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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

PHYLLIS MOLCHATSKY and STEVEN SCHNEIDER, M.D., Plaintiffs,	No.
- against -	**COMPLAINT**
UNITED STATES OF AMERICA, Defendant.	

Plaintiffs Phyllis Molchatsky and Steven Schneider, M.D. (collectively, "Plaintiffs"), by their attorneys, Herrick, Feinstein LLP, for their Complaint against Defendant the United States of America (the "United States") allege as follows:

NATURE OF THE ACTION

1. This complaint seeks money damages suffered by Ms. Molchatsky, a disabled retiree and single mother, and Dr. Schneider, a physician, arising from the serial, gross negligence of the United States Securities and Exchange Commission ("SEC")[1] in performing its

[1] The SEC has primary responsibility for enforcing the federal securities laws and regulating the securities industry, the nation's stock and options exchanges, and other electronic securities markets. Its mission "is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." (http://www.sec.gov/about/whatwedo.shtml, accessed October 13, 2009)

non-discretionary functions during its multiple investigations and examinations of Bernard Madoff ("Madoff") and his firm, Bernard L. Madoff Investment Securities LLC ("BMIS"), triggered primarily by its receipt of numerous detailed, credible complaints between 1992 and 2008. As the Office of the Inspector General of the SEC (the "OIG")[2] and its forensic experts have determined in its report dated August 31, 2009 (the "Report"), the SEC had countless opportunities to stop the Ponzi scheme Madoff operated over sixteen years, and botched all of them. (A copy of the Report is annexed hereto as Exhibit A.)[3]

2. Through its negligent actions and inactions (hereinafter collectively referred to as the "SEC's negligence"), the SEC caused Madoff's scheme to continue, perpetuate, and expand, eventually resulting in billions in losses by investors, and directly caused Plaintiffs to lose more than $2.4 million. The SEC owed a duty of care to all of those investors, including Plaintiffs, because it was reasonably foreseeable that they would rely on the SEC to remove the danger posed by Madoff if the SEC had information confirming the existence of that danger. The SEC breached its duty of care and, in doing so, proximately caused Plaintiffs' injuries, in that those injuries were the natural, probable, and foreseeable outcome of the SEC's failure to terminate Madoff's Ponzi scheme despite its multiple opportunities to do so. The fact that Madoff's own actions also contributed to Plaintiffs' injuries does not protect the SEC from

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[2] The SEC's Office of the Inspector General "is an independent office within the U.S. Securities and Exchange Commission (SEC or Commission) that conducts audits of programs and operations of the Commission and investigations into allegations of misconduct by staff or contractors. The mission of the OIG is to detect fraud, waste and abuse, and to promote integrity, economy, efficiency and effectiveness, in the Commission's programs and operations." (*see* http://www.sec-oig.gov/, accessed October 13, 2009)

[3] The factual allegations contained herein are based principally on the findings of the Report, which relied on the OIG's extensive review of documents and sworn testimony obtained from numerous current and former SEC employees, email and document searches, document requests to third parties, and a team of experts and consultants with "unique and specialized experience." (Report pp. 5-6) To the extent that the allegations made herein are not expressly set forth in the Report, they are based on reasonable inferences drawn therefrom, or upon plaintiffs' information and belief. To the extent that factual allegations or

liability, because the SEC's negligence was both a substantial factor in bringing about those injuries, and because those injuries would not have occurred but for the SEC's negligence. Had the SEC carried out its functions with even a minimum of reasonable due care, many, if not most, of Madoff's victims would have been spared the financial ruin they face today.

3. Furthermore, the SEC's negligence is not shielded by the doctrine of sovereign immunity because it did not occur in the performance of its discretionary functions. Those members of the SEC staff who investigated Madoff from time to time were not crafting policy or making rules. Rather, the SEC staff was carrying out their usual and regular obligations to examine and investigate its registrants and potential wrongdoing within the context of defined policies and routine common-sense practices,[4] and failed to fulfill their duties.

