

BECKER & POLIAKOFF LLP

Helen Davis Chaitman

HCHAITMAN@BECKER-POLIAKOFF.COM

Peter W. Smith

PSMITH@BECKER-POLIAKOFF.COM

11 Wharf Avenue – Suite 4
Red Bank, New Jersey 07701
(732) 842-1662

and

45 Broadway
New York, New York 10006
Telephone (212) 599-3322
Facsimile (212) 557-0295

*Attorneys for Plaintiffs Stanley Baer,
Jesse L. Cohen, Alan Roth, Elaine Ruth
Schaffer, and Lenore H. Schupak*

**UNITED STATES DISTRICT COURT
DISTRICT OF NEW JERSEY**

STANLEY BAER, JESSE L. COHEN,
ALAN ROTH, ELAINE RUTH
SCHAFFER and LENORE H.
SCHUPAK,

Plaintiffs,

v.

UNITED STATES OF AMERICA,

Defendant.

CASE NO.:

COMPLAINT

Plaintiffs Stanley Baer, Jesse L. Cohen, Alan Roth, Elaine Ruth Schaffer, and Lenore H. Schupak (collectively, “Plaintiffs”), by their attorneys, Becker & Poliakoff LLP, for their Complaint against the United States of America allege as follows:

SUMMARY OF ACTION

1. Plaintiffs sue the United States under the Federal Tort Claims Act (the “FTCA”), 28 U.S.C. §§ 2671 *et seq.*, for the damages they incurred as a result of the negligent and

wrongful acts and omissions of the Securities Exchange Commission (the “SEC”) in conducting its investigations of the operations of Bernard L. Madoff Investment Securities LLC (“BLMIS”) in response to numerous credible reports to the SEC of BLMIS' wrongdoing.

2. But for the SEC’s negligent and wrongful acts (the “SEC’s Incompetence”), BLMIS would have been shut down in 1992 or shortly thereafter, thereby avoiding investor losses of approximately \$50 billion. As a direct result of the SEC’s Incompetence, BLMIS continued its operations until December 11, 2008. During the period from 1992 to December 11, 2008, Plaintiffs, along with thousands of others, lost their lives’ savings.

3. The SEC was formed pursuant to the Securities Exchange Act of 1934 with the express purpose of protecting the integrity of the United States securities markets so that Wall Street insiders would not be able to wrongfully enrich themselves at the expense of the average investor. The failure of the SEC to uncover the fraud perpetrated by Bernard L. Madoff (“Madoff”) -- despite seven investigations over a 14-year period -- is a stunning and painful example of the SEC’s utter failure to fulfill its fundamental purpose.

4. The SEC owed Plaintiffs a duty to execute its functions in accordance with federal law, in accordance with the standards to which it held others in the securities industry, and in accordance with the standards to which it purportedly held its own personnel. It breached these duties in every respect.

5. The SEC’s Incompetence was the direct cause of the Plaintiff’s financial injuries. These injuries were a natural, probable and foreseeable outcome of the SEC’s failure to uncover the Madoff Ponzi scheme and of the SEC’s false assurances to the public, as early as December 1992, that the operations of BLMIS were legitimate.

6. The SEC's Incompetence is not shielded by the discretionary function exception to the waiver of sovereign immunity under the FTCA. The SEC's Incompetence did not occur in the performance of its discretionary function. Nor is the SEC's Incompetence susceptible to any policy considerations. On the contrary, the SEC's essential purpose was flagrantly frustrated by its own failure to abide by federal law and its consistent failure to adhere to its own internal standards. In conducting its numerous investigations of BLMIS, the SEC consistently disregarded the standards of competence which it imposed upon third parties. To give just a few examples:

(a) In flagrant violation of federal regulations prohibiting the SEC from giving preferential treatment to important or powerful figures on Wall Street, the SEC treated Madoff with "kid gloves" because of his stature in the industry and his friendship with senior SEC officials. As a result, the SEC failed to take the most basic investigatory steps that would have uncovered and put an immediate end to Madoff's fraud. But for the preferential treatment given to Madoff by the SEC, the BLMIS fraud would have been discovered in the early 1990's and investors in BLMIS would have saved tens of billions of dollars.

(b) The SEC has fostered a culture of incompetence for over a decade, pursuant to which personnel who spend their time looking at pornography on their office computers and personnel who utterly fail to fulfill their jobs are continued in the SEC's employment. This conduct resulted in the failure of SEC personnel to exercise even a minimal level of competence with respect to the BLMIS investigations. Personnel from different offices failed to communicate with each other. When they did "coordinate" with each other, they misinformed each other to conceal their own incompetence in conducting previous Madoff investigations.

People were re-assigned and whatever information these people had was not communicated to others who were replacing them on the investigation.

(c) Despite the fact that it is essential for the SEC's performance of its functions that it intelligently evaluate whistle blower information, SEC personnel consistently disregarded the requirement that information contained in credible tips be "sufficiently vetted." As a result, the SEC disregarded numerous indicia of fraud without appropriate review and enabled BLMIS to operate from 1992 through 2008.

(d) SEC personnel disregarded internal policies and practices governing the SEC's investigations. For example, SEC staff failed to follow the most fundamental procedures to confirm through third-party sources the information provided to them by Madoff and BLMIS.

7. After Madoff confessed on December 11, 2008, SEC Chairman Christopher Cox admitted that the SEC had received credible and specific information regarding BLMIS' wrongdoing as early as 1992. Cox asked the Office of the Inspector General of the SEC (the "OIG") to commence an investigation to determine why the BLMIS Ponzi scheme was not detected years earlier (the "OIG Investigation").

8. In his initial press release on December 16, 2008, Cox admitted that the SEC's incompetence had allowed BLMIS to operate:

Our initial findings have been deeply troubling. The Commission has learned that credible and specific allegations regarding Mr. Madoff's financial wrongdoing . . . were repeatedly brought to the attention of SEC staff I am gravely concerned by the apparent failures over at least a decade to thoroughly investigate these allegations

SEC Press Release 2008-297: *Statement Regarding Madoff Investigations*, December 16, 2008 at 1.

9. The OIG, along with experts hired to assist with the OIG Investigation (the "FTI Engagement Team"), issued its report on August 31, 2009 (the "Report"). The Report concluded

that, despite numerous credible and detailed complaints, the SEC missed countless opportunities to uncover Madoff's Ponzi scheme because it failed to follow basic SEC procedures during the course of its many investigations of BLMIS.¹ As the Report acknowledged, the failure to detect Madoff's Ponzi scheme resulted from "systematic breakdowns in the manner in which the SEC conducted its examinations and investigations." (Report at 457.)

10. To compound its wrongdoing, following Madoff's arrest, the SEC actively participated with the U.S. Attorney's Office in the criminal investigation of BLMIS so as to conceal its own culpability for the \$64.8 billion of investor losses that are directly attributable to the SEC's wrongful conduct.

11. It cannot be a legitimate governmental policy of the SEC to systematically engage in seven incompetent investigations over a period of fourteen years so as to enable BLMIS and Madoff to steal tens of billions of dollars from innocent investors who justifiably believed that the SEC was competent to perform the function for which it was created.

12. Nor can it be a legitimate governmental policy of the SEC to use its investigatory powers to assure that the true facts will never be disclosed concerning the SEC's liability for enabling Madoff to operate from 1992 - 2008.

PARTIES

13. Plaintiff Stanley Baer is an individual residing at 5 Jonathan Smith Road, Morristown, New Jersey. Mr. Baer made an initial investment in BLMIS in the 1970's and made additional deposits thereafter. Mr. Baer submitted an administrative claim to the SEC under the FTCA on April 23, 2010. The SEC failed to respond to the claim within six months of its submission and the claim is therefore deemed rejected. *See* 28 U.S.C. 2675(a).

¹ The Report is annexed hereto as Exhibit A and is fully incorporated herein.

14. Plaintiff Jesse L. Cohen is an individual residing at 43 Beekman Terrace, Summit, New Jersey. Mr. Cohen made an initial investment in BLMIS on or about November 16, 2006, and made an additional investment thereafter. Mr. Cohen submitted an administrative claim to the SEC under the FTCA on May 6, 2010. The SEC failed to respond to the claim within six months of its submission and the claim is therefore deemed rejected. *See* 28 U.S.C. 2675(a).

15. Plaintiff Alan Roth is an individual residing at 19 River Drive, Marlboro, New Jersey. Mr. Roth made an initial investment in BLMIS on or about July 2, 2001, and made additional investments thereafter. Mr. Roth submitted an administrative claim to the SEC under the FTCA on July 23, 2010. The SEC failed to respond to the claim within six months of its submission and the claim is therefore deemed rejected. *See* 28 U.S.C. 2675(a).

