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From: Ed Epstein <[REDACTED]>
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Subject: The Lone Swindler Theory: Did Madoff Act Alone? (Draft: Please Do Not Circulate Without Permission)

Did Madoff Act Alone?

By Edward Jay Epstein

Madoff did not share the credit for perpetrating the biggest Ponzi Scheme in the annals of crime. After his arrest on December 11th 2008 he insisted to the FBI and federal prosecutors that he, acting entirely alone, organized and ran the confidence game that created over \$50 billion in imaginary profits and that resulted in more than 6,500 investors losing \$13.2 billion in real money. According to him, the entire operation was confined to a sealed-off suite of offices called "House 17", located one floor below his legitimate market-making business in the Lipstick Building on 3rd Avenue Manhattan. It required a coded key-card for entry, and access was limited to only about 20 employees. In the back of suite was the so-called "the cage" in which three clerks logged in all the checks and wires that were deposited or withdrawn in the JP Morgan Chase bank account for Madoff's "Investment Advisory" service (which was, unknown to them, the cover for the Ponzi Scheme swindle). They manually recorded the amounts on index cards for Madoff, which gave him a running tally of how much actual money was available. Beyond the "cage" was an open area in which three young researchers filled in the historic prices of stocks and options that Madoff requested, using tables from the Bloomberg wire service and other public sources. This data, according to Madoff, allowed him to forge trades, which he would later send in the form of a printed list to data-entry clerks in a glass-enclosed area in the center of the room called the "fish bowl." They would then punch his lists into an 1988-vintage IBM AS 400 computer (which was not connected to any external system.) The computer then calculated "commissions" as well as "profits" or "losses," and generated daily and monthly customer statements for each account, which were then printed and posted by regular mail. As the "profits" were consistently greater than the "losses", the value of the accounts increased accordingly. All these operations were done under the eagle-eye supervision of Madoff's long-time deputy, Frank DiPascali. According to Madoff, neither DiPascali or anyone else in House 17, had any inkling that the trades they were processing were fictional. As for his 18th floor employees, and his accountants— he used a two-man accounting firm that worked out of a 700 square foot office in Westchester— all they saw was the wealth of computer-generated statements showing he trading the shares.

The flaw in his lone swindler story became evident to me when I was allowed to examine Madoff's actual confirmation slips. These were made available to me at a global business intelligence company founded by former American and British intelligence officers, which specializes in investigating, as they put it, "opaque business environments". The person there who had obtained these Madoff files from off-shore "feeder" funds that had been supplying Madoff with more than half the money funneled into the Ponzi scheme since 1998. Unlike hedge funds which invest money, feeder funds simply raise money and then turn it over to a hedge fund with which it has an arrangement. Ordinarily, the feeder fund gets a relatively small percent of the money it corrals from the hedge fund— typically 1 percent— while the hedge fund charges the investors both a hefty performance and net asset fee. Madoff had, however, offered select feeder funds a much better deal. Instead of charging them anything for managing their money, he would work for them for free, allowing them to collect the entire performance fee, which could be as much as 20 percent of the profits. This provided a bonanza for feeder funds which deducted the performance fee from their clients' accounts each year, transferred it to their own "carry" account, and then withdrew it. To justify these fee, these funds verified that the trades reported in Madoff's confirmation slips were in keeping with the conditions specified in the trading authority that they had agreed upon. Since conditions often varied between feeder funds, and even their sub-funds, Madoff could not make all the same fictional trades for all the funds. As a result, by 2008, he needed to invent a huge number of transaction in order to keep turning over the \$64 billion that supposedly was in his accounts (especially since he "sold" all his holding and went to cash before each reporting period). The typical "trade," as far as I could concern from the file, was well under \$500,000, which meant he needed to invent hundreds of thousands of trades a year that both conformed to the different conditions in the trading authorizations, was consistent with the price of that security that day, and resulted in his achieving his overall "targeted earnings." Each slip I reviewed

contained every relevant details of the transaction, including even the securities "cusip number"

"It is impossible that Madoff could do all this work himself," the person at the private intelligence firm said as he pushed over to me a foot-high stack of Madoff confirmation slips.. "Every price on every slip had to be checked against the actual high and low that day. Just the paperwork for these feeder funds would require the full-time services of a group of people who knew exactly what they were doing." He estimated that "at a minimum, you would need 5 people." These operatives would presumably also have to be willing and discrete participants in a con game.

Furthermore, these feeder funds were not the only part of the criminal enterprise that required systematic forgery. A handful of Madoff's long-time associates had about 100 accounts that had been used between 1992 and 2008, to siphon off billions through redemptions. To get fictional profits into these men's accounts Madoff faked transactions on a very different scale from those faked for the feeder funds. Some were credited with fictional trades that produced a rate of return 40 times greater than that of the off-shore feeder funds. In one such favored account, according to the Trustee for the bankruptcy, Madoff "purported to earn over 950% in 1999" [emphasis Trustee's], while most of the feeder funds were earning a mere 15 percent. In another favored account, according to a SEC complaint, not a single loss was reported in thousands of trades over a ten year period. These were bespoke accounts, custom-tailored to produce enormous profits. Just two of his long time associates were thus able to withdraw \$8.8 billion (which is more than half the money actually lost in the Ponzi scheme.) In addition, such customized padding of accounts was used, according to the SEC, to pay some associates off the books, and, via back-dating, to minimize tax bills. These customized transactions exponentially added to the fraudulent paperwork.

In reality, this was not a financial scandal, but a well-run confidence game. Not a penny of the \$13.2 billion that disappeared was lost in the stock market. The lion's share of this loot exited through a few accounts that had been systematically inflated with non-existing "profits" over two decades and its ultimate whereabouts still remains a mystery. To be sure, Madoff, was the impressive face of the criminal enterprise. As a former Chairman of the NASDAQ stock exchange and well-respected doyen of Wall Street, he lent what is crucial in any confidence game: credibility. As federal prosecutors themselves pointed out before he was sentenced to 150 years in prison, "his demonstrated ability to lie, mislead, and deceive is staggering." If so, his claim that he was the sole employee and sole author of this criminal enterprise can hardly be accepted at face value, especially since he may have a interest, such as fear of the consequences, in not fully sharing the credit.

Regards

Ed

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