4. Before Madoff first came to the SEC's attention, he was well-known and highly regarded as one of the wizards of Wall Street. A one-time Chairman of NASDAQ, with billions supposedly under management, investors angled for a purportedly "rare" opportunity to "get in with Bernie." They were lured by the consistent, year-in-year-out double-digit returns produced by the "proprietary" "split-strike conversion" strategy that made him the envy of his competitors. Unlike the SEC, Plaintiffs had no way of knowing that the returns Madoff was promising, and delivering, were being paid with money he stole from other investors, not with the proceeds from a brilliant trading strategy and the uncanny "gut feel" Madoff claimed to

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determinations made in the report are not expressly restated herein, they are hereby fully incorporated by reference.

[4] Throughout this complaint, for the sake of simplicity, "policies" refer to any formal or informal policies, rules, standards, guidelines, procedures, codes, routines or other directives implemented by the SEC to govern the conduct of its agents. "Practices" refers to common-sense standards of conduct required of SEC agents in the course of exercising their duties with reasonable due care, regardless of whether the SEC had promulgated any formal or informal policies with respect to that conduct.

possess. In disregard of its non-discretionary obligations, the SEC repeatedly over many years failed to expose the fraudulent scheme being perpetrated by Madoff.

5. Beginning in 1992, and continuing through 2008, the SEC received a steady stream of at least eight complaints or submissions indicating that Madoff was operating a Ponzi scheme. In response, the SEC commenced four formal investigations or examinations, as well as several informal reviews or inquiries.[5] But throughout the course of those many inquiries, the SEC staff consistently disregarded SEC policy that "all relevant information contained in tips and complaints *must* be sufficiently vetted" and that, even if the staff is skeptical, they "*must* still review all of the allegations before any conclusions can be made with regard to the legitimacy of such allegations." (Report p. 167, n. 104) (emphasis added)[6] The SEC's rank negligence, incompetence, inexperience, inattentiveness, and laziness, caused Madoff and BMIS to pass through the SEC's investigations unscathed. Indeed, over many years, although the SEC was presented with innumerable smoking guns unveiling Madoff's wrongdoing, the SEC staff failed to follow up and failed to recognize any of them for what they were—the keys to unraveling possibly the largest financial fraud in history.

6. The SEC's negligence would take many forms over the course of its multiple investigations of Madoff. Inquiries were delegated from SEC teams that had expertise

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5 The OIG identified several other investigations, inquiries and examinations other than those described in this Complaint, but the OIG concluded that none of them were related to, or could have exposed, Madoff's Ponzi scheme. Plaintiffs have declined to include a discussion of those other investigations, inquiries and examinations in this Complaint in reliance on the OIG's conclusion, but specifically reserve all of their rights to amend their pleading to incorporate them in accordance with facts and circumstances as they develop.

6 For the sake of clarity, throughout this Complaint, the names of SEC staffers are omitted and are all simply referred to as staff, or where appropriate, "junior" staff or "supervising" staff. Full names of the relevant individuals are provided in the Report. Likewise, all varieties of SEC inquiries, whether informal reviews, examinations, or investigations, are referred to as "investigations." A more complete description of the technical variations between the relevant terms is set forth in the Report.

in financial fraud to ones that did not. Critical tasks were assigned to junior staffers who had no relevant training or experience. Those junior staffers were at best functionally unsupervised, and at worst, were given supervision that actively discouraged them from pursuing leads. Policies and practices regarding case opening and closing memoranda, investigation planning memoranda, and communications between SEC offices and teams were routinely disregarded. Investigative teams consistently failed to contact third parties to confirm Madoff's claimed trading activities, even when called for by the teams' own plans for their investigations. Petty jealousies and inter-office rivalries led to tipsters being disregarded and key resources of other SEC teams going unutilized. And clouding every step of the SEC's various investigations was a perception of Madoff's power and influence that cowed staff members into giving him the benefit of the doubt, despite their suspicions—or even knowledge—that he had lied to them.

7. For at least sixteen years, the SEC's failure to follow basic investigative procedures and practices, or even to observe simple common sense, allowed Madoff to perpetuate his scheme, drawing in innumerable new victims who were totally unaware that the government agency sworn to protect them had fallen down on the job.