16. Plaintiff Elaine Ruth Schaffer is an individual residing at 22 Yorkshire Drive, Monroe Township, New Jersey. Mrs. Schaffer made an initial investment in BLMIS on or about December 4, 1992, and made an additional investment thereafter. Mrs. Schaffer submitted an administrative claim to the SEC under the FTCA on May 28, 2010. The SEC failed to respond to the claim within six months of its submission and the claim is therefore deemed rejected. *See* 28 U.S.C. 2675(a).

17. Plaintiff Lenore H. Schupak is an individual residing at 53 Norfolk Street, Bergenfield, New Jersey. Ms. Schupak made an initial investment in BLMIS on or about January 22, 1993, and made additional investments thereafter. Ms. Schupak submitted an administrative claim to the SEC under the FTCA on June 24, 2010. The SEC failed to respond to the claim within six months of its submission and the claim is therefore deemed rejected. *See* 28 U.S.C. 2675(a).

JURISDICTION AND VENUE

18. This action is brought under the FTCA, 28 U.S.C. §§ 2671, *et seq.* and the Court has jurisdiction under 28 U.S.C. §§ 1331 and 1346(b).

19. All conditions precedent to this FTCA action have been met with respect to each Plaintiff.

20. The United States is a proper defendant in this action for monetary damages arising from negligent and wrongful acts and omissions of the SEC employees.

21. Venue is proper in this district based upon 28 U.S.C. §§ 1391(e)(3) and 1402(b) because Plaintiffs reside in this district.

FACTUAL ALLEGATIONS

The Purpose of the SEC Is to Protect the Public Investor

22. The SEC was created to instill public confidence in the capital markets and to assure that the United States would never suffer the kind of global economic collapse that Wall Street's insiders caused in 2008. The 1929 stock market crash, which prompted the creation of the SEC, was caused by “wide spread abuses in the securities markets . . . , includ[ing] price manipulation, the excessive use of credit to finance speculative activities, and the misuse of corporate information by corporate officials.”²

23. The SEC was created by the Securities Exchange Act of 1934 (the “Exchange Act”) “to enforce the newly-passed securities laws, to promote stability in the markets and, *most importantly, to protect investors.*”³ The preamble of the Exchange Act makes clear that the SEC is “necessary because perfecting the mechanisms of a national market system and ensuring the

² Rose Arce, *The Sec And The Extent Of Its Power To Sanction: an Analysis Of Teicher V. Securities And Exchange Commission - Did The Court Correctly Apply Chevron V. Natural Resources Defense Council To A Matter Of Agency Interpretation?*, 30 GOLDEN GATE U. L. REV. 593, 595-596 (2000) (citing K. FRED SKOUSEN, AN INTRODUCTION TO THE SEC 2-4 (4th ed. 1987)).

³ *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, <http://www.sec.gov/about/whatwedo.shtml> (last visited Jan. 14, 2011) [“Investor’s Advocate”].

maintenance of fair and honest markets are vital to the national public interest of the United States.”⁴ Throughout its existence, the SEC has advertised that its mission is to “protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.” (The Investor’s Advocate.)

24. SEC Chairwoman Mary L. Shapiro has acknowledged that the SEC’s primary function is to instill public confidence in the capital markets:

All economic activity starts with capital. . . . **Markets that attract this capital are critical to America's economic future. And a strong, focused, vibrant, and nimble market regulator is critical to getting investors back into the market and to maintaining their trust and confidence in the future. Such a regulator is fundamental to the future growth of our economy.**⁵

25. Shapiro described the SEC’s internal standards to the Senate Banking Committee. She stated that the SEC “enforce[s] the securities laws aggressively and intelligently, without fear or favor. Enforcement is one of [SEC’s] core competencies and a central part of [its] heritage as an agency.” *Id.* “We conduct examinations of . . . [brokerage] firms to assess their compliance with laws and regulations. And when we find violations or deficiencies, we direct that corrective action be taken.” *Id.* Throughout its investigations of BLMIS, the SEC failed to adhere to the standards that Shapiro described.

The SEC Is Mandated by Statute and Regulation Not to Favor Wall Street Insiders

⁴ Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: a New International Framework*, 48 HARV. INT’L L.J. 31, 43 (2007).

⁵ Testimony of Mary L. Shapiro Concerning Enhancing Investor Protection and Regulation of the Securities Market before the Senate Committee on Banking, Housing, and Urban Development, March 26, 2009, <http://www.sec.gov/news/testimony/2009/ts032609mls.htm> (emphasis added).

26. “The Securities and Exchange Commission has been entrusted by Congress with the protection of the public interest in a highly significant area of our national economy.”⁶ The SEC staff has an “*obligation to preserve the sanctity of the laws administered by them*” which obligation “*requires that they . . . [enforce the laws] vigorously and diligently but at the same time fairly and impartially and with dignity.*”⁷

27. The SEC staff is obligated to avoid even the appearance of partiality, *i.e.*, the “impression . . . that any person can improperly influence [them], that any person unduly enjoys [their] favor or that [they are] affected in any way by the rank, position, prestige, or affluence of any person.”⁸ Its employees are mandated to “act impartially and not give preferential treatment to any . . . individual.”⁹ Given the effect that the acts of the SEC have on the trust and confidence of the general public, it is critical that its staff, especially, “maintain unusually high standards of . . . impartiality. . . .”¹⁰

28. “[A]ssur[ance] that everyone receives fair and respectful treatment, without regard to wealth, social standing, publicity, politics, or personal characteristics” is “vital” to the Enforcement Division’s mission of “protect[ing] investors and the markets by investigating potential violations of the federal securities laws.”¹¹

The SEC Is Obligated to Investigate Tips from Credible Sources

⁶ 17 CFR § 200.735-2(a) (Westlaw 2011).

⁷ 17 CFR 200.64 (Westlaw 2011) (emphasis added).

⁸ 17 CFR 200.61 (Westlaw 2011).

⁹ 5 CFR 2635.101(b)(8) (Westlaw 2011) (emphasis added). Obligations stated in 5 CFR part 2635 are applicable to the SEC staff pursuant to 17 CFR 200.735-3(a).

¹⁰ 17 CFR 200.735-2(a).

¹¹ Securities and Exchange Commission Division of Enforcement SEC Enforcement Manual, dated January 13, 2010 (the “Enforcement Manual”) at 7.

29. “The Commission’s staff has the obligation to *diligently* examine and investigate instances of securities fraud.”¹² All allegations contained in a tip or a complaint from a credible source “must be sufficiently vetted” before allegations can be dismissed. (Report at 167 n. 104, 230.)

30. A staff member who lacks the ability to comprehend a financial transaction is absolutely obligated to consult with other SEC staff personnel to assure that all allegations of fraud are fully investigated.

The SEC Missed Ten Opportunities to Uncover Madoff’s Fraud from 1992 – 2008

1. The SEC’s First Missed Opportunity: The 1992 Investigation of Avellino & Bienes

31. In June 1992, the SEC received several complaints from customers of Avellino & Bienes (“A&B”) who were concerned with the firm’s promise of making “100%” safe investments with consistently high rates of return. (Report at 42-43.) This investment opportunity appeared to prospective investors as “special” and “exclusive” because the firm accommodated only those who were “recommended.” (*Id.* at 42 n. 15.)

32. The Enforcement team of the SEC’s New York office (the “Enforcement Team”) suspected that A&B was operating a Ponzi scheme and initiated an investigation (the “1992 Investigation”) during which it learned that A&B placed all of its funds with Madoff, who retained control over all the investments and made all the investment decisions. (*Id.* at 46.)

33. The SEC was informed by A&B that Madoff had not lost on a single trade executed for the firm since 1962 and that Madoff used a strategy of buying Fortune 500 stocks

¹² OIG Report *Concerning Investigation of SEC’s Response to Concerns Regarding Robert Allen Stanford’s Alleged Ponzi Scheme*, March 31, 2010, at 10 (citing *The Commission’s Cannon of Ethics*, 17 C.F.R. §§ 200.50, *et seq.*).

and hedging them against the S&P index. A principal of A&B admitted that he had no input into how the strategy was employed. (*Id.*)

34. Despite those red flags, the SEC was content with closing the investigation, simply charging A&B with operating as an unregistered investment company, and requiring that it refund all of its investors' money. (*Id.* at 51.) The Enforcement Team never investigated the possibility that Madoff was running a Ponzi scheme and never traced where the money came from to pay investors of A&B because ““when Madoff was approached about liquidating the investments and returning the funds, . . . he was able to do so . . . and [that he was able to] get the cash available within a very short period of time”” illustrated that the money was where it was expected to be. (*Id.* at 53, 49 (inner citation omitted.))

35. Common sense required the SEC to trace the money that was used to pay back the A&B investors. The SEC, however, never did this. If it had simply examined Madoff's other discretionary brokerage account balances with the Depository Trust Company (“DTC”), it would have found that Madoff had liquidated other accounts to pay back the A&B investors. (*Id.* at 49.) The SEC, however, brought no charges against Madoff. (*Id.* at 51.)

