismissing the securities fraud claim on the ground that the Amended Complaint failed to plead scienter in the manner required by the Private Securities Litigation Reform Act of 1995).

[174] *See In re* J.P. Jeanneret Assocs., Inc., 769 F. Supp. 2d 340, 364 (S.D.N.Y. 2011) ("Only when the adviser makes its promise with no intention of fulfilling it does the breach of contract claim turn into a federal securities claim.").

[175] 745 F. Supp. 2d 386 (S.D.N.Y. 2010).

[176] *Id.* at 410.

[177] *Id.* at 412.

[178] *Id.* at 410 (holding that duty to update prior statements arises when those statements "have become misleading as the result of intervening events").

[179] *Id.*

[180] *Metropolitan Life Ins. Co. v. Tremont Grp. Holdings, Inc.*, No. CIV.A. 7092-VCP, 2012 WL 6632681, at *2–3 (Del. Ch. Dec. 20, 2012). ("According to the Complaint, TGH's website represented that Tremont engaged in a "rigid due diligence and selection process." Specifically, the website allegedly stated

enforceable exculpation clause, the plaintiffs were forced to prove that the fund acted with "gross negligence or willful and reckless conduct"[181] which they suggested the fund had done by: failing to supervise the investments, conducting no due diligence, remaining willfully ignorant despite warnings, and having knowledge they couldn't actually perform the due diligence at the time because Madoff didn't allow it. The court ultimately held the PPM and website advertisements of their due diligence process were representations, and the Carriers adequately pled both fraud and intentional misrepresentation for the lack of due diligence.[182]

In another case, which involved Tremont and the Rye Select Broad Market XL Fund, *In re Tremont*, a plaintiff fund sued Tremont and Rye for making representations of due diligence and then failing to complete any whatsoever. [183] Again, it was impossible for a fund like Rye to perform due diligence as Madoff overtly disallowed such due diligence of his extremely secretive and unconventional practices.[184] Nevertheless, Tremont represented on its website "thorough manager research, careful due diligence, advanced risk allocation and time tested portfolio management."[185] Additionally, the plaintiff used Tremont representations in Form ADV (filed with the SEC in 2006), in which the fund advertised its proprietary software programs that

---

that Tremont only selected managers that "passed through our exhaustive multi-stage due diligence process" and that it employed "a comprehensive, proprietary database enabling us to capture both qualitative and performance-based quantitative information on hedge fund managers and to compare managers to their peer groups . . . . As a preliminary matter, Tremont denies having represented that TOF III's investments would be subject to a robust due diligence process. It asserts that TGH's website cannot support a fraud claim because the PPM contained a non-reliance provision. Even if that were true, however, the Complaint alleges that the PPM itself represented that the investments were subject to a due diligence process. Moreover . . . Tremont warranted in the LPA that the PPM contained no false statements.").

[181] *Id*. at *7 (summarizing Carriers' six allegations of gross negligence and willful and reckless conduct).

[182] *Id*. at *17 (explaining each rejection of Tremont's arguments and holding that plaintiff adequately pled both fraud and intentional misrepresentation).

[183] *In re* Tremont Sec. Law, State Law, & Ins. Lit., No. 08 Civ. 11117, 2013 WL 5179064, at *1 (S.D.N.Y. Sept. 16, 2013) *aff'd,* Elendow Fund, LLC v. Rye Inv. Mgmt., 588 F. App'x 27 (2d Cir. 2014).

[184] *Id*. at *6.