8. By December 2008, however, the economy bore down on Madoff (Lehman Brothers' collapse, the 50% decline in the stock market, and a tidal wave of other financial calamities) and seriously hampered his ability to keep the Ponzi scheme afloat. Redemptions were far outpacing his ability to draw in new victims. On December 11, 2008, Madoff purportedly confessed the scheme to his sons. The next day, he revealed his fraud to the world. His entire business he said, was "one big lie," and the billions he had been entrusted was simply "gone -- all gone." Thousands of innocent victims, including individuals running the

gamut from successful businesspeople to disabled single mothers, charities, universities, pension funds—and even Madoff's own friends—suddenly found out that they had lost everything.

9. Bernard Madoff is obviously the chief culprit in the scheme that imploded so shockingly in December 2008. However, the SEC must be held accountable and responsible for its own negligent actions and inactions that directly and proximately caused the loss of billions of investor funds. The SEC investigated Madoff on multiple occasions over sixteen years and had innumerable chances to expose the fraud. The SEC failed to do so because the assigned staff committed numerous negligent, non-discretionary acts and inactions due chiefly to their inexperience, incompetence, bureaucratic pettiness, laziness, inattentiveness, and an agency culture of deference to powerful industry figures. Rather than protect the investing public by uncovering and disclosing that Madoff was perpetuating a fraudulent scheme, the SEC's ineptitude directly resulted in Madoff using, to the detriment of his many victims, the multiple, implied "clean bills of health" issued by the SEC to Madoff to market his scheme to unsuspecting victims, vastly expanding his fraudulent web.

10. Plaintiffs here were among those scammed by Madoff. Dr. Schneider, a physician now approaching retirement age, began investing his IRA directly with Madoff in 1997, five years after the SEC could have stopped Madoff during its first investigation of him in 1992. Ms. Molchatsky, a disabled retiree, invested her entire life savings in one of Madoff's feeder funds in late 2001, after the SEC had twice been explicitly warned by a whistleblower, Harry Markopolos, that Madoff was a fraud. When the scheme collapsed, Dr. Schneider discovered he had lost more than $750,000 of his retirement savings, and Ms. Molchatsky discovered she had lost $1.7 million. Both had made their investments in reliance on Madoff's reputation, clean regulatory record, and the SEC's implied stamp of approval.

11. After the Madoff scheme collapsed, the then-Chairman of the SEC made the following remarkable statement—and preliminary admission of the SEC's negligence—as he was announcing the investigation that would be conducted by OIG:

> Our initial findings have been deeply troubling. The Commission has learned that credible and specific allegations regarding Mr. Madoff's financial wrongdoing, going back to at least 1999, were repeatedly brought to the attention of SEC staff, but were never recommended to the Commission for action. I am gravely concerned by the apparent multiple failures over at least a decade to thoroughly investigate these allegations or at any point to seek formal authority to pursue them.
>
> Moreover, a consequence of the failure to seek a formal order of investigation from the Commission is that subpoena power was not used to obtain information, but rather the staff relied upon information voluntarily produced by Mr. Madoff and his firm.
>
> In response, after consultation with the Commission, I have directed a full and immediate review of the past allegations regarding Mr. Madoff and his firm and the reasons they were not found credible, to be led by the SEC's Inspector General. The review will also cover the internal policies at the SEC governing when allegations such as those in this case should be raised to the Commission level, whether those policies were followed, and whether improvements to those policies are necessary.

(A copy of the full press release is annexed hereto as Exhibit B.)

12. The OIG's Report revealed real and meaningful "multiple failures" of the SEC, and that its staff failed to follow the SEC's own internal policies and practices and the common-sense dictates of ordinary due care during the SEC's multiple investigations of Madoff. Indeed, as Chairperson Schapiro stated publicly on September 4, 2009 in a statement regarding the OIG report, the SEC's negligence was a "failure we continue to regret"—small solace to the victims who have lost billions.