36. During the 1992 Investigation, the SEC staff was fully aware of Madoff's prominence in the securities industry and this prominence influenced the staff to not scrutinize Madoff's operations. (*Id.* at 50, 60, 383.) As admitted by an SEC Branch Chief, “it was fair to say that because of Bernard Madoff's reputation at that time as a large broker-dealer, there may not have been any thought to look into Madoff's operation any further.” (*Id.* at 50, 383.)

37. The Report acknowledged that “the examination team was well aware of Madoff's reputation and that [it] may have factored into their decision not to scrutinize Madoff's operation more carefully.” (*Id.* at 60.)

38. The SEC staff had a legal obligation to conduct its investigations without regard to Madoff's status in the securities industry.¹³ Its failure to do so was a breach of such duty and caused Plaintiffs' damages. The SEC's failure to fulfill its legal obligation is not protected by the discretionary function exception under the FTCA.

39. Inspector General Kotz reached the following conclusion with respect to the SEC's conduct during the 1992 Investigation:

The result 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. (*Id.* at 26-27.)

40. Despite its utter failure to investigate Madoff's operations, the SEC publicly assured investors that the SEC had investigated Madoff and gave him a clean bill of health. Martin Kuperberg, a SEC Senior Associate Regional Administrator, gave a statement to *The Wall Street Journal*, which was quoted in its December 1, 1992 issue, stating that "[r]ight now, there's nothing to indicate fraud" and that the returns appeared to have been generated legitimately.¹⁴

¹³ See 17 CFR 200.64; 17 CFR 200.61; 5 CFR 2635.101(b)(8); 17 CFR 200.735-2(a); Enforcement Manual at 7.

¹⁴ Randall Smith, "SEC Breaks up Investment Company that Paid Off but Didn't Register," *The Wall Street Journal*, December 1, 1992.

41. In a follow up article on December 16, 1992, *The Wall Street Journal* identified A&B's mystery "broker with the Midas Touch" as ". . . none other than Bernard L. Madoff -- a highly successful and controversial figure on Wall Street, but until now not known as an ace money manager."¹⁵

42. The Plaintiffs knew of, and relied upon, Kuperberg's statements to *The Wall Street Journal*.

43. The OIG Investigation concluded "that investors who may have been uncertain about whether to invest with Bernard Madoff were reassured by the fact that the SEC had investigated and/or examined Madoff, or entities that did business with Madoff, and found no evidence of fraud." (Report at 425.) Further, Madoff used the SEC's Incompetence to his advantage by bragging to prospective customers that he had the SEC's "seal of approval." (*Id.* at 425.)

44. Hundreds of A&B investors reinvested their money with Madoff, or failed to withdraw their money, solely in reliance on Kuperberg's assurance that Madoff's operations were legitimate. (*Id.* at 425-27.) By allowing Madoff to expand his pool of victims with the SEC's endorsement, the SEC became a substantial aider and abettor of Madoff's fraud.

2. The SEC's Second Missed Opportunity: Markopolos' First Submission to the SEC in May 2000

45. In May 2000, Harry Markopolos, a Chartered Financial Analyst and Certified Fraud Examiner, submitted a detailed, eight-page complaint to the Boston District Office of the SEC (the "BDO"), which explained that the "magnitude and consistency of Madoff's returns" coupled with "the secrecy" of his operations raised red flags as to the legitimacy of Madoff's

¹⁵ Randall Smith, "Wall Street Mystery Features a Big Board Rival," *The Wall Street Journal*, December 16, 1992.

reported returns (the “2000 Complaint”). (*Id.* at 61.) Markopolos provided two possible explanations for the unusually consistent returns, both of which entailed an illegal practice: (1) “that the returns are real, but they are coming from some process other than the one being advertised”; or (2) that Madoff’s entire operation “is nothing more than a Ponzi scheme.” (*Id.* at 61.)

46. Markopolos’ 2000 Complaint specifically stated that “Madoff’s returns were unachievable using the trade strategy he claimed to employ, noting Madoff’s ‘perfect market-timing ability’” and Madoff’s disallowance of outside performance audits. (*Id.* at 61-63, 27.)

47. Markopolos presented his analysis at a meeting at the BDO, at which time he encouraged the SEC to investigate Madoff. (*Id.* at 63-64, 27.) He left the meeting with the impression that SEC Senior Enforcement Official lacked any “basic understanding of finance” and did not comprehend his concerns about Madoff. (*Id.* at 64.) Markopolos and an SEC staff accountant later testified that it was clear that the SEC staffer did not understand the information presented. (*Id.* at 27.)

48. The BDO did not conduct an investigation of Markopolos’ complaint. Although a BDO staffer initially stated that he was going to refer the 2000 Complaint to the SEC’s Northeast Regional Office (“NERO”), there was no evidence that he did so. (*Id.* at 64-65.)

49. The OIG Investigation concluded that the lack of any understanding of the information presented “was likely the reason that the BDO decided not to pursue Markopolos’ complaint or even refer it to the NERO.” (*Id.* at 27, 64-66.)

50. The failure of the BDO to consult with other SEC personnel concerning Markopolos’ allegations was an act of incompetence for which the SEC is liable to Plaintiffs. This failure is not protected by the discretionary function exception under the FTCA.

3. The SEC's Third Missed Opportunity: Markopolos' Second Submission in March 2001

51. In March 2001, Markopolos submitted a second detailed complaint to the BDO that "supplemented his previous 2000 complaint with updated information and additional analysis" (the "2001 Complaint"). The analysis in the 2001 Complaint was supported by the experience of two other individuals with expertise in investment funds. The 2001 Complaint concluded that the "numbers really are too good to be true." (*Id.* at 27, 67.)

52. This time, the BDO referred the 2001 Complaint to NERO. However, despite the fact that the 2001 Complaint was "more detailed than the average complaint in those days" NERO decided not to investigate the complaint only *one day* after receiving it. (*Id.* at 27, 71-73.)

53. The SEC again breached its obligation to scrutinize the allegations in a complaint. In fact, the SEC dismissed the 2001 Complaint without any substantive review.¹⁶ The SEC staffer who dismissed the complaint admitted during the OIG Investigation that she did not adequately review the 2001 Complaint because she didn't understand it and that the complaint "should have been reviewed for more than one day before decision was made regarding its disposition." (*Id.* at 72-73.) The staffer failed to consult someone else with greater understanding and failed to undertake the minimum obligation of understanding the allegations in the 2001 Complaint.

¹⁶ See OIG Report *Concerning Investigation of SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme*, March 31, 2010, at 10 (citing *The Commission's Cannon of Ethics*, 17 C.F.R. §§ 200.50, *et seq.*); see also Report at 167 n. 104, 230.

54. The SEC staffer's decision to not investigate the allegations in the 2001 Complaint resulted from mere laziness. Failure to undertake steps to at least appreciate the allegations in a complaint is not a decision grounded in policy considerations.¹⁷

4. The SEC's Fourth Missed Opportunity: May 2001 Articles Question Legitimacy of Madoff's Returns

55. Only a month after NERO dismissed the 2001 Complaint, *MAR Hedge* and *Barron's* both published articles questioning Madoff's returns and operations (the "2001 Articles"). (Report at 27, 74.)

56. Despite the fact that the articles appeared in reputable publications, the SEC staff handling the 2001 Complaint never bothered to read the 2001 Articles, even when their importance was brought to their attention. (*Id.* at 76-77.)

57. In fact, there were remarkable similarities between the allegations contained in the 2001 Articles and the 2001 Complaint. Yet, the decision to disregard the 2001 Complaint was never revisited. (*Id.* at 77.)

5. The SEC's Fifth Missed Opportunity: May 2003 Hedge Fund Manager's Complaint Identifies "Indicia of a Ponzi Scheme"

58. In May 2003, an examiner of the SEC's Office of Compliance Inspections and Examinations ("OCIE") of the Washington D.C. Investment Management Group (the "SEC IMG") received a detailed complaint (the "Hedge Fund Manager's Complaint") from a registered hedge fund manager who was considered a "highly credible source of information." Like the

¹⁷ See *OIG Report Concerning Investigation of SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme*, March 31, 2010, at 10 (citing *The Commission's Cannon of Ethics*, 17 C.F.R. §§ 200.50, *et seq.*); Report at 167 n. 104, 230; *see also Coulthurst v. U.S.*, 214 F.3d 106, 111 (2d Cir. 2000) (holding that federal employee's failure to "perform a diligent inspection out of laziness" or out of careless or inattentiveness is a decision that does not involve considerations of public policy). Similarly, the SEC staff's lazy and/or careless execution of the investigation – even if a discretionary act at its inception – is not shielded because it is an "abuse of discretion." *See Coulthurst*, 214 F.3d at 110.

two Markopolos complaints and the 2001 Articles, it laid out red flags about Madoff's operations that the hedge fund manager identified while performing due diligence on two of Madoff's feeder funds. (*Id.* at 77-78, 28.)