[185] *Id*. at *3 (arguing they relied on such representations included on the website and in Tremont's Form ADV to their detriment).

monitor the performance of fund manager and assure fund compliance.[186] The court held that plaintiff Elendow Fund's generic allegations pertaining to its reliance upon representations as those described in the complaint was inadequate to render its reliance allegation plausible.[187] Additionally, while there were possible bad due diligence practices, none of the allegations were sufficient to prove the mens rea for securities fraud.[188]

Madoff-related cases also include those in which investors seek to hold third parties involved with either audit or some amount of control of the feeder fund accountable for the damages caused by the Madoff investments. In *FutureSelect Portfolio Management, Inc.*, plaintiff investor brought an action against both the parent of Tremont (Oppenheimer), the grandparent of Tremont (MassMutual) as well as an Auditor (Ernest & Young).[189] Tremont had promised the investor that Madoff was the investment manager of Rye, subject to Tremont's oversight and ongoing due diligence.[190] Additionally, investors were told that a lengthy due diligence processes had been carried out on Madoff's operations, and that the firm was completely satisfied with the results.[191] Along with Madoff's accountant, Ernst & Young audited the Broad Market and Prime funds for several years without raising any red flags.[192] FutureSelect filed actions for securities fraud, negligence, negligence misrepresentations against Tremont, its parents and grandparents, and Ernst & Young for negligent misrepresentation for the audits.[193] The court found that it was possible for a jury to find that FutureSelect reasonably and justifiably relied on Tremont's misstatements on due diligence, invested, and was harmed by the

---

[186] *Id.* at *7 (describing the form as including representations that stated Tremont engaged with custodians "on a daily basis" and used its software to continually evaluate managers' performance).

[187] *Id.*

[188] *Id*. at *7–8 (explaining that generic allegations of reliance on statements without explicitly referencing which "statements described above" they relied on is not sufficient to pass muster under the *Twombly* standard).

[189] *FutureSelect Portfolio Management, Inc. v. Tremont Group Holdings, Inc.*, 309 P.3d 555, 560 (Wash. Ct. App. 2013).

[190] *Id.* at 562.

[191] *Id*. (observing that a Tremont representative visited a FutureSelect principal to solicit an investment claiming to subject Madoff to "ongoing due diligence" and that Tremont had a "comprehensive understanding of Madoff's operations").

[192] *Id.* at 561.

[193] *Id.* at 562.

investment.[194] Additionally, the court found the parent and grandparent could be held responsible if the plaintiff could prove they knew firsthand that Tremont had no ability to perform the due diligence on Madoff it was promising its investors.[195]

In another case dealing with third parties involved with feeder funds, *In re Meridian Funds*, the plaintiff alleged that a group of interconnected investment funds, the funds' CEO, and the funds' auditor, engaged in a course of conduct that deceived the plaintiff.[196] In particular, the plaintiff alleged that the defendants caused the plaintiff to invest in the Meridian Fund, where the plaintiff would not have invested had the plaintiff known the truth about the Meridian defendants' business practices, and that the defendants misled the plaintiff regarding their business, operations, management, and the intrinsic value and performance of their investments.[197] The court was tasked with evaluating, among other things, the legal and accounting analyses, reference checks, analysis and evaluation of investment strategies; quantitative analysis of investment returns based on various technical metrics; and the screening of external investment managers purportedly performed by Meridian.[198] The court also evaluated defendant's failure to notice various red flags pertaining to Madoff's fund. Such red flags included the following facts: (1) that no securities had been purchased by the fund in thirteen years, (2) that the fund's returns had not been consistent with market, that Madoff's operations were highly secretive, (3) that Madoff refused to provide his customers with access to electronic trading records, and (4) that Madoff's fund avoided filing SEC disclosures.[199] The court held that the complaint

---

[194] *Id*. at 581.

[195] *Id*. at 574–75 (finding that because Tremont directors and officers also served as employees, directors, and officers at the parent and grandparent companies, plaintiffs' claim that parent and grandparent companies controlled Tremont and thus knew about Tremont's insufficient due diligence could survive a motion to dismiss).

[196] *In re* Meridian Funds Grp. Sec. & Emp. Ret. Income Sec. Act (ERISA) Lit., No. 09-CV-7099 TPG, 2015 WL 1258380 (S.D.N.Y. Mar. 13, 2015).