13. The OIG's Report concluded as follows:

The OIG investigation found that the SEC received numerous substantive complaints since 1992 that raised significant red flags concerning Madoff's hedge fund operations and should have led to questions about whether Madoff was actually engaged in trading and should have led to a thorough examination and/or investigation of the possibility that Madoff was operating a Ponzi scheme. However, the OIG found that although the SEC conducted five examinations and investigations of Madoff based upon these substantive complaints, they never took the necessary and basic steps to determine if Madoff was misrepresenting his trading. We also found that had these efforts been made with appropriate follow-up, the SEC could have uncovered the Ponzi scheme well before Madoff confessed.

The OIG found that the conduct of the examinations and investigations was similar in that they were generally conducted by inexperienced personnel, not planned adequately, and were too limited in scope. While examiners and investigators discovered suspicious information and evidence and caught Madoff in contradictions and inconsistencies, they either disregarded these concerns or relied inappropriately upon Madoff's representations and documentation in dismissing them. Further, the SEC examiners and investigators failed to understand the complexities of Madoff's trading practices and the importance of verifying his returns with independent third parties.

The OIG did not find that the failure of the SEC to uncover Madoff's Ponzi scheme was related to the misconduct of a particular individual or individuals, and found no inappropriate influence from senior-level officials. We also did not find that any improper professional, social, or financial relationship on the part of any former or current SEC employee impacted the examinations or investigations.

Rather, there were systematic breakdowns in the manner in which the SEC conducted its examinations and investigations, and for that reason, the OIG is issuing under separate cover two audit reports providing the SEC with specific and concrete recommendations to improve the operations of both OCIE [Office of Compliance Inspection and Examinations] and Enforcement.

The OIG also recommends that the Chairman carefully review this ROI and share with OCIE and Enforcement management, the

> portions of this ROI that relate to the performance failures by those employees who still work at the SEC, so that appropriate action (which may include performance-based action, as appropriate) is taken, on an employee-by-employee basis, to ensure that future examinations and investigations are conducted in a more appropriate manner and the mistakes and failures outlined in this ROI are not repeated.

(Report pp. 456-457)

14. The SEC did not have "discretion" to conduct its investigations with the blatant lack of reasonable due care revealed in the Report, which evidenced such outrageous, wanton indifference to public safety as to constitute gross negligence. The misconduct of the SEC staff had nothing to due with rule-making or policy analysis and implementation. Rather, this is a case of individual agency staff members with no rule-making function failing to follow the SEC's clear policies and practices, while the entity subject to SEC regulation engaged in a massive fraudulent scheme, resulting in damages to thousands of investors, causing a worldwide financial tsunami.

15. The SEC cannot evade accountability with a shield of immunity that is designed to be reserved for policy decisions. Nor can the SEC seek refuge in a warped premise that because the damage inflicted was so vast, it is somehow incapable of being remedied civilly. Plaintiffs respectfully request that the Court award them compensatory damages in the amount of their net principal investments in Madoff's scheme, plus reasonable attorneys' fees, costs, and such other and further relief as the Court deems just and proper.

THE PARTIES

16. Plaintiff Phyllis Molchatsky is a resident of the State of New York.

17. Plaintiff Steven Schneider, M.D. is a resident of the State of New York.

18. Defendant United States of America is the federal government constituted by the Constitution of the United States, and is the proper party defendant under the Federal Tort Claims Act ("FTCA") in this action for damages resulting from the negligence of the United States Securities and Exchange Commission ("SEC") and its agents and employees.

JURISDICTION AND VENUE

19. This action arises under the Federal Tort Claims Act, 28 U.S.C. §§ 2671, *et seq*. ("FTCA").

20. On December 23, 2008, Ms. Molchatsky submitted an Administrative Claim for the FTCA claim set forth below to the SEC.

21. On March 13, 2009, Dr. Schneider submitted an Administrative Claim for the FTCA claim set forth below to the SEC.

22. By letter dated June 22, 2009, the SEC denied Ms. Molchatsky's claim. All conditions precedent to her FTCA action have been met.

23. By letter dated September 10, 2009, the SEC denied Dr. Schneider's claim. All conditions precedent to his FTCA action have been met.

