Interview Notes

On January 6, 2009, David Kotz and Heidi Steiber traveled to New York City to meet with several employees of [redacted] The following notes of our meeting constitute attorney work product and include our thoughts and mental impressions.

Meeting participants included [redacted], the current Managing Director and Chief Administrative Office of [redacted] who served as General Counsel at the time [redacted] performed due diligence on Bernard Madoff; [redacted], the personal privacy [redacted] who was on a team performing due diligence on Madoff; [redacted], the current Managing Director and General Counsel; and [redacted], the Director of Litigation and Regulatory Affairs.

[redacted] expressed concern about it becoming public that [redacted] helped us with our investigation because they are fearful of finding themselves entrenched in civil litigation as a third party. They would like us not to name them in the report or to tape record them, but they said that we could follow up with them for clarifications or to ask additional questions.

[redacted] wanted us to understand that they dealt with Madoff in personal privacy and that because of the time that has elapsed their memories are not completely clear and they only have limited documentation of the transaction. Pursuant to their agreement with the company they were planning to acquire, most of the documentation was destroyed.

Personal Privacy **Transaction**

The two members of the meeting that were involved with the Personal Privacy transaction were [redacted] on the legal side and [redacted] on the business side. [redacted] provided a narrative of the Personal Privacy transaction. [redacted] said that [redacted] was the world leader in equity derivatives. In the Personal Privacy time period, [redacted] wanted to expand its customer activity in the U.S. and had been approached by Personal Privacy and investment bank, to purchase Personal Privacy[1] If [redacted] would have purchased

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[1] Background from Personal Privacy article: [redacted] audit at the time was conducted by three people who visited Mr. Madoff's headquarters in the red-granite skyscraper on Third Avenue in Manhattan. They were part of a larger 25-person group examining a potential acquisition of Personal Privacy which had lent money to investors in Mr. Madoff firm, among others. Mr. Madoff's employees told the team that his strategy consisted of balancing holdings in large Standard & Poor's stocks with options to buy and sell shares, known as puts and calls, according to the banker, who was not authorized to speak publicly about the matter. Ideally, this approach produces low volatility and minimizes risk. But when [redacted] back-tested the strategy, it could not match the results that Mr. Madoff claimed to have produced. "It's a strategy that can lose sometimes, but the monthly returns were almost all positive," the banker said. "Something wasn't right." [redacted] was also troubled by the fact that Peter Madoff, Mr. Madoff's brother, was the chief compliance officer. Ultimately, Personal Privacy then a unit of Personal Privacy was sold to Personal Privacy the cross-town rival of [redacted] Personal Privacy has nearly $500 million in exposure to Mr. Madoff, a major contributor to the $1.4

Personal Privacy it would be getting a book of business that included two types of structured alternative investments that involved Madoff: (1) credit facilities, which were secured by hedge fund shares; and (2) rights relating to baskets of hedge funds.

Because ■ was considering purchasing an entire ongoing business that included a large book of business, human resources, the back office, and other areas of the operation, ■ had assembled a large team of about 30 people to perform due diligence. Only 3-4 members of the team performed due diligence on all of the hedge managers, which included Madoff. The due diligence process lasted 2-3 weeks.

The due diligence team looking at the hedge fund managers did a variety of things as part of due diligence. They looked at the collateral for loans and the credit risk of the hedge funds and their managers. They would give a color, such as green, yellow, red, black, etc. for every hedge fund manager.

At the time, Madoff was a very large part of the portfolio they were looking at because he had a very large hedge fund they thought to hold assets of about $1.5 billion. Some of the equity derivates they were looking at included mono-manager trades where only one hedge fund is used as collateral. As a rule, ■ does not do mono-manager trades because they want a more diversified basket of hedge funds for collateral.

In this case, there were many hedge fund managers involved in Personal Privacy book of business. ■ did not look at every manager; they looked at managers that were not their clients and hedge fund managers that were not already part of their fund to funds. The other fund managers they had already performed some due diligence upon.