[197] *See id.* at *2 ("[During] all relevant times, the Meridian Defendants and E&Y carried out a . . . course of conduct which was intended to and did: (i) deceive Plaintiff regarding the Meridian Defendants, and each of their business, operations, management and the intrinsic value and performance of [their investments] and (ii) cause Plaintiff to invest in the Meridian fund where it would otherwise not have").

[198] *See id*. at *3.

[199] *See id.*

failed to support an inference that the Meridian defendants knowingly or recklessly misrepresented their due diligence and that many of the alleged misrepresentations in this context were non-actionable "puffery."[200]

In *Anwar*, plaintiffs who had invested in four of defendant's hedge funds that had reinvested the funds in a Ponzi scheme brought a putative class action. [201] The complaint "allege[d] violations of federal securities law and common law tort, breach of contract and quasi-contract causes of action."[202] The plaintiffs sued the hedge funds and, among others, the funds' administrators alleging that there were obvious signs of fraud and that the administrators knew that the hedge fund had represented to the plaintiffs that they had "employed thorough due diligence, monitoring and verification of Fund managers, including Madoff, and strict risk controls." The defendants knew these representations were false or were "willfully blind to the evident falsity,"[203] and "were failing to disclose clear deficiencies in their monitoring of BMIS's activities."[204]

These facts present a different fact pattern than *South Cherry Street*.[205] The distinction is important. *South Cherry Street* only involved the defendant's failure to learn what it would have learned if it had done more to inform itself; the plaintiff alleged the defendants not only ignored what was handed to them, but also ignored that what they were given was readily suspicious to any reasonable person

---

[200] *Id*. at *7.
[201] Anwar v. Fairfield Greenwich Ltd., 728 F. Supp. 2d 372, 387 (S.D.N.Y. 2010).
[202] *See id.* at 387.
[203] *Id*. at 443.
[204] *Id*.
[205] *Compare* S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 111 (2d Cir. 2009) (holding that an asset manager's failure to inform itself as thoroughly as it should have about an investment did not constitute knowing or reckless transmission of false information) *with Anwar*, 728 F. Supp. 2d at 411 (holding that an asset manager was liable for fraud when it ignored an ongoing series of warning signs it received that should have aroused the suspicion of any reasonable person).

exercising ordinary prudence.[206] The court stated that the defendants' "fraud alert" should have been flashing red.[207]

In re Austin Capital Management involved a putative class action brought by investors in Austin Capital Management, a fund that had invested in Rye Select Prime Fund, managed by Tremont Partners.[208] The plaintiffs' allegations against numerous defendants involved violations of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Employment Retirement Income Security Act of 1974, as well as breach of contract, breach of fiduciary duty, unjust enrichment, gross negligence, common law fraud, negligent misrepresentation, and violations of state blue sky laws.[209] The court analyzed materials disseminated to investors by Austin Capital describing defendant Austin's IDD, enumerating "the numerous steps which would be taken to scrutinize the 'manager', or 'hedge fund managers.'"[210] The court held that allegations that Austin Capital failed to perform due diligence on Madoff adequately or that it failed to react to red flags pertaining to Madoff's fraud were insufficient for a cause of action based on securities fraud because "the allegations in plaintiffs' complaint were held to the stringent requirements of the [Private Securities Litigation Reform Act]."[211]

In *Hecht v. Andover Associates Management Corp.*,[212] investors asserted a claim against their hedge fund, its investment consultant, and the company's auditor for negligence and gross negligence in investing with Madoff without performing its promised

---

[206] *Anwar*, 728 F. Supp. 2d at 411 (holding that an asset manager was liable for fraud when it ignored an ongoing series of warning signs it received that should have aroused the suspicion of any reasonable person).

[207] *Id*. ("A fair inference that flows from the facts alleged is that if they failed to see the perceptible signs of fraud, it may have been because they chose to wear blinders.").