24. This court has jurisdiction under, and by virtue of, 28 U.S.C. §§ 1331 and 1346 (b).

25. Venue is founded in this judicial district based on 28 U.S.C. §§ 1391 (e)(2) and 1402 (b), as a substantial part of the acts or omissions complained of occurred in this district, and on 28 U.S.C. §§ 1391 (e)(3) and 1402 (b) as the named plaintiffs reside in this district.

FACTUAL ALLEGATIONS

A. Background - Bernard Madoff's "Business"

26. In 1960 Bernard Madoff founded Bernard L. Madoff Investment Securities LLC, a brokerage firm, through which he rapidly accumulated thousands of clients. In 1990, 1991, and 1993, Madoff served as the Chairman of the NASDAQ Stock Market, and the trust and authority he had developed in that position enabled him to attract a wide array of investors to his firm in subsequent years. These investors included individuals, charities, universities, and pension funds, who often entrusted their entire life savings or endowments to Madoff.

27. Madoff promised his clients a double-digit annual return on their investments, year in and year out, regardless of whether there was a bull or bear market. These promises were regarded as unrealistic by various respected authorities in the securities industry. But over the years, Madoff appeared to deliver on his promises. Investors received account statements showing consistent gains, and redemptions were paid to investors without delay.

28. Some lucky investors chose to liquidate their accounts after accumulating what appeared to be a substantial profit. But many chose to maintain, or even increase, their investments, given the prospect of continuing gains—a prospect that also enticed innumerable additional investors to entrust their money to Madoff. And new victims, enticed by stories of Madoff's remarkable success, were induced to invest in the scheme, allowing Madoff to keep it afloat by using their money to pay redemptions by the old investors.

29. Madoff claimed that his firm's success was due to a unique trading strategy called "split-strike conversion," which involved buying puts and selling covered call options on the Standard & Poor's ("S&P") 100 index to hedge his clients' blue-chip portfolios,

converting those portfolios to cash at the end of selected quarters, and then beginning again with a repurchase of a similar hedged portfolio.[7] When asked about his strategy, Madoff was always evasive, saying that it was a proprietary secret. Other firms that attempted to apply similar strategies were unable to produce profits that were remotely comparable to Madoff's.

30. Madoff operated his business in a highly secretive and centralized fashion, shrouded from public scrutiny. In fact, Madoff operated the investment advisory component of the business (which was allegedly the profit-making center of the operation) from a separate floor of the firm's offices in Manhattan's Lipstick Building located at 885 Third Avenue, with access restricted to Madoff and a small handful of his most trusted confederates. Only Madoff had access to the books and records supposedly accounting for those assets and for the billions of dollars in trades he claimed to be executing.

31. Until 1992, the consistent and hefty rate of return, the unusual "proprietary" trading strategy, and the obsessive secrecy did not arouse even the faintest suspicion at the SEC. But right under the most powerful securities regulator's nose, Madoff was running the "World's Largest Ponzi Scheme."

B. June 1992 - Avellino & Bienes and the SEC's First Missed Opportunity

1. Background & Red Flags

32. In June 1992, customers of a firm known as Avellino & Bienes provided the SEC with promotional materials created by Avellino & Bienes that touted "100%" safe investments that would return consistently high rates of return over significant periods of time.

[7] A "put" is an option to sell a security in the future, while a "call" is an option to buy a security in the future. Madoff claimed that by buying puts and selling calls, a strategy called a "collar," he could hedge his customers' losses and generate consistent returns.