59. After a phone conference with the hedge fund manager and the receipt of his complaint, the OCIE Branch Chief in the SEC IMG understood that some of the allegations in the complaint were "indicia of a Ponzi scheme." (*Id.* at 80.)

60. Despite its expertise, the SEC IMG referred the complaint to OCIE's Broker-Dealer/Self-Regulatory Organization Group (the "SRO Group"). (*Id.* at 82.)

61. In violation of the SEC's internal policy to promptly investigate allegations of a Ponzi scheme, the SEC's investigation was inordinately delayed. Then SEC Director Lori Richards testified that "'cause examinations are a priority' and she would expect the staff to begin . . . [it] within 'days, hours, weeks perhaps'" from receipt of the complaint. (*Id.* at 85.)

62. Similarly, the FTI Engagement Team hired to assist with the OIG Investigation concluded that significant questions raised during a cause investigation should be resolved quickly because "[s]ignificant delays or inactivity may allow for illegal activity to continue unimpaired for longer periods of time, resulting in potentially greater harm to customers and investors." (*Id.* at 130 n. 84.)

63. Nevertheless, the OCIE's SRO Group did not open an investigation until December 2003, approximately seven months after the Hedge Fund Manager's Complaint was submitted. (*Id.* at 89.) No explanation was provided by the SEC for the delay. (*Id.* at 89, 29.)

64. Once the investigation was initiated, it was staffed with attorneys who had no experience in equity and options trading -- the specific expertise of the SEC's IMG. (*Id.* at 29.)

65. The SRO Group’s lack of experience in investment management issues raised in the Hedge Fund Manager’s Complaint triggered an obligation to consult other groups within the SEC with experience to evaluate the allegations.¹⁸ Nonetheless, the SRO Group “decided not to request investment advisor staff support . . . even though . . . such support could have been arranged.” (*Id.* at 29.)

66. The FTI Engagement Team concluded that the SRO Group “should have, at a minimum, sought Investment Management advice.” (*Id.* at 83 n. 49.)

67. Furthermore, the scope of the investigation was wrongly determined. The SRO Group staff had a duty to review suspicions raised in the Hedge Fund Manger’s Complaint, rather than limit its consideration to the allegations that the team was competent to investigate.¹⁹ Despite such an obligation, issues raised in the Hedge Fund Manager’s Complaint “other than front-running²⁰ – such as auditor independence, Madoff’s extraordinary returns, and lack of liquidity in the options market to support alleged trading – were not investigated *at all* in the examination.” (*Id.* at 93.)

68. The SRO Group staff admitted that front-running was the *sole* focus of the investigation irrespective of the various allegations raised in the complaint because “that was the area of expertise” of the group. (*Id.* at 93-94, 96.)

¹⁸ See 15 U.S.C. 78q(k) (Westlaw 2011).

¹⁹ See *OIG Report Concerning Investigation of SEC’s Response to Concerns Regarding Robert Allen Stanford’s Alleged Ponzi Scheme*, March 31, 2010, at 10 (citing *The Commission’s Cannon of Ethics*, 17 C.F.R. §§ 200.50, *et seq.*); see also Report at 167 n. 104; 230.

²⁰ Front-running is the “illegal practice of a broker executing orders on a security for its own account while taking advantage of advance knowledge of pending orders from its customers.” (Report at 93 n. 60). For example, the broker buys 100 shares of “x” stocks prior to executing an order for 100 shares of “x” stock for his client knowing that execution of the client’s order will drive up the value of the stock. As a result, the broker will be able to close his positions at a profit based on new price level.

69. The SRO Group had no discretion to ignore its obligation to thoroughly examine all the allegations contained in the Hedge Fund Manager's Complaint; they had no authority to selectively hand-pick those areas that were convenient for them to investigate.

70. The FTI Engagement Team concluded "that to focus an exam based upon the expertise of a team rather than on the complaint itself is *nonsensical*." (*Id.* at 94 n. 63; 138) (emphasis added.)

71. Nonsensical decisions are not grounded in policy considerations.

72. The SRO Group started out properly by drafting a letter to the NASD "which was critical to any adequate review of the complaint because the data and information . . . would have assisted in independently verifying trading activity conducted" by Madoff. (*Id.* at 30, 97.) Obtaining transaction data for all order executions effected by Madoff from an outside source, such as the NASD, would have enabled the SRO Group to compare the information provided by the NASD against the information received from Madoff. Such an analysis would have proven that Madoff was not making the trades he purported to be making. However, the SRO Group decided not to send the letter to the NASD because it would have been "time-consuming" to review the information produced by the NASD. (*Id.* at 30.)

73. The SRO Group could not have competently investigated front-running without obtaining trade data from an independent third-party. The then-SEC Director Swanson testified that he was "perplexed" by the team's failure to request data from the NASD because the data was necessary to investigate front-running. (*Id.* at 98.)

74. The SEC's decision to avoid the burden of reviewing reliable, third party information in connection with its investigation of BLMIS was not a protected act of discretion

because, as Swanson admitted, review of NASD data was necessary for the investigation into front-running. Moreover, NASD data is reliable and accessible to the SEC. (*Id.* at 97.)

75. Decisions grounded in laziness cannot be rationalized after-the-fact as decisions involving policy considerations, absent some support in the record that the decision was policy-based.²¹ There is no evidence that the decision to not obtain documents from the NASD was based on an SEC policy. “According to the OIG’s expert, had a letter been sent out, the NASD would have provided order and execution data that would have indicated that Madoff did not execute the significant volume of trades . . . that he represented . . . and the data would likely have provided the information necessary to reveal the Ponzi scheme.” (*Id.* at 30.)

76. Even with respect to the information that the SEC demanded from Madoff himself, the SEC did not demand that Madoff produce the necessary information. While a request for detailed audit trail data from Madoff was included in all six drafts of the supplemental document request that the SEC prepared, the final request given to Madoff crossed out the demand that he produce detailed audit trail data. (*Id.* at 31, 108.) No concrete explanation for this behavior was provided during the OIG Investigation. (*Id.* at 108-09).

77. An SEC senior staffer testified that he might have changed his mind because the audit trail data “can be tremendously voluminous and difficult to deal with and is a huge resource issue.” (*Id.* at 109.) Assuming this testimony is accurate, laziness does not establish a legitimate basis for the SEC’s failure to competently investigate BLMIS. Nor is laziness grounded in policy.

78. Documents and information that Madoff produced as a result the SEC’s document request contradicted the information contained in the Hedge Fund Manager’s Complaint and the

²¹ See *In re Katrina Canal Breaches Consol. Litigation*, No. 05-4182, Slip. Op. at 101 (SRD) (Nov. 18, 2009) (citing *Marlys Bear Medicine v. U.S.*, 241 F.3d 208, 1216-17 (9th Cir. 2001)).

2001 Articles. Inexplicably, the SRO Group nevertheless accepted Madoff's representations without further scrutiny. (*Id.* at 100-01.)

79. For instance, Madoff stated that he was not managing money. This representation conflicted with the Hedge Fund Manager's Complaint and the 2001 Articles, which indicated that Madoff was managing money for hedge funds. (*Id.* at 100.) Nevertheless, the SRO staff indicated that they did not recall "any effort [being made] to determine whether statements Madoff made in his responses to their document requests were accurate." One staffer indicated that the veracity of Madoff's statements was not tested because "the concern was front-running." (*Id.* at 101.)

80. In April 2004, despite the fact that the concerns raised in the Hedge Fund Manager's Complaint were unresolved, the SEC staff was told to focus their priorities on mutual fund work. (*Id.* at 126.)

81. The SRO Group failed to draft a closing report at the conclusion of the investigation despite the fact that this was required by internal SEC standards. (*Id.* at 136.) It was later determined that failure to draft a closing report was a "critical error" because "[t]he lack of a closing report results in ambiguity and confusion when it is necessary at a later time to recall all activity conducted during an examination months or years later." (*Id.* at 144.) In this case specifically, had the report been prepared, NERO would have had a comprehensive understanding of the scope of this investigation and its findings when its investigation was commenced.

82. The SEC's utter failure to adhere to its own internal standards is explained by the fact that SEC personnel treated Madoff with "kid gloves." As one staff attorney admitted, "the fact that Madoff was a well-known figure may have played a role in the decision to put [the

investigation] on the back burner because the exam supervisors may have thought it was unlikely he was engaging in fraud.” (*Id.* at 129.)

83. Indeed, pandering to someone as powerful as Madoff resulted in the removal by the SEC of one employee who functioned as a lead examiner on the Madoff investigation, “after she raised questions about the veracity and completeness of documents and explanations provided by Madoff regarding his trading activities.” (*Id.* at 120.) When analyzing the data that the SEC received from Madoff pursuant to supplemental document requests, she noticed discrepancies between data provided in the documents and the representations that Madoff made about his strategy to the SRO Team. (*Id.* at 117-18). She related her findings and concerns to her superiors who, instead of praising her for her diligence, confronted her with hostility and ultimately had her removed. (*Id.* at 120.)