■ does not use a specific checklist when performing due diligence but does look at the same basic things. One area they look at as part of due diligence is **independence criteria**. For example, they look to see what firm acts as the prime broker[2] and make

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billion loss the Paris giant's corporate and investment banking unit announced on Tuesday for the first 11 months of 2008.Like Personal Privacy had losses on money it lent to hedge fund firms, which in turn invested the cash with Mr. Madoff. ■ collateral, quite possibly worthless, included a stake in the Madoff fund. Mr. Madoff's firm had been especially appealing to Continental investors because it appeared to offer the kind of steady, predictable returns with a minimum of volatility that conservative European institutions — and especially private family money managers — typically seek. ■ ■, itself the victim of an apparent scam early this year when unauthorized bets by a trader, Personal Privacy Personal Privacy caused a Personal Privacy loss, was not the only financial firm to think Mr. Madoff's unfailing record was too good to be true, said Personal Privacy a project manager at the Hedge Fund Center of the London Business School. "Madoff did not pass due diligence for many European hedge fund companies," Personal Privacy said. "Experienced people know there are many ways to provide the kind of return stream offered by Madoff, almost like a bank account, and one of them is a Ponzi scheme." Smaller American investment advisory firms like personal privacy also spotted problems with Mr. Madoff's strategy early on, but ■ ■ is the first major investment player known to have steered clients away him.

[2] Prime brokerage is the generic name for a bundled package of services offered by investment banks and securities firms to hedge funds and other professional investors needing the ability to borrow securities and cash to be able to invest on a leveraged basis and achieve an absolute return. The business advantage to a

certain there are independent parties clearing the trades, an independent back office that produces asset values for accounts, etc. If sufficient independence was not present, the hedge fund was ineligible to use for collateral. Today it is an exception to have a hedge fund with no independence. At the time of the due diligence in Personal Privacy it was already an infrequent occurrence. One of their major concerns is transparency. They want to see what the [trade] positions are and want to have an independent custodian holding the assets so they can see how much money is under management.

The due diligence team then tried to get the information they needed from Madoff. They sent him a list of questions in preparation for a scheduled meeting, but **Madoff cancelled the meeting**. In an effort to try to elicit Madoff's trade strategy they obtained Madoff's trade records from Fairfield (a hedge fund) for the1989 or 1990-2002 time period. They did not receive trade tickets. Instead, they were shown a chart that was part of the marketing returns showing trading profits for 2000-2002 of 9-12%. They thought the **returns were impossible, especially considering that the technology bubble burst** during this time. They determined that particularly in the years 2000, 2001 and 2002, there was no way Madoff's performance could be that good, saying it was "readily apparent" that it the returns were not possible (noting that Madoff's returns in the years 2000-2003 were in the neighborhood of 8% which was not conceivable in that type of down market.)

One of the major tip-offs that Madoff's claimed performance could not be legitimate arose when obtained from Fairfield records of all transactions for a 12-month period. The records showed that Madoff's performance driver was the price he was selling at as compared to the Volume-Weighted Opening Price (VWOP). The record showed that Madoff was buying and selling baskets of stocks that included about 45-50 stocks. He was buying the stocks at 1% below VWOP and selling at 50-100 basis points above VWOP. Because of their industry experience, knew that this type of perfect timing was simply not possible. uses a computer program to try to trade to beat VWOP, and they are very happy if they are able to beat VWOP by 5 basis points. Madoff was beating VWOP by 100 basis points consistently on every stock, outperforming the market 90% of the time. did not understand how this could be possible, and there was a concern that Madoff owned a market-making business and that there was a lack of independence. noted that it was a red flag for them when they were not able to understand or explain a matter like this.

Another red flag to was that Madoff **did not take a management fee** on the accounts he managed. This was very unusual because they calculated that he could generate a minimum of $300 million of fees on the money he managed. The standard hedge fund fee is 2% of the assets under management and 20% of the gains. On top of this fee, if a customer invested in a fund of funds, then he paid an additional 1% of assets under management and another 10% of the gains to the fund of funds manager. Personal Privacy

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hedge fund of using a Prime Broker is that the Prime Broker provides a centralized securities clearing facility for the hedge fund, and the hedge fund's collateral requirements are netted across all deals handled by the Prime Broker.

said that in all of his work setting up hedge funds over numerous years, he has never seen a hedge fund manager forego a management fee.

A further red flag for [redacted] was the **huge volume of options** that Madoff claimed to purchase. [redacted] was active in the options market and never saw Madoff trading in this market. [redacted] thought they based upon his options strategy, Madoff would have been a large player in the options market. They also thought it was odd that he was supposedly trading the options over the counter with Madoff Securities rather than with a firm with a presence in this area like UBS, etc. [redacted] employees found it notable that they did not know even one worker on the options floor at Madoff Securities. They knew of no one trading options for Madoff, specifically noting that they had never seen any broker on the floor who was actively trading for Madoff.