The opportunity to invest with Avellino & Bienes was portrayed as "special" and exclusive, and the firm claimed that VIP clients would earn even higher returns.[8] (Report pp. 41-42)

33. The Enforcement team of the SEC's New York office opened an investigation, and the red flags that had prompted the investigation soon multiplied. The team quickly learned that Madoff had complete control over all of Avellino & Bienes's investments. He made all investment decisions with no input from Avellino or Bienes, who merely funneled investor money to Madoff. One of the firm's principals told the SEC that Madoff had not lost money on a single trade executed for a firm customer since their exclusive relationship began in 1962. The principal explained that Madoff was able to achieve these results by using a strategy based on blue-chip stocks hedged by options on the S&P index. (Report pp. 45-46)

2. The SEC's Negligent Handling of its Investigation

34. The Enforcement team suspected, based on the red flags raised before and during its initial investigation, that Avellino & Bienes was operating a Ponzi scheme, but never considered the possibility that Madoff was also running a Ponzi scheme. The team's investigation was tailored and carried out accordingly, resulting in the first of many missed opportunities to catch Madoff. (Report p. 46, n. 20; 49)

35. The team the SEC assigned to investigate Avellino & Bienes was woefully inexperienced. Both examiners assigned to the case were only 2 years out of college, and had no expertise or understanding of how Ponzi schemes operated. (Report pp. 46-47) Moreover, the supervisor later admitted that the team may have been overawed by Madoff, stating that "it was

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[8] The façade of an "exclusive club" is often used to enhance the allure of investing in a Ponzi scheme, making investors feel "lucky" to have the opportunity to participate in an opportunity touted as being only for the "elite."

fair to say that because of...Madoff's reputation at that time...there may not have been any thought to look into [his] operation any further." (Report p. 50)

36. The team conducted a very limited examination, failing to take rudimentary steps that would have demonstrated that Avellino & Bienes was merely one of many fronts for Madoff's Ponzi scheme.

37. For example, the team made no effort to obtain bank records or otherwise trace the source of the money that was used to repay Avellino & Bienes' investors. This was critical because if Avellino & Bienes were operating a Ponzi scheme as suspected, it should not have had access to cash to pay off investors. The team's supervisor later told OIG that the team "should have been aware" of this fact, and one of the staffers testified that it would have been "common sense" to trace the money. (Report p. 49)

38. Critically, the team did not make any effort to obtain any other information independently from third parties, which an SEC branch chief would later tell OIG was "the only way to verify" whether a Ponzi scheme is being conducted. (Report p. 290, n. 202) Although the team did review records from the Depository Trust Corporation ("DTC"), [9] they obtained those DTC records from Madoff, not directly from DTC, and the Madoff-supplied records were later determined to have been falsified.

39. Moreover, with respect to document requests to Madoff, "[n]one of the [team members] interviewed by the OIG recalled whether the SEC eventually received the information and documents concerning Bernard Madoff that it requested in discovery." (Report p. 58) And the documents the team did receive only threw up more red flags. For example, the

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[9] The DTC is the entity which holds actual paper stock certificates on behalf of their owners, and maintains and operates the records and mechanisms necessary for buyers and sellers to transfer ownership without

team's auditors were unable to confirm Madoff's trading activity using his customer statements, which the auditors found indecipherable.

40. A senior-level SEC examiner later told OIG, "clearly if someone ... has a Ponzi [scheme] and, they're stealing money, they're not going to hesitate to lie or create records." (Report p. 49) The lead staffer on the team later admitted to the OIG that the team "should have been aware that the money used to pay back Avellino & Bienes' customers could have come from Madoff," and that independent confirmation of the source from DTC was essential. (Report p. 49) The supervisor stated that the DTC confirmation was "missed and should have been followed up on." Another team member characterized the failure to look into the actual source of the funds as a failure to observe "common sense." (Report p. 60)

41. Separately, while the lead staffer believed that the entire Avellino & Beines operation raised red flags and was "suspicious," the team took no actions to investigate Madoff's alleged investment strategy, which was the sole vehicle for Avellino & Bienes's investments. They never attempted to determine whether the strategy could actually achieve the returns Madoff claimed, or to substantiate the extraordinary claim that he had never suffered a trading loss in three decades. (Report p. 60)

3. Closing of the Investigation & Conclusions

42. Instead of taking the simple steps required by SEC policy and common-sense practice, the SEC took the easy way out. It brought an action against Avellino & Bienes for selling unregistered securities, and required it to refund all of its customers' money. Again, however, the team made no effort to determine where Avellino & Beines was getting the funds

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having to take custody of or actually exchange the physical certificates. DTC's records can easily be used to verify claims of ownership of securities.

to pay out a full redemption to all of its customers, reflecting a basic lack of understanding of Ponzi schemes. Of course, the money was coming from Madoff, who could only have been relieved to evade discovery of his entire scheme by paying redemptions to a single fund's customers.