84. The SEC staff does not have discretion to favor Wall Street insiders and to enforce the securities laws arbitrarily. Nor is protection of Wall Street insiders based on policy considerations. The SEC violated its obligation to the public and the Plaintiffs to investigate Madoff and BLMIS impartially and to prevent the appearance of favoritism based on Madoff’s position in the industry.²² (*Id.* at 129.)

6. The SEC’s Sixth Missed Opportunity: The April 2004 Discovery of Emails Prove that Madoff Was Misrepresenting His Options Trading

85. In April 2004, just as the SRO Group investigation was coming to a halt, a nearly identical investigation was begun by the NERO. (*Id.* at 132.) An investment advisor manager of NERO, while conducting a routine examination of Renaissance Technologies LLC (“Renaissance”), an unrelated company, discovered internal e-mails that noted red flags that the

²². See 17 CFR 200.64; 17 CFR 200.61; 5 CFR 2635.101(b)(8); 17 CFR 200.735-2(a); Enforcement Manual at. 7.

company identified while performing due diligence on Madoff (the “Renaissance E-mails”). (*Id.* at 31, 145.)

86. The red flags included Madoff’s “(1) incredible and highly unusual fills for equity trades [unlikely explained by cherry-picking]; (2) misrepresentation of his options trading; (3) secrecy; (4) auditor [being Madoff’s brother-in-law]; (5) unusually consistent and non-volatile returns over several years; and (6) fee structure.” (*Id.* at 31.) In fact, one e-mail “provided a step-by-step analysis of why Madoff must [have] be[en] misrepresenting his options trading.” (*Id.* at 31, 148.)

87. Renaissance ultimately reached the conclusion that Madoff was not trading options because there was insufficient volume for him to trade on an exchange and it would have been impossible for him to find counterparties to conduct over-the-counter options trades given that he always made money on a trade. As a result of this conclusion, Renaissance started divesting itself of its investments with Madoff. (*Id.* at 153.)

88. The information that Renaissance used to reach its conclusion was information that was publicly available and that “was readily available to the SEC.” (*Id.* at 151.)

89. The NERO Investment Advisor Examination group referred the Renaissance E-mails to the Broker-Dealer Examination Group (the “BDE Group”) of NERO on April 22, 2004. (*Id.* at 160-61.)

90. Despite the fact that the Renaissance E-mails raised suspicions typically of the type handled by the Investment Advisor Examination group, the BDE Group gave “no consideration . . . to performing a joint investigation.” (*Id.* at 32.)

91. An investigation team was not assembled until late December 2004, nearly eight months after the SEC’s discovery of the Renaissance E-Mails. The preparation for the

investigation did not commence until late March 2005, nearly a year after the referral. (*Id.* at 161-63, 32.)

92. Despite the alarming nature of the allegations in the Renaissance E-Mails and despite the SEC's policy to promptly commence an investigation where there is evidence of securities fraud, the SEC felt no "particular urgency [to promptly initiate an investigation] because . . . it [was] unlikely that a firm of BMIS's size and legitimacy would "rip people off." (*Id.* at 164; 85, 130 n. 84.)

93. In the spring of 2005, as the BDE Group was conducting its investigation, it learned from Madoff that the SRO Group was concluding a cause investigation of almost identical issues. (*Id.* at 34, 132,195.)

94. The SEC is required to have its various units communicate and cooperate with each other in order to efficiently carry out its mandate.²³ Nevertheless, the SRO Group and the BDE Group conducted two totally separate, independent but contemporaneous investigations of Madoff and both units failed to track each other's investigation and to coordinate with each other. (*Id.* at 142.) The SRO Group was "supposed to" enter its investigation into an examination tracking system. (*Id.* at 132.) It failed to do so.

95. According to SEC internal policy, there should never be two simultaneous investigations of the same entity without the knowledge of each investigative team. (*Id.* at 132-33.) Here, the SRO Group's failure to log the investigation into the system resulted in duplicative investigations and waste of the very same SEC resources that purportedly led SEC staff not to seek independent third party confirmation of what Madoff told them.

²³ See 15 U.S.C. 78q(k); Enforcement Manual at 7-8.

96. Despite the duplication of effort, neither SEC investigative team "sufficiently vetted" the allegations in the Renaissance E-Mails. (*Id.* at 167 n. 104, 230.) The SEC staff violated its obligation to "*diligently* examine and investigate instances of securities fraud."²⁴ The "examination team's analysis of the . . . emails was insufficient." (*Id.* at 230.)

97. The BDE Group failed to investigate any allegations contained in the Renaissance E-mails other than cherry picking and front-running. (*Id.* at 166-67; 227; 230.) Even though the red flags associated with Madoff's options trading was a critical part of the Renaissance E-mails, it was not a focus of the investigation. (*Id.* at 171.)

98. All the BDE Group did to investigate Madoff's options trading was to ask him about his options trading. The issue was simply disposed of by Madoff's misrepresentation that he was no longer using options as part of his strategy. (*Id.* at 172.) The BDE Group accepted this misrepresentation without question even though it was inconsistent with the Renaissance E-Mails, the two 2001 Articles, and a critical part of the investment strategy Madoff claimed to employ. (*Id.* at 172.)

99. The BDE Group staff never even bothered to contact Renaissance to follow-up on the allegations contained in the Renaissance E-mails, even though the staff knew Renaissance had independent evidence that Madoff's executions were "highly unusual." (*Id.* at 174.) Nor did the BDE Group follow up on the particularly troublesome information that BLMIS' auditor was his brother-in-law. (*Id.* at 230.) Had the SEC performed a cursory review of BLMIS's auditor, Friehling & Horowitz, CPA's, PC ("F&H"), it would have inevitably uncovered the fact that, since approximately 1993, it has been sending letters to the American Institute of Certified

²⁴ OIG Report *Concerning Investigation of SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme*, March 31, 2010, at 10 (citing *The Commission's Cannon of Ethics*, 17 C.F.R. §§ 200.50, *et seq.*).

Public Accountants (“AICPA”) indicating that it has not been performing audits in order to avoid peer review.²⁵ In the meantime, F&H was signing off on all paperwork as BLMIS’s auditor.

100. In the view of the OIG, the failure to assure themselves that Madoff’s auditor did not have a conflict of interest was a critical failure of the BDE Group’s team. Generally, “in conducting due diligence of the auditor, an examiner will review the auditor’s engagement letter, reports and work papers.” Despite the significance of verifying this one fact, the basic due diligence was not conducted. (*Id.* at 230.)

101. The FTI Engagement Team concluded that, if Madoff’s auditor had been scrutinized, the Ponzi scheme would have likely been uncovered. (*Id.* at 174.) In fact when NERO’s Division of Enforcement investigated Madoff’s accountant after Madoff confessed on December 11, 2008, it took only “*a few hours*” after obtaining the paperwork for the team to determine that no audit work had been performed. (*Id.* at 33.)

102. Even after the SRO Group forwarded all of its investigation documents to NERO’s BDE Group, the SRO Group failed to bring the Hedge Fund Manager’s Complaint to the attention of the BDE Group. As a result, the BDE Group never adequately reviewed or considered the allegations contained in the Hedge Fund Manager’s Complaint during the course of its investigation. (*Id.* at 233, 34.)

103. The BDE Group’s failure to consider allegations contained in the Hedge Fund Manager’s Complaint violated the SEC policy requiring that all credible complaints and tips be sufficiently vetted.

²⁵ F&H was enrolled in a program conducted by AICPA that required participating firm’s work to be peer reviewed by other auditing firms. F&H had been sending letters to AICPA indicating that it has not performing audits in order to circumvent peer review of its work for BLMIS.

104. Even after the two teams realized that simultaneous investigations were conducted, there were only a couple of brief phone conferences between offices with very little information being sharing. (*Id.* at 34.) To the extent that any information was shared, a senior-level examiner from the SRO Group reminded the junior BDE Group examiners that “Madoff was a powerful and well-connected” individual and that they should always remember that. (*Id.* at 34, 199, 384.) One BDE Group staffer construed the warning “to raise a concern for them about pushing too hard without having substantial evidence.” (*Id.* at 199.)

105. During the course of the BDE Group’s investigation, junior staff consistently encountered inconsistent stories and lack of cooperation from Madoff. However, senior SEC staff gave them no support and “actively discouraged [them] from forcing the issue.” (*Id.* at 33-34.) When junior staff pointed out Madoff’s lies, they were assured by senior SEC personnel that “it could [just] be a matter of semantics.” (*Id.* at 35.)