[208] *In re* Austin Capital Mgmt., Ltd., Sec. & Emp. Ret. Income Sec. Act (ERISA) Lit., No. 09 M.D. 2075, 2012 WL 6644623, at *1 (S.D.N.Y. Dec. 21, 2012).

[209] *Id*.

[210] *Id*. at *3 (stating that such steps included putting some of his own money into the investment, making his compensation depend on profits, and having a reputable auditor).

[211] *Id*. at *4 (holding that such allegations were "seriously flawed").

[212] No. 06100/09, 2010 WL 1254546 (N.Y. Sup. Ct. 2010) *rev'd on other grounds by* 979 N.Y.S.2d 650 (N.Y. Sup. Ct. App. Div. 2014).

due diligence investigation, among other causes of action.[213] In particular, the plaintiffs alleged that Ivy, the consultant, recommend Madoff without performing due diligence or agreed upon trade confirmation of Madoff's trades.[214] The plaintiffs sued for gross negligence for failure to perform due diligence, no confirmation slips were checked and "statements reported purchases and sales of securities at prices outside the range at which the securities traded on the days in question."[215] If they had done this basic due diligence, the fund would have learned of Madoff's fraud and the investor would have been able to liquidate its investments. On a motion to dismiss, the court held it was possible that a jury may infer from the alleged actions that the defendants engaged in gross negligence.[216] The court emphasized two behaviors that showed the defendants' disregard to investor rights and safety of investments—failure to exercise even slight care in due diligence and entrusting assets to Madoff.[217]

In addition to traditional tort related actions, courts have had to confront due diligence related issues in the bankruptcy proceedings following the discovery and dissolution of the Madoff Ponzi scheme.[218] Irving Picard, the trustee for the liquidation of the fund, was entrusted with filing actions against feeder funds and individual investors that had withdrawn funds from Madoff before the Ponzi scheme collapsed.[219] These funds would ultimately be collected as part of the bankruptcy and given to the victims of the Madoff scheme.[220] Many of these bankruptcy related lawsuits hinged on proving the

---

[213] *Id*. at *3–4 (reporting seven different causes of actions including: (1) breach of administrative services agreement; (2) breach of partnership agreement; (3) negligence; (4) gross negligence; (5) breach of fiduciary duty; (6) aiding and abetting breach of fiduciary duty; and (7) an additional count of aiding and abetting breach of fiduciary duty).

[214] *Id.* at *4.

[215] *Id*.

[216] *Id*. at *10 (finding that "gross negligence is the failure to exercise even 'slight care' or 'slight diligence.' It is also conduct that is so careless as to show complete disregard for the rights and safety of others.").

[217] *Id*.

[218] *E.g.*, *In re* Bernard L. Madoff Inv. Sec. LLC, No. 08-99000 (SMB), 2015 WL 4734749, at *1 (Bankr. S.D.N.Y. Aug. 11, 2015).

[219] HENRIQUES, *supra* note 138, at 256 (explaining that New York state law allowed Picard to seek the return of cash withdrawn by feeder funds within six years of Madoff's bankruptcy filing).

[220] *Id.* at 256 (estimating the cash losses of Madoff's victims to be approximately $20 billion).

feeder funds' intent in facilitating Madoff's fraudulent investment business—something that due diligence evidence was uniquely suited to do.[221]

In *In re Bernard L. Madoff Inv. Sec. LLC*, the court had to evaluate if the defendants knowingly facilitated Madoff's fraudulent investment advisory business.[222] Madoff feeder funds Kingate Global Fund, Ltd. and Kingate Euro Fund, Ltd. had received transfers aggregating $825 million from Bernard L. Madoff Investment Securities LLC (BLMIS) within six years of the filing date of the BLMIS liquidation proceeding.[223] The firm advertised that it used "four limbs of due diligence: qualitative, legal, quantitative, and operational", and that each due diligence limb was performed by a separate team[224] that wrote its own separate due diligence report.[225] Additionally, the due diligence policy explicitly referred to a fund manager's unwillingness to meet with investors, something Madoff never did, to be a red flag indicative of possible fraud.[226]