Counterbalancing these very negative issues for Madoff were certain positive factors in his favor. First, [redacted] saw that the fund of funds (like Fairfield) was **audited by a well-known firm**, such as PwC. There were no conditions to the fund of funds audit, and they never looked to see who had audited Madoff's firm. Second, **Madoff had not been the subject of any major actions by the SEC or the NASD**. When asked how much weight they gave to the fact that the SEC and FINRA regulated Madoff Securities, [redacted] and [redacted] did not provide a precise weighting. They said it was "something that was considered." A third factor in Madoff's favor was that his fund was distributed by well-known fund advisers, such as Tremont and Fairfield, who they thought would have done thorough due diligence on Madoff. Fourth, they were well-aware of **his and his family's prominent role in regulatory circles**. They knew they had prominent positions in many securities organizations, including SIA and the NASD. For example, they said the fact that [redacted]'s personal privacy with Madoff influenced their view of Madoff's legitimacy. Finally, nothing untoward was turned up in Personal Privacy background check. Personal Privacy did a Level A review, which involved reviewing publicly available documents. They had Personal Privacy do the report because of the unusual and suspicious things (discussed above) that they had discovered in their due diligence process.

They made a list of all of the negatives and the positives for using Madoff as collateral and in the end they did not feel comfortable going forward with purchasing transactions that involved Madoff. They asked Personal Privacy if they would sell Personal Privacy [redacted] to them without Madoff-effected transactions. Personal Privacy said no and sold Personal Privacy [redacted] to [redacted] [redacted]'s competitor, instead. [redacted] never wrote a due diligence report, as they normally would, because they decided not to go forward with the purchase. **They may have some documents from this period.**

[redacted] personal privacy They think that personal privacy must not have done due diligence on the hedge fund managers, but they do not know what was involved in personal privacy due diligence process. In 2005, when they bought the business from personal privacy the Madoff-effected assets were not included. It was the view of the management of [redacted] that, based on the due diligence performed in Personal Privacy, that the bank was to have no Madoff exposure.

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When asked what they made of Madoff allegedly putting all of his investments into treasuries at the end of a quarter, they said it made sense if you think that he was just using the capital from investors for his market making business. [redacted] was unwilling to explicitly state that because of the lack of independence they suspected Madoff was front running or running a Ponzi scheme. When it was uncovered that Madoff was operating a Ponzi scheme, [redacted] said he was surprised because he thought it was a market making scheme. [redacted] did not think Madoff was operating an out-and-out fraud.

None of the interview participants had heard of the Markopolous letter or his accusations in 2003. [redacted] had read an article about the consistency of Madoff's returns as part of due diligence. [He was likely referring to the Michael Ocrant article.]

Regulator Inspections and Fraud Detection

The meeting participants stated that with hindsight it was easy to detect the fraud at Madoff's broker-dealer. [redacted] has extensive experience working at both retail and institutional broker-dealers. He pondered how Madoff's advisory business would have been set up in relation to the broker-dealer and what regulators would have seen when they inspected the broker-dealer. He thought that Madoff might have been shown to be a customer with a contract to receive rebates or payments back on his executions. Regulators should have asked what the financial arrangement was between Madoff and the firm. [redacted] said that this was a complicated issue, and he would need to think about it. [redacted] thought the fraud would have only been detected if one looked at the broker-dealer to see if the claimed assets under management were actually there.

[redacted] said that he did not want to be on record critiquing regulators. He thinks that in an inspection they are looking for one thing, and he implied that because of their focus they can miss the bigger picture. In this case, [redacted] and [redacted] thought it would have been a **big** red flag to regulators that the market maker was family fun and that the head of compliance was Madoff's niece. This lack of independence would have been something for regulators to look at carefully. They also noted that the fee structure should have been a **big** red flag for examiners as [redacted] said he doesn't know any hedge fund managers who didn't take a fee ever.

The meeting participants expressed their frustration with regulatory reviews because even thought their broker-dealer is only a proprietary and institutional broker-dealer, they are reviewed by people used to reviewing retail broker-dealers and they are asked questions from a checklist that are inapplicable to a non-retail broker. They can understand that the focus of regulators, especially FINRA, has been on customer protection for the last several years, which leads to the type of inspections that regulators have been conducting.

However, they pointed out that regulators seem to have problems looking at unique models, and they speculated that the same retail broker dealer approached was used to review Madoff Securities, which is a market maker. The regulators that review a

market maker should have expertise in reviewing market makers because they present unique risks. They noted that in the past, SEC examiners asked inapplicable questions in their examinations.