106. The SEC’s conduct violated its obligation to carry out its duties impartially and prevent even the appearance of preferential treatment.²⁶ A senior compliance examiner at the BDE Group acknowledged “that at the senior levels of the SEC, the hesitancy towards rocking the boat may be even more pronounced with respect to someone like Bernie Madoff, who’s a well-known person in industry.” (*Id.* at 387.) In fact, the same senior compliance examiner indicated that the SEC only pursues investigation of those with insignificant financial resources. (*Id.*) This examiner acknowledged that Madoff’s status as a financial titan may have caused the failure to scrutinize his operations more closely. He said that it is easier to be more aggressive when you are examining a “penny-stock firm” rather than, for instance, Goldman Sachs, noting

²⁶ See 17 CFR 200.61; 17 CFR 200.64; 5 CFR 2635.101(b)(8).

that it would be “very difficult” for someone in his position “to tell Bernie Madoff that he’s a liar.” (*Id.*)

107. Another senior compliance officer similarly confirmed that supervisors in the past “have been reluctant to push issues against influential people.” (*Id.*)

108. Thus, clearly the SEC consistently violated federal law by treating Madoff and BLMIS preferentially in every single one of its examinations. But for this breach of its duties, the BLMIS Ponzi scheme would have been discovered in 1992.

109. One consequence of the preferential treatment that SEC personnel improperly accorded to Madoff and BLMIS was its failure to adhere to the fundamental principle that, in investigating a Ponzi scheme, the SEC always obtains information from an independent source.

110. The SEC’s general practice is to obtain trading data from the firm investigated, unless there is a “particular reason” to obtain it from an independent source. (*Id.* at 191.) As the OIG stated, “[I]f an examiner was doing Ponzi review, then you would go to DTC and very well may go to OCC if options were implicated.” (*Id.*) The OIG concluded that a basic comparison of Madoff’s alleged trading activity against FINRA/NASD or DTC/NSC data would have revealed that Madoff did not execute the trade he claimed. (*Id.* at 233.)

111. The SEC had direct access to DTC and SEC personnel were easily able to “blue sheet” any stock to determine, in a matter of minutes, what trades have been executed by a particular broker without having to leave the SEC’s offices.

112. Madoff himself stated that his Ponzi scheme would have been uncovered if the SEC had contacted DTC directly. (*Id.* at 207.) The SEC’s failure to do so cannot be explained as anything other than a non-sensical decision based on sheer laziness or on a determination -- at

senior levels of the SEC -- to protect Madoff. Such conduct is not protected by the discretionary function exemption under the FTCA.

113. The NERO Branch Chief testified that during NERO's post-confession investigation, in a matter of "a few days, NERO confirmed through either a DTC terminal or a phone call . . . to DTC that Madoff had not been placing trades for his clients." (*Id.* at 207 n. 146.) Thus, the contention that SEC personnel did not have the time to pour through third party sources is patently false.

114. Given the concern with purported options trading contained in the Renaissance E-mails, the BDE Group needed to identify Madoff's counterparties to verify whether the purported options trades took place. (*Id.* at 154-55.) Regardless of whether BLMIS traded stocks in the United States or in Europe and regardless of whether BLMIS traded options over an exchange or over-the-counter, SEC staff should have insisted on confirmation of the trades through third party sources. (*Id.* at 154-55).

115. Yet, the SEC's document demand of BLMIS did not request information on counter-parties -- an omission that SEC staff was incapable of explaining. Similarly, a document request mailed to Madoff, once again, did not contain a request for trade data. (*Id.* at 178.)

116. The BDE Group staff had research indicating that some of the Madoff feeder funds claimed to use a strategy that required options trading, yet Madoff had told examiners he no longer used options as part of his trading strategy." (*Id.* at 220.) They hoped that a visit with the feeder funds would resolve the mystery. Yet, senior SEC personnel directed the examiners not to spend the time visiting with the feeder funds, purportedly because they had already spent enough time on the Madoff investigation and because of concern that it might cause the feeder funds to pull their money out of Madoff. (*Id.* at 220-21.) Senior SEC personnel never showed such concern for the smaller targets of their investigations and such a concern is improper and unlawful.

117. During the course of its investigation, the BDE Group was told by Madoff that Barclays cleared trades for some of BLMIS' feeder fund customers. (*Id.* at 205, 187.) The SEC followed proper protocol by immediately sending a document request to Barclays requesting all trading data. (*Id.* at 188.)

118. Barclays wrote a letter to the SEC denying the existence of any relevant transaction activity in the account. The letter suggested that the U.K. affiliate of Barclays should be contacted because “a prime brokerage and trading relationship with a Madoff-affiliated entity exists with [the] UK affiliate.” The SEC decided not to contact the U.K. affiliate of Barclays but rather to rely upon data provided by Madoff. (*Id.* at 189.)

119. In September 2005, the BDE group closed its investigation without resolving any issues other than the fact that Madoff was not engaged in front-running. (*Id.* at 35, 223.) The BDE Group’s closing report, filed at the end of the investigation, failed to adhere to internal SEC standards because it failed to identify “open questions” that remained and “other issues that arose” during the investigation. (*Id.* at 234.) Inclusion of such information was critical because it would permit an individual reviewing the report in the future to easily understand the scope of the investigation conducted and identify issues that were resolved and issues that were left unresolved. (*Id.* at 234-35.)

7. The SEC’s Seventh Missed Opportunity: Markopolos’ Third Submission in October 2005

120. In October 2005, Markopolos submitted his third complaint, which identified approximately 30 red flags indicative of a Ponzi scheme (the “2005 Complaint”) and which contained more detailed versions of the red flags brought to the SEC’s attention in previous years. (*Id.* at 35, 238-40.)

121. The BDO found Markopolos “credible” and the allegations contained in his complaint very troublesome. (*Id.* at 240.) The SEC decided that NERO was the more appropriate office to conduct the investigation and the 2005 Complaint was referred to NERO. (*Id.* at 242-43.)

122. To ensure that NERO appreciated “the potential urgency of the situation,” the Director of BDO personally emailed the 2005 complaint to the Director of NERO, in the hope that doing so would make certain that NERO would take the submission seriously. (*Id.* at 36; 243-44.)

123. Nevertheless, the 2005 Complaint was assigned to a NERO Enforcement Team (“Enforcement Team”) that was reluctant to investigate the allegations. (*Id.* at 36.) While the BDO senior staff vouched for Markopolos’ credibility, the Enforcement Team dismissed his complaint at the outset. The Enforcement Team justified its skepticism about pursuing the allegations because Markopolos was not an insider; that is, he was “neither a Madoff employee nor an investor.” (*Id.* at 247.)

124. Instead of evaluating Markopolos' allegations, the Enforcement Team staff questioned Markopolos’ motives. They claimed that they doubted his credibility, in part, based upon their belief that he was seeking a bounty, despite the fact that he stated in his complaint that he was ineligible for a bounty, even if the SEC discovered that Madoff was operating a Ponzi scheme. (*Id.* at 249-50.)

125. In fact, the Enforcement Team’s reluctance to investigate Markopolos’ 2005 Complaint may have resulted from the Branch Chief’s dislike of Markopolos as a result of “telephone exchanges between the two where Markopolos inquired about the [Branch Chief’s] understanding of his 2005 submission, derivatives, and Madoff’s fraud.” (*Id.* at 251 n. 174.)

126. The law does not permit the SEC to evaluate complaints based upon the personal dislike of the complainant. The SEC was obligated to investigate Markopolos' allegations.²⁷ While “[i]t may be the case, after a thorough review, that certain information is not entirely accurate or even biased to a certain extent . . . , the examiner must *still* review all of the allegations before any conclusions can be made with regards to the legitimacy of such allegations.” (*Id.* at 167, n. 104.)

127. The decision to disregard the 2005 Complaint was made at the outset and explains why the Enforcement Team refused to consider additional information that Markopolos tried to offer during the course of the investigation and why the Enforcement Team failed to contact industry professionals that supported Markopolos' allegations. (*Id.* at 274-75.)

128. Despite the urgency emphasized by the Director of BDO at the time of submission, the Enforcement Team did not take steps to initiate a matter under inquiry (“MUI”) until December 2005, approximately eight weeks after its receipt,²⁸ and an MUI was not actually opened until January 2006. (*Id.* at 263.)

129. The Assistant Director of the Enforcement Division admitted that MUI's should be opened promptly and that this particular MUI “should have been opened sooner.” (*Id.* at 263.) Opening a MUI “at the beginning” of an investigation is “necessary” so that the staff is informed “of other relevant information that the SEC receive[s] about the subject of the investigation.” (*Id.* at 37.)

²⁷ See Report at 167, n. 104; 230; OIG Report *Concerning Investigation of SEC's Response to Concerns Regarding Robert Allen Stanford's Alleged Ponzi Scheme*, March 31, 2010, at 10 (citing *The Commission's Cannon of Ethics*, 17 C.F.R. §§ 200.50, *et seq.*)

²⁸ According to Enforcement Division's policy, complaints that are serious and substantial are often undertaken for a detailed review and result in the opening of a MUI. (*Id.* at 263 n. 183.)

