

STATS CODE: NY-6066

SUMMARY MEMORANDUM

November 13, 1992

TO: Office of General Counsel

FROM: New York Regional Office ("NYRO")

SUBJECT: In the Matter of King Arthur (NY-6066)
Avellino & Bienes ("A&B")
Frank J. Avellino ("Avellino")
Michael S. Bienes ("Bienes")

RECOMMENDATION: That the Commission:

Deliberative Process



**ACTION
REQUESTED BY:**

Duty Officer

**OTHER OFFICES OR
DIVISIONS CONSULTED:**

**Division of Corporate Finance
Division of Market Regulation
Division of Investment Management**

**SUNSHINE ACT STATUS
RECOMMENDATION:**

**Closed pursuant to 17 C.F.R. §§ 200.402 (a)(5), (7)
and (10)**

PERSONS TO CONTACT:

**Richard H. Walker
Regional Administrator
NYRO (212) 264-1636**

**Edwin H. Nordlinger
Deputy Regional Administrator
NYRO (212) 264-1639**

Personal Privacy

former Enforcement Assistant Regional Director

former New York Enforcement Staff Attorney

**John Gentile, Chief
Branch of Broker-Dealer Inspection #5
NYRO (212) 264-8578**

STATS CODE: NY-6066

ACTION MEMORANDUM

November 13, 1992

TO: Division of Enforcement

FROM: New York Regional Office ("NYRO")

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**OTHER OFFICES OR
DIVISIONS CONSULTED:**

**Division of Corporation Finance
Division of Market Regulation
Division of Investment Management**

**NOVEL, COMPLEX, OR
IMPORTANT ISSUES:**

None

SOURCE OF CASE:

Referral from Miami Branch Office

**PRIOR COMMISSION
ACTION:**

None

**SUNSHINE ACT STATUS
RECOMMENDATION:**

**Closed pursuant to 17 C.F.R. §§ 200.402 (a)(5), (7)
and (10)**

PERSONS TO CONTACT:

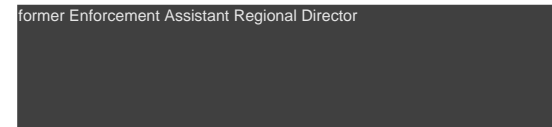
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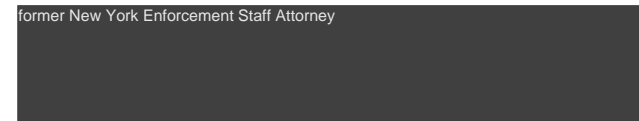
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Personal Privacy



I. SUMMARY

Since in or about 1984, A&B has been operating as an unregistered investment company, issuing and selling unregistered securities to the public. A&B sells these securities by informing investors that in return for investing with A&B (*i.e.*, purchasing A&B's instruments), investors will receive a fixed stated interest rate, usually between 13.5% and 20%. The money A&B collects from investors through the sale of A&B's securities is sent to Bernard L. Madoff Securities, Inc. ("Madoff").^{1/} Madoff invests the money in the securities market.

A&B profits from the spread between the money it makes through its trading activities at Madoff, and the money it pays out to investors in terms of interest. The interest rate given to investors is fixed and is not contingent on the amount of money A&B makes through Madoff's investments in the securities market. Both the number of investors who have invested with A&B through the purchase of A&B's instruments and the amount of money raised by A&B has steadily increased over the years. As of October 1992, there were more than 1,000 investors who had invested with A&B through the purchase A&B's securities; and the total amount of money raised by A&B through the sale of A&B's securities was in excess of \$441 million.

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^{1/} Madoff has been registered as a broker-dealer with the Commission since January 9, 1960, and is a major third-market participant specializing in computer guided trading strategies.

II. PROPOSED RESPONDENTS AND RELATED ENTITIES

A. **A&B** is a general partnership registered in Florida. Its main office is located at 70 East 55th Street, New York, New York, 10022. Additionally, A&B maintains an office at Avellino's Florida address - 4750 Northeast 23rd Avenue, Fort Lauderdale, Florida. A&B is comprised of two general partners: Avellino and Bienes. A&B is not, and has never been, registered with the Commission as a broker, dealer or investment company.

Between 1962 and 1984, A&B was in the certified public accounting business. However, in 1984 A&B stopped rendering accounting services and began its current operations. A&B's current business operations are comprised solely of investing in the securities market.

B. **Avellino** is 56 years old and resides at Personal Privacy

[REDACTED] Avellino received a Bachelor of Science degree in accounting from the City College of New York in 1958. Avellino became certified as an accountant in 1965. Avellino has been affiliated with A&B and its predecessor entities since approximately 1962. Avellino is also a partner in other businesses, and serves as a director of New Egypt Development, Optus Software, Inc., and Benchwarmer Clothes.

C. **Bienes** is 56 years old and resides at Personal Privacy

[REDACTED] Bienes received a Bachelor of Science degree from New York University in 1958. Thereafter, in 1966 Bienes