Another issue related to broker-dealer reviews is the lack of training or understanding that some of the examiners display. They said that some career regulators appear to be without understanding of the operations they are examining and have come to doubt that many of the examiners are even registered (Series 7, etc). They think that examiners need to know the ABC's of everything they are looking at. However, knowing terms such as VWOP is one thing, but unless you have experience in the industry, you will not understand what VWOP+100 means in practice.

The meeting participants also expressed criticism that **regulators actually link up the broker-dealer reviews and the adviser reviews**. On the adviser side of Madoff's business, they would have expected regulators to contact the custodian to verify customer balances. They also think that **OCIE needs to follow-up where issues arise during an examination**. They are not sure there are mechanisms to follow up and make sure that issues are remediated. With its current staff, OCIE currently may not be able to follow up, unlike the Federal Reserve which is on site to follow up.

If they had a wish list of regulatory changes it would include having somewhere to go to ask complicated rule interpretation questions. The present hotline is for very simple questions and the current no-action letter process is very lengthy and costly. They would like to think about the issue of improvements at more length.

Enforcement Division

Meeting participants expressed that they had horrible experiences dealing with the Division of Enforcement. They stated that the Division is slow and rigid. They stated that with the AUSA, they can at least have a dialogue, but they do not find that they have that same ability with the staff of the enforcement division. They find there is less rigidity at the most senior levels of the Division.

They feel like even when they self-report they get punished just as if they did not self-report. They feel there is not a thoughtful dialogue even if the entity does all of the right things. They do not feel that the SEC recognizes that most regulated entities want to do the right thing and that the SEC (including OCIE) does not work with them in the way that the Federal Reserve, which is on the premises, does.

The Division is also slow. They said that they self-reported a matter in December 2001 and they have not yet heard back. What they have experienced is that the Division delays for 6 months to a year and then the Division will contact them and expect for them to respond in a very short time frame, such as a week.

They feel like they have only three opportunities per case to call over the staff's head and get a thoughtful discussion and consideration of an issue. Once they call over

the staff's head, the staff hates them. They think that they get a better response form senior members of the Division because they are more confident and feel they have more authority to make decisions. They also feel like they are unfairly pushed to accept settlements with the threat of enforcement actions. Firms give into the pressure because they have a long term reputational interest.

They feel like senior members of the Division give them a more rational hearing that does the staff, but they do not feel they receive better or worse treatment from senior members of the Division. They do not find that the staff in the Division is trying to endear themselves to the industry to get jobs. They find them completely adversarial. They said that they have former SEC and AUSA's represent them not because they feel they will get preferential treatment but because they come into interactions with the staff having credibility, they know the culture of the agency, they may have had similar cases, and they know who to go to at the agency.

Hedge Fund Regulation

[redacted] stated that when he heard that the SEC was called to regulate hedge funds he wondered how they could possibly do this in terms of staff. The world does not know what this takes as a capacity matter. The meeting participants thought that it was better not to regulate an area unless the regulator does it well because regulation provides the stamp of legitimacy on the regulated entity. It is not sufficient to regulate hedge funds by coming in for an examination every few years. The requirement has to be more than filing a Form ADV. In theory though, it is better for them as someone who runs funds of funds to have someone else looking at hedge funds. They also recommended having a set of industry standards for what auditors review because when they see validated financial statements they assume that the auditor is out validating the information therein.

They did not blame regulators for not having the same expertise as found in the industry because the agencies cannot afford these experts. They did say that they think the industry (including former hedge fund managers) has the expertise and is willing to train agency personnel. Unlike regulators, [redacted] is an engineer and can walk in and see right away that the claimed investment strategy will not work. They also emphasized that [redacted] has a market risk division that looks specifically at counterparty risk. They think the industry will devote time to teaching agency personnel how to look for the right things. They cautioned against fighting the last fight because the next problem with hedge funds will be something different than the Madoff scheme.

They also raised the issue of **whether it is the SEC's role to police and verify trading strategies** and verify whether the strategy leads to a certain rate of return.

Tips

When asked how the SEC could get [redacted], and other similar firms, to provide tips to the SEC when they thought there was an area that raised suspicion. They said that one of their major concerns was defamation. They were concerned when they essentially black-

balled Madoff that they would be sued for defamation. They think that there would have to be some **guarantee of confidentiality and immunity** to make them comfortable providing tips.

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