130. The delay was particularly destructive in this case because the Enforcement Team was not notified about an e-mail from an informant who identified himself as a Madoff investor. The e-mail expressed concern that “Madoff [was] running a very sophisticated fraudulent pyramid scheme.” (*Id.* at 264.) The tip was never investigated and was not forwarded to the Enforcement Team because no record of an investigation or of Markopolos’ 2005 Complaint existed in the SEC’s system when it was searched on October 28, 2005 and November 21, 2005. (*Id.* at 264.)

131. Once the investigation was underway, the BDE Group misrepresented to the Enforcement Team the scope of the investigation it had conducted in 2004-2005. (*Id.* at 255.) By so doing, the BDE Group breached its obligation to “share such information . . . as appropriate to foster a coordinated approach” to the investigation. The BDE Group had no authority to lie about the allegations it actually investigated and such conduct is not protected under the discretionary function exception under the FTCA.²⁹

132. Even though the BDE Group investigated only front-running and failed to resolve any other suspicions raised in Markopolos’ complaints, the team dismissed the possibility of a Ponzi scheme in its communications with the Enforcement Team, stating that the issues in Markopolos’ 2005 Complaint are “basically some of the issues . . . [already] investigated” and that they don’t think they “missed anything.” (Report at 255-56.)

133. It was not until the OIG’s Investigation that the BDE Group’s staff admitted “that their examinations did not refute Markopolos’ allegations regarding a Ponzi scheme and that their examiners’ reaction may have given the impression their examination had a greater focus than it did.” (*Id.* at 36, 258-59.)

²⁹ See 15 USC 78q(k); 5 CFR 2635.101(b)(11); 17 CFR 200.64.

134. The OIG concluded that the misrepresentations may have been made out of concern for their own reputations “if Enforcement discovered a fraud that they had missed.” (*Id.* at 257.) The misrepresentation did in fact create an impression of a broader scope of investigation and impacted the manner in which the Enforcement Team conducted its investigation.

135. Several Enforcement Team staffers testified that, given SEC’s recent investigation and its failure to detect anything other than “technical violations,” they believed that it was highly unlikely that Madoff was operating a Ponzi scheme. (*Id.* at 258-59.)

136. Had the Enforcement Team actually looked at the examination report provided by the BDE Group, it would have realized that the possibility of a Ponzi scheme remained an unresolved issue because the BDE Group had not investigated the red flags suggesting that Madoff was operating a Ponzi scheme. (*Id.* at 259-60.)

137. Thus, instead of investigating Markopolos' "highly likely" suspicion that Madoff was operating a Ponzi scheme, the Enforcement Team staff focused its investigation on “whether Madoff was front-running, even though that is precisely what the BDE Group had investigated, whether Madoff should register as an investment banker, or whether Madoff’s hedge fund investors’ disclosures were adequate.” (*Id.* at 266; 37.)

138. Essentially, the Enforcement Team’s plan primarily involved comparing documents that Madoff had already provided to the BDE Group's examination staff, which Madoff had fabricated, with documents that Madoff had sent his investors (which he also fabricated).” (*Id.* at 269.)

139. Yet again the SEC’s enforcement staff’s investigation was corrupted by its belief that “Madoff did not fit the profile of a Ponzi scheme operator” because of his prestigious

reputation. (*Id.* at 261.) The Enforcement Branch Chief testified that, while there may not have been an intentional desire “to ignore the allegation,” she admitted that there “there’s an inherent bias towards [the] sort of people who are seen as reputable members of society . . .” (*Id.* at 262, 388.)

140. At the outset of the investigation, Enforcement staff caught Madoff in lies, but they failed to follow-up on the inconsistencies. For instance, documents that the Enforcement Team received from a Madoff feeder fund, pursuant to a document request, confirmed that Madoff had previously lied to the BDE Group about having stopped using options as part of his strategy. Nonetheless, the team never confronted Madoff with respect to this lie. (*Id.* at 37, 271.)

141. There is no possible explanation for this utter failure on the part of the SEC other than its institutional deference to powerful Wall Street figures, even though such deference violates the law. Indeed, the Enforcement staff acknowledged that Madoff’s prestige had an impact “to the extent that they were less likely to believe that Bernie Madoff had engaged in a Ponzi scheme.” (*Id.* at 388.)

142. In February 2006, Enforcement staff reached out to the SEC Office of Economic Analysis (“OEA”) for assistance in analyzing Madoff’s trading. (*Id.* at 295.) However, the OEA failed to do any work on the Madoff investigation by April 2006. (*Id.* at 297.) One OEA staffer with expertise in options trading did, in fact, later review some of the documents that OEA received and, based on *only twenty minutes of review*, “concluded that the split-strike conversion strategy was not a strategy that would be expected to earn significant returns in excess of the market.” He admitted that, had he known that Madoff was managing approximately \$15 billion, “he would have realized that there was no way he could be using his broker-dealer to generate his claimed returns.” (*Id.* at 299-300.) While he communicated to his superior that Madoff was

probably engaging in illegal conduct because his alleged split-strike conversion strategy could not earn the returns he alleged, the conclusion was never related to the Enforcement staff. (*Id.* at 300.)

143. In May 2006, the Enforcement Team took sworn testimony of Madoff, despite an explicit warning from a senior NASDAQ officer that the team did not have the basic understanding of Madoff's strategy to take Madoff's testimony. (*Id.* at 38). In his testimony, Madoff provided "evasive answers," answers that contradicted his previous representations, and he provided some information that could have been used to discover that he was operating a Ponzi scheme. (*Id.* at 39, 310.)

144. One critical piece of information that Madoff provided was that all his trades for all of his advisory accounts were cleared through his account at DTC. He further stated that the account was segregated at DTC from his brokerage accounts and he provided his account number when prompted by the examiner. (*Id.* at 312, 39.)

145. As of this point in time, had the SEC been functioning competently, they were within one five-minute phone call to DTC from discovering the Ponzi scheme. Even Madoff later admitted that he thought "the game was over" at that point. (*Id.* at 39, 312.)

146. An Enforcement staffer reached out to the DTC and was informed that Madoff did not have two segregated accounts but rather a single unsegregated one. Clearly, Madoff had lied in his deposition. Yet the staffer concluded, without any basis, that lack of segregation made it impossible to verify the trades. (*Id.* at 312.)

147. Had the verification process been attempted at that point in time, it would have revealed that Madoff was not trading in the volume he was claiming and the Ponzi scheme would have been uncovered 2 ½ years earlier. (*Id.* at 39, 313.)

148. After Madoff confessed on December 11, 2008, “*it took only a few days and a phone call . . . to DTC to confirm that Madoff had not placed any trades with his investors’ funds.*” (*Id.* at 333.) A simple phone call verification could have saved billions of dollars of investor losses.

149. “Several SEC officials testified that verifying trading was a fundamental step in an investigation of a Ponzi scheme.” (*Id.* at 323.) Two Assistant Directors confirmed that “obtaining independent [trading] records was *required* when *seriously pursuing* a Ponzi scheme investigation.” (*Id.* at 325) (emphasis added). Yet, the Enforcement Team failed to obtain confirmation from DTC of Madoff’s alleged trading activity. By so doing, the SEC violated the SEC’s internal, mandatory policy.

8. The SEC’s Eighth Missed Opportunity: December 2006 Letter from a “Concerned Citizen”

150. Contrary to his representations to the SEC, the SEC concluded in 2006 that Madoff was functioning as an investment advisor. The penalty imposed by the SEC on Madoff for lying to it as to his activities was simply that he was required to register as an investment adviser and, with that, the SEC closed its investigation.

151. The closing report was prepared in January 2008, when the matter was officially closed despite the fact that the Enforcement staff knew that Madoff made numerous misrepresentations to them, as well as to the BDE Group. (*Id.* at 349-50, 356.)

152. While the investigation was idle, the Enforcement Team received a letter from an anonymous “concerned citizen” dated December 6, 2006 (the “December Letter”). It warned the SEC that “[a]ssets well in excess of \$10 Billion owned by the late Norman F. Levy, an ultra-wealthy long time client of the Madoff firm have been co-mingled with funds controlled by the Madoff company with gains thereon retained by Madoff.” (*Id.* at 352.)

153. This time, the investigation consisted of simply asking Madoff's attorney whether the person whose account was referenced in the tip was a Madoff investor. When Madoff's attorney answered in the negative, the Enforcement staff accepted his answer at face value and decided that they "were done" and did "not have to worry any further." (*Id.* at 41, 352.)

154. Had the SEC investigated the possibility of Norman F. Levy investing with BLMIS, it would have obtained documentary evidence that he was one of Madoff's largest investors (*Id.* at 41, 354) and had provided approximately \$100 billion of financing to BLMIS.³⁰ Once again, the SEC deviated from its duty to investigate complaints in a reasonably competent way.