43. The SEC's negligence in the Avellino & Beines investigation included, without limitation:

- Assignment of a Ponzi-scheme investigation to SEC staff who had no experience with Ponzi schemes;
- Failure by the staff who received the initial complaint to tell the investigating staff that a Ponzi scheme was suspected;
- Failure to obtain DTC statements from DTC itself, instead of requesting them from Madoff;
- Failure to inquire as to the source of the money used to pay back Avellino & Beines customers; and
- Failure to inquire further when Avellino & Bienes were unable to produce any detailed financial statement or records.

44. As the OIG's Report concluded:

> The result [of the SEC's investigation of Avellio & Bienes] was a missed opportunity to uncover Madoff's Ponzi scheme 16 years before Madoff confessed. The SEC had sufficient information to inquire further and investigate Madoff for a Ponzi scheme back in 1992. There was evidence of incredibly consistent returns over a significant period of time without any losses, purportedly achieved by Madoff using a basic trading strategy of buying Fortune 500 stocks and hedging against the S&P index. Yet, the SEC seemed satisfied with closing Avellino & Bienes down, and never even considered investigating Madoff, despite knowing that Avellino & Bienes invested all of their clients' money exclusively with Madoff. The SEC's lead examiner said Madoff's reputation as a broker-dealer may have influenced the inexperienced team not to inquire into Madoff's operations.

(Report, pp. 26-27)

C. June 1997 - Dr. Schneider Entrusts His Retirement to Madoff

45. In June 1997, Dr. Schneider decided to place his Individual Retirement Account ("IRA") with BMIS. At the time, he felt privileged to be able to do so because Madoff was widely-known for his consistent, reliable success on behalf of his clients, and was equally well-known for his (purported) selectivity in allowing new investors to join his "exclusive club." Moreover, Dr. Schneider took comfort in the fact that Madoff was running an operation that was highly regulated by government and self-regulatory agencies, chiefly the SEC.

46. Of course, Dr. Schneider did not know that five years earlier, Madoff had been closely linked to an investment operation the SEC had shut down. He did not know that the SEC had dismantled that alleged Ponzi scheme, which invested all of its money with Madoff, without ever substantively investigating Madoff himself. He certainly had no way of knowing that the SEC had negligently relied on Madoff, and not DTC, or any other independent third party, to provide the corroboratory documents that purportedly proved that he was actually trading, when in fact he was not. In short, Dr. Schneider had no way of knowing that the SEC had been a hair's breadth from exposing Madoff as a total fraud in the early days of the scheme before billions were looted, but had failed to do so because of its rank incompetence.

D. May 2000 - Harry Markopolos's First Attempt

47. In May 2000, eight years after the SEC's first chance to stop Madoff slipped away during the Avellino & Bienes investigation, an industry analyst and Certified Fraud Examiner named Harry Markopolos gave the SEC's Boston office an eight-page complaint questioning the legitimacy of Madoff's reported returns, and provided substantial evidence and analysis to support his complaint. (Report p. 61)

48. Markopolos set forth two possibilities for Madoff's performance: (a) that "[t]he returns are real, but they are coming from some process other than the one being advertised, in which case an investigation is in order;" or (b) "[t]he entire fund is nothing more than a Ponzi Scheme." Markopolos contended that Madoff's returns were unachievable using the "split-strike conversion" strategy and pointed out that Madoff's "perfect market-timing ability" was not a realistic explanation. Markopolos also pointed out that Madoff did not allow outside performance audits, further indicating a real risk of fraud. (Report p. 61)