Despite its touting of what sound like above industry standards, Madoff's asset management advisors, FIM Limited and FIM Advisers (FIM), applied none of these standards to BLMIS and admitted as much.[227] In a March 2008 due diligence report, Kingate Global's due diligence "page was blank."[228] In an email conversation

---

[221] *E.g.*, *In re Bernard L. Madoff Inv. Sec. LLC,* 2015 WL 4734749, at *1.
[222] *Id*. at *1, 4.
[223] *Id.* at *1.
[224] *Id.* at *4 ("Its due diligence included monitoring 'the effectiveness of the systems and procedures used to value the investment portfolio, the independence of the pricing of the portfolio, the effectiveness of the reconciliations performed' and the prime broker arrangement with the fund. It also monitored on a weekly basis the risk of the portfolio and the individual funds within the portfolio.").
[225] *Id*. ("Each due diligence team created a report, and the four reports were combined into a single report, usually spanning between forty-five and fifty pages, that would ultimately be presented to the investment committee. FIM 'scored' each of the 'limbs' of due diligence to assist its analysts in evaluating each fund, and would not invest in a fund until it completed its due diligence procedures. An analyst who had a concern with an investment discussed the issue and closely monitored the fund manager, typically through weekly or bi-weekly contact. If the concern persisted for three months, the investment committee's policy was to redeem the investment.") (citations omitted).
[226] *Id*.
[227] *Id.*
[228] *Id*.

chain between the fund managers, the head of operational due diligence admitted FIM had done no due diligence on the fund and that such due diligence would be impossible considering Madoff explicitly disallowed this type of scrutiny.[229] Furthermore, what little analysis was actually completed revealed that the returns were "too good to be true" and the "limited downside" made them feel "uneasy."[230] Additionally, internal notes between the fund managers revealed they had noticed the unusual results and asked why nobody on Wall Street could duplicate the results.[231] They eventually concluded that BLMIS' remarkably consistent returns were likely the result of illegal front running.[232] Taken together, the court concluded that this constituted evidence that the fund had either actual knowledge of the fraud, or was willfully blind to such an extent that it constituted a deliberate failure to acquire actual knowledge of the fraud's existence.[233]

4. Expert Testimony: Best Practices

Examining the litigation record with regards to expert testimony helps identify prevailing best practices for private fund IDD. Experts often testify on behalf of plaintiffs who are attempting to establish the proper due diligence industry standards that should be applied in a given case, pointing out specific failings that could make a certain defendant liable.[234] Expert testimony can also provide private

---

[229] *Id*.

[230] *Id*.

[231] *Id*. at *5 (listing FIM's due diligence related questions concerning BLMIS, including "Why has no-one [sic] been able to duplicate similar results?").

[232] *Id*. (chronicling "impossibly consistent" returns during the dot com bubble and 2008 recession as indications of a scam).

[233] *Id*. at *12.

[234] *See generally* Expert Report of Tsvetan N. Beloreshki, Toledo Fund, LLC v. HSBC Bank USA, Nat'l Assoc., No. 11 Civ. 7686(KBF), 2012 WL 2850997 (S.D.N.Y July 9, 2012) (No. 11-cv-07686), 2012 WL 5962116; Expert Report of Paul Gompers, Austin Police Ret. Sys. v. Kinross Gold Corp., 957 F. Supp. 2d 277 (S.D.N.Y. Mar. 22, 2013) (No. 12-cv-01203), 2014 WL 10916653; Expert Report of Boris Onefater, Formica v. Rowe, No. 10-00921, 2012 WL 6917065 (M.D. Fla. Oct. 23, 2012); Report of Robert Picard, Toledo Fund, LLC v. HSBC Bank USA, 2012 WL 2850997 (S.D.N.Y July 9, 2012) (No. 11-cv-07686), 2012 WL 5962115; Initial Expert Report of Dr. Steve Pomerantz, Picard v. Katz, 466 B.R. 208 (S.D.N.Y. Jan. 17, 2012) (No. 11-cv-03605), 2011 WL 7453916; Expert Report of Dr. René M. Stulz, United States v. Ferguson, 584 F. Supp. 2d 447 (D. Conn. Oct. 31, 2008) (No. 06-cr-

fund managers with guidance on how their fund's applied due diligence practices compare with purported industry standards.

Using Westlaw's Expert Materials tool, the author synthesized the applicable cases to identify expert testimony on applicable private fund IDD standards. Westlaw's Expert Material tool's coverage begins in 1996 and assesses "selected reports, affidavits, deposition (both full and partial), and trial transcripts from expert witnesses from the state and federal courts of the United States."[235] The author hand-selected relevant expert reports that dealt specifically and in-depth with private fund IDD.

Major failures or red flags in private fund IDD among private fund advisers include: (1) a lack of written policy or processes in place to ensure compliance;[236] (2) the individual conducting the due diligence having little to no experience (especially on the particulars of hedge funds);[237] (3) use of basic spreadsheet formulas unable to account for subjective data or systematically update information;[238]

---

137), 2008 WL 4177308; Expert Report of Dr. René M. Stulz, Bruhl v. PricewaterhouseCoopers Int'l. Ltd. II, 257 F.R.D. 684 (S.D. Fla. Sept. 30, 2008) (No. 03-23044), 2008 WL 3228500; Affidavit of Christopher Swenson, Danis v. USN Comm's., Inc., 121 F. Supp. 2d 1183 (N.D. Ill. Nov. 7, 2000) (No. 98 C 7482), 2000 WL 35409624.

[235] *See* THOMSON REUTERS WESTLAW, *Expert Materials Scope Information*, https://1.next.westlaw.com/Browse/Home/ExpertMaterials?transitionType=Default&contextData=(sc.Default)# (last visited July 2016) (displaying Content Highlights, including "Selected reports, affidavits, depositions (both full and partial), and trial transcripts from expert witnesses from the state and federal courts of the United States.").

[236] Picard, *supra* note 234, at 8.

[237] Beloreshki, *supra* note 234, at 8 ("In contrast, HSBC's decision-making process relied on key input and decision-making by parties that lacked understanding of the Transaction's terms."); Onefater, *supra* note 234, at 9 ("Rowe failed to conduct appropriate due diligence on the investments he was recommending to his clients, including Formica."); Picard, *supra* note 234, at 9 ("I reviewed the backgrounds of a number of the senior members and they were ill equipped with little experience with hedge funds and their particular attributes.").

[238] Beloreshki, *supra* note 234, at 11–14 ("[T]he Monitoring Spreadsheets were not designed to and could not be used for the purpose of determining whether any of the Reference Funds satisfied the Eligibility Requirements specified in Annex I of the Transaction confirmation."); Picard, *supra* note 234, at 9 ("One of the most glaring failures was HSBC's use of excel spreadsheet formulas to maintain measurable data without any process or mechanism to ensure compliance with subjective data . . . .").

(4) not checking paper statements or election records to confirm trade data;[239] (5) not checking credentials and performing background checks on fund staff;[240] (6) dealing with firms with no third party controls (e.g., broker-dealer, custodian, administrators) or substantive auditors (with no auditing history);[241] and (7) failing to assess fund performance against common benchmarks and assess how a fund could make money in declining markets.[242]

Commonalities in expert testimony and expert consensus on applicable standard private fund IDD industry practices, as stipulated in the examined litigation record, include: qualitative review of firm "marketing materials, offering documents, subscription documents, manager track record[s]"[243]; onsite manager meetings;[244] detailed due diligence questionnaires;[245] monthly portfolio analysis or regression

---

[239] Pomerantz, *supra* note 234, ¶ 128.

[240] *See* Onefater, *supra* note 234, at 9.

[241] *See* Report or Affidavit of Michael G. Mayer, SEC v. Quan, 701 Fed. Sec. L. Rep. 97 (D. Minn. Oct. 8, 2013) (No. 11CV00723), 2013 WL 10208453 at 44; Onefater, *supra* note 234, at 9.

[242] Onefater, *supra* note 234, at 9 ("He did nothing further even though the markets were declining in 2000, 2001 and 2002 yet Nadel-Moody continued to make money month after month. . . . Frankly, such activity falls far short of an appropriate due diligence, as previously defined.") (citations omitted).

[243] *Id*. (demonstrating that Rowe did not request various documents in order to conduct appropriate due diligence); Picard, *supra* note 234, at 6 ("In order to perform that review, he will typically request firm/fund marketing materials, offering documents, subscription documents, manager track record and the manager biography."); *see* Pomerantz, *supra* note 234, ¶ 57 ("Due diligence can be performed using information from a variety of sources. For example, investors will collect information from publicly-available sources including databases and marketing materials.").

[244] Onefater, *supra* note 234, at 6; Picard, *supra* note 234, at 6–7; Pomerantz, *supra* note 234, ¶ 47; Stultz, *supra* note 234, at 10.

[245] Beloreshki, *supra* note 234, at 17; Onefater, *supra* note 234, at 5; Picard, *supra* note 234, at 7 ("This stage should include completion and review of detailed due diligence questionnaires pertaining to the fund manager. In this instance, while the questionnaire should gather basic information about the eligible funds, it is critical that it seek information of each fund, his operations, investment strategy and underlying investments."); Pomerantz, *supra* note 234, ¶ 58 n.55 ("A due diligence questionnaire is a document that potential investors provide to investment advisers prior to investing. The questionnaire requests information regarding background, investment philosophy, historical performance, and other due diligence-related issues."); Stultz *supra* note 234, at 10 ("The investor asks the manager to complete a

analysis, style drift analysis;[246] qualitative reviews of fund employees including background checks;[247] assessment of fund processes (including buy sell disciplines, risk management, investment research, team approach, technology and infrastructure);[248] assessment of management fees;[249] review of public documents such as SEC Form ADV II;[250] confirmation and assessment of an independent auditor and the fund having an extensive audit record;[251] and regular peer reviews and benchmarking.[252] Specifically, in addition to testifying experts, the

---

due diligence questionnaire which asks detailed questions about a large number of issues important to the investor.").

[246] Beloreshki, *supra* note 234, at 16; Onefater, *supra* note 234, at 10; Picard, *supra* note 234, at 8 ("This performance information will result in further in depth analysis in the event it is outside of its normal range and/or outside of similar market or strategy range."); Pomerantz, *supra* note 234, ¶ 167 ("[I]nstitutional clients and high net worth clients, in my experience, often conduct performance attribution analyses on a regular basis in order to both to monitor the returns and to fully understand whether the performance was achieved in a method consistent with the stated investment styles").

[247] Mayer, *supra* note 234, at 16 ("Background investigations, including investigations performed upon the borrowing entity and the management team."); Onefater, supra note 234, at 9–10; Picard, *supra* note 234, at 7 ("Separately, the investor will complete final reviews of the manager's background, audits, prime broker and make an investment decision."); Pomerantz, *supra* note 234, ¶ 50 ("Investors evaluate the personnel and qualifications of the investment adviser as much as the investment itself. This assessment includes the individuals with key roles, the reporting structure of the business, the hiring and termination processes, and whether all team members understand the philosophy and process they are supposed to be implementing.").

[248] Beloreshki, *supra* note 234, at 16; Onefater, *supra* note 238, at 9–10; Pomerantz, *supra* note 234, ¶ 51.

[249] Onefater, *supra* note 234, at 6; Pomerantz, *supra* note 234, ¶ 56 ("Fees for investment advisers typically consist of management fees and/or performance fees. It is both customary and essential that the compensation structure be created in a way so as to align the interests of the adviser and the investor.").

[250] Onefater, *supra* note 234, at 6; Pomerantz, *supra* note 234, ¶ 131 n.154.

[251] Onefater, *supra* note 234, at 9; Picard, *supra* note 234, at 7 ("Separately, the investor will complete final reviews of the manager's background, audits, prime broker and make an investment decision."); Pomerantz, *supra* note 234, at ¶¶ 152–54.

[252] Pomerantz, *supra* note 234, ¶ 47.

SEC has also pointed to Form ADV as a major step in creating sufficient transparency to conduct due diligence effectively.[253]

IV. Discussion

This is the first comprehensive study that addresses the astounding lack of guidance on private fund IDD in the United States. According to some anecdotal estimates, private fund advisers spend a substantial amount of their time dealing with private fund IDD issues.[254] Nevertheless, legal guidance on private fund due diligence is very limited and the private fund industry is left to its own devices to ensure adequate due diligence standards. This lack of guidance is surprising given the significant growth of the private investment fund industry,[255] the associated growth of private fund IDD,[256] and its increasing role in the investment allocation process, capital formation, and private fund litigation. Beginning in the early 2010s, courts have started to outline sometimes inconsistent private fund IDD standards.

The data provided in this study seems to suggest that private fund advisers since 2010 increasingly engage in private fund IDD to protect themselves from investor criticism and lawsuits. Since 2010, an increasing number of SEC Form ADV II brochure filers included IDD disclosures and the number of filers who include those disclosures has remained relatively even between 2012 and 2014.[257] The intensity of IDD mentioning relative to total SEC Form ADV II brochure filings has increased substantially; the due diligence count exceeded the total ADV II filings for the first time in 2014.[258] Filers appear to see a need

---

[253] Rules Implementing Amendments to the Investment Advisers Act of 1940, No. IA-3221, 76 Fed. Reg. 42,950, 42,963–64 (July 19, 2011) (codified at 17 C.F.R. pt. 275 & 279) ("Other commenters, however, supported public disclosure of information by these advisers and suggested that such data would be useful, for example, for prospective clients who were conducting 'due diligence' reviews of advisers. . . . [W]e believe the public reporting requirements we are adopting will provide a level of transparency that will help us to identify practices that may harm investors, will aid investors in conducting their own due diligence, and will deter advisers' fraud and facilitate earlier discovery of potential misconduct.").

[254] *See generally supra* text accompanying notes 51–58.

[255] *See generally* Stultz, *supra* note 2.

[256] *See generally* SHAIN, *supra* note 1.

[257] *See* Figure 2.

[258] *See* Figure 1.

to increase the quantity of IDD disclosures in Form ADV II between 2011 and 2014.[259]

The increasing caseload on private fund IDD since 2005 could suggest that applicable legal standards need to be further clarified. The data shows that between 1995 and 2015 private fund IDD has reached new and lasting prominence in the court system.[260] Madoff-related cases in the aftermath of the discovery of the Madoff Ponzi scheme in 2008 only partially explain the significant increase in the prevalence and importance of private fund IDD after 2009. This study has demonstrated that the legal standards applicable to private fund IDD are somewhat inconsistent and suboptimal, and merit clarification.

The heightened emphasis on private fund IDD as demonstrated in this study could foreshadow the possibility of standardization of private fund IDD. Lacking standards for private fund IDD can partially be attributed to private funds' unique position in markets. Unlike mutual funds, private funds evolved as unregistered entities, free from most regulatory oversight. Accordingly, the private fund IDD evolved without regulatory oversight. In analogy to banks' risk evaluation, fifteen years ago banks operated with general risk evaluation strategies but no uniformity and no applicable standards, whereas today banks' risk evaluation is heavily regulated and has evolved into a science. Private fund IDD may follow the same evolution. Private fund advisers will likely pass associated costs through to their investors.

---

[259] *See* Table 1.
[260] *See* Figure 3.