155. The OIG's report correctly concluded that "[a]n accused fraudster's unsubstantiated denial of wrongdoing is insufficient grounds for concluding that the accusation is without merit," especially when the SEC staff knew that Madoff lied to them in the past. (*Id.* at 353.)

9. The SEC's Ninth Missed Opportunity: Markopolos' Fourth and Final Submission in June 2007

156. In June 2007, Markopolos sent his final warning, attaching "some very troubling documents that show the Madoff fraud [was] getting even more brazen." The email was dismissed as "another fishing expedition." (*Id.* at 354.)

10. The SEC's Tenth and Final Missed Opportunity: March 2008 Letter Warning SEC that Madoff Keeps "Two Sets of Records"

157. In March 2008, approximately three months after Madoff's investigation was concluded, Cox's office received another tip regarding Madoff's involvement with Norman F. Levy, the investor who was subject of the December Letter. This tip alerted the SEC that "[i]t

³⁰ See the January 24, 2011 letter SIPC president Stephen Harbeck to Congressman Scott Garrett, Chair of the House Subcommittee on Capital Markets, Insurance, and Government-Sponsored Enterprises, at 14-15.

may be of interest” that Madoff kept two sets of records “[t]he most interesting of which is on his computer which is always on his person.” (*Id.* at 358.)

158. Despite the fact that the tip suggested it came from an insider with personal knowledge, the Enforcement staff decided not to pursue it because it was “anonymous” and “lack[ed] detail.” (*Id.* at 359.)

159. Thus, when dealing with someone of Madoff's prominence, the SEC disregarded detailed complaints from someone as obviously knowledgeable as Markopolos, on the theory that he was not an insider; and disregarded tips from an insider, because they were anonymous.

Madoff’s December 2008 Confession

160. On December 11, 2008, Madoff confessed to his sons that BLMIS was a Ponzi scheme. At that time, the statement balance of investments in BLMIS totaled \$64.8 billion.

161. Within days, “the SEC learned that credible and specific allegations regarding Madoff’s financial wrongdoing were repeatedly brought to the attention of SEC staff” and that the SEC missed opportunities to detect the fraud dating back to 1992. (*Id.* at 1.)

162. In response to the mandate of Chairman Cox, the OIG concluded that:

[D]espite numerous credible and detailed complaints, the SEC never properly examined or investigated Madoff’s trading and never took the necessary, but basic, steps to determine if Madoff was operating a Ponzi scheme. Had these efforts been made with appropriate follow-up at any time beginning in June of 1992 until December 2008, the SEC could have uncovered the Ponzi scheme well before Madoff confessed.

163. The OIG also concluded that “the examiners’ and investigators’ awareness of Madoff’s stature played an ancillary role in the conduct of their examination and investigatory work.” (*Id.* at 382.)

FIRST CLAIM FOR RELIEF **(NEGLIGENCE)**

164. Plaintiffs repeat the allegations heretofore stated.

165. Under the FTCA, 28 U.S.C. 1346(b)(1), the United States is liable “for injury or loss of property . . . caused by the negligent or wrongful act[s] or omission[s] of [SEC’s] employee[s] . . . while acting within the scope of . . . employment, under circumstances where the United States, if a private person, would be liable to the claimant in accordance with the law of the place where the act or omission occurred.”

166. The SEC owes a duty of reasonable care to all investors who are foreseeably endangered by its conduct.

167. The SEC owes a duty to all investors not to behave wrongfully towards them.

168. Plaintiffs are investors who were foreseeably endangered by the SEC’s conduct.

169. The standard of care by which the SEC’s conduct must be measured is established by the laws and regulations pursuant to which it operates, by the standards it generates internally, and by the standards it imposes upon the targets of its enforcement activities.

170. While the SEC may not have had a duty to investigate Madoff and BLMIS in the first instance, once it undertook to investigate Madoff and BLMIS in 1992, it had a duty to conduct its investigation in accordance with federal law, with its own internal standards, and consistent with the standards it imposes upon others.

171. As set forth above and in greater detail in the Report, the SEC utterly failed to adhere to the aforesaid standards and thereby caused the Plaintiffs the loss of their investments, the loss of the amounts they paid in taxes to both federal and state taxing authorities, a reasonable return on their investments, and other economic damages.

172. The Plaintiffs' losses were the natural, probable, and foreseeable consequence of the SEC’s negligence.

173. To the extent that the Court concludes any breaches of duty by SEC staff were committed in connection with the performance of any discretionary function, those breaches are nonetheless actionable because decisions involving failure to adhere to acceptable standards of conduct are not the type of economic, political, or social decisions that were meant to be protected by Congress.

**SECOND CLAIM FOR RELIEF
(AIDING AND ABETTING BREACH OF FIDUCIARY DUTY)**

174. Plaintiffs repeat the allegations hereto stated.

175. BLMIS owed Plaintiffs and other BLMIS investors a fiduciary duty to act in their best interests and to perform its services with the degree of care, caution, and prudence expected in the financial services industry.

176. BLMIS breached its fiduciary obligations to Plaintiffs and other BLMIS investors by perpetrating a massive Ponzi scheme.

177. SEC employees had actual knowledge that BLMIS breached the fiduciary obligations it owed to Plaintiffs and other BLMIS customers, *inter alia*, by reason that its employees were well aware of the numerous red flags suggesting that BLMIS was operating a Ponzi scheme; and that an SEC employee was informed by the DTC during the course of NERO's investigation of the 2005 Complaint that equity trades for Madoff's advisory investment business and the broker-dealer business were kept in one segregated account at the DTC despite Madoff's prior testimony that advisory positions were segregated. The SEC employee knew that commingling of funds was a violation of federal securities law. Thus, the SEC had actual knowledge that BLMIS breached its fiduciary obligations.

178. The SEC substantially assisted BLMIS in breaching the fiduciary obligations it owed to Plaintiffs and other BLMIS customers. The SEC failed to conduct a single competent

investigation and affirmatively assisted Madoff and BLMIS in breaching its fiduciary duties to the Plaintiffs and other BLMIS investors by issuing him a “clean bill of health” and publicizing its confidence in Madoff’s integrity.

179. As a direct and reasonably foreseeable result of BLMIS’s breach of fiduciary duty and the SEC’s aiding and abetting in that breach, Plaintiffs suffered substantial injury.

**THIRD CLAIM FOR RELIEF
(AIDING AND ABETTING FRAUD)**

180. Plaintiffs repeat the allegations hereto stated.

181. Madoff through BLMIS defrauded Plaintiffs and other BLMIS customers by virtue of running a Ponzi scheme. As part of this operation, false statements were repeatedly made to Plaintiffs and other BLMIS customers, both orally and through the written confirmations and monthly statements sent throughout the existence of each Plaintiff’s investment regarding the sale and repurchase of securities and other financial instruments, the value of investors accounts, and the total value of assets under management.

182. Allegations contained herein are sufficient to give rise to an inference of the SEC’s actual knowledge of the fraud committed by Madoff through BLMIS. SEC employees were well aware of the numerous red flags suggesting that BLMIS was operating a Ponzi scheme. SEC employees during the course of its investigation of the Hedge Fund Manager’s Complaint learned of discrepancies between data provided in the documents submitted by Madoff and representations he made about his strategy, as well as inconsistencies between the information provided and findings of third parties that were communicated to the SEC.

183. For example, during the investigation of the Renaissance E-mails, the SEC was informed that Madoff was not trading options and, therefore, could not be executing the split-strike conversion strategy. The BDE Group, in that same investigation, confirmed with Barclays

that there was no transaction activity in Madoff's account, despite the fact that Madoff himself advised the SEC that Barclays cleared his trades. Lastly, during the course of Markopolos' 2005 Complaint, an OEA staffer at the SEC confirmed that Madoff's split-strike conversion strategy could not generate such high returns. The Enforcement team never acted on the information because it was never communicated to its division.

184. The SEC substantially assisted BLMIS in the fraud. The SEC staff assisted Madoff in the concealment of the Ponzi scheme by failing to uncover it even though it was required to do so. In fact, the SEC affirmatively assisted Madoff and BLMIS by legitimizing BLMIS' operations dating back to 1992.

PRAYER FOR RELIEF

WHEREFORE, Plaintiffs respectfully request judgment in their favor as follows:

- (a) Awarding each Plaintiff compensatory damages in an amount to be determined at trial, but not less than each Plaintiff's total loss resulting from the Madoff fraud plus all consequential damages and prejudgment interest;
- (b) Awarding Plaintiffs attorneys' fees and costs pursuant to 28 U.S.C. 2412;
- (c) Awarding Plaintiffs such further relief as the Court deems just and proper.

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BECKER & POLIAKOFF LLP

By: /s/ Helen Davis Chaitman
Helen Davis Chaitman
45 Broadway
New York, New York 10006
(212) 599-3322

*Attorneys for Attorneys for Plaintiffs Stanley
Baer, Jesse L. Cohen, Alan Roth, Elaine
Ruth Schaffer, and Lenore H. Schupak*