49. Markopolos subsequently attended a meeting at the Boston office in which he explained his analysis and encouraged the SEC to investigate Madoff. However, it was clear to Markopolos and an SEC accountant in attendance that the top SEC staffer at the meeting had "zero comprehension" of what Markopolos was explaining. In fact, Markopolos characterized the staffer as "not having a basic understanding of finance." The Report would later conclude that the senior staffer's ignorance of the subject matter was the likely reason that Markopolos's 2000 warning was disregarded by the Boston office. (Report p. 64)

50. This same staffer later stated that he had forwarded the complaint to the New York office, which he claimed was the proper office to handle the complaint because of Madoff's location in New York. However, the OIG found no evidence that he had actually forwarded the complaint, and nobody in the New York office recalls receiving it. (Report pp. 64-65)

51. In summary, the SEC's negligence in its handling of Markopolos's 2000 complaint included, without limitation:

- Assigning an SEC staff member who "had zero comprehension of topics" Markopolos discussed with him, who was "very ill-trained, uninformed about industry practices, did

not understand financial instruments...[and who] [d]idn't even have a basic understanding of finance" to investigate Markopolos' complaint; and

- That staff member's failure to forward Markopolos' complaint to the SEC's New York office despite that staffer's claims that he did.

E. March 2001 - Markopolos Tries Again

52. In March 2001, ten months after filing his first complaint, Markopolos returned with a second complaint, with updated information and additional analysis aimed at simplifying the presentation to the SEC staffers. The new complaint included an analysis of Madoff's returns versus the S&P 500, showing that:

> [Madoff purportedly] [e]arned over 15½% a year for over seven years with extremely low standard deviation of 4.3% versus the S&P 500 which earned over 19½% but with 12.9% annual standard deviation over the same period. This program earned 80% of the market's return with only one third of the risk. Think about it! Is this really possible, or is it too good to be true? *(I have attached an excel spreadsheet comparing and contrasting Madoff's program to the S&P 500 index.)*
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> Only 3 down months vs. the market's down 26 months during the same period, with a worst down month of only -1.44% (April 1993) vs. the market's worst down month of -14.58% (August 1998). ...
>
> These numbers really are too good to be true. And every time I've thought a company's or a manager's numbers were "too good to be true," there has been fraud involved.
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> Yes, access to order flow is worth something but this worth can be measured in pennies per share. ...
>
> Yes, Madoff can make more intelligent short-term bets via their access to order flow. However, short-term forecastability does not lead to long-term knowledge of where the stocks that he buys are headed. Short-term he may know there are a lot of IBM shares to buy, but that doesn't lead to knowledge of where IBM will be trading next month.

> Madoff's out-of-the-money OEX index puts do offer protection against systemic market declines. However, his 30-35 stock portfolio has individual company risk in it and should experience more frequent and more sizeable losses than what his performance record indicates.

(Report pp. 67-68)

53. Markopolos concluded that Madoff's "numbers really are too good to be true." Markopolos's analysis was supported by the experience of two of his colleagues, Neil Chelo and Frank Casey, both of whom had substantial experience and knowledge of investment funds, and both of whom offered their corroboration to the Boston office. (Report pp 68-70)[10]

54. This time, the Boston office did refer Markopolos's second complaint to New York, but the New York office decided, after just one day, not to investigate the complaint. The senior Enforcement attorney in New York who received Madoff's second complaint rejected it out of hand, sending an email stating, "I don't think we should pursue this matter further." Later, the Enforcement attorney told the OIG that she "would have needed to consult" someone more experienced to actually understand Markopolos's complaint, but did not do so. (Report p. 73) The OIG "could find no explanation for why Markopolos's complaint, which the Enforcement attorney...acknowledged was 'more detailed than the average complaint,' was disregarded so quickly." (Report p. 27)

55. In summary, the SEC's negligence in its handling of Markopolos's 2001 complaint included, without limitation:

- Assigning the review of the complaint to an SEC staff member who had never handled a Ponzi-scheme investigation and had no understanding of options trading, an integral part of Madoff's purported strategy;

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[10] Chelo was a chartered financial analyst, chartered investment analyst, and a financial risk manager with substantial experience researching hedge funds. Casey was a registered investment adviser with an options specialization. (Report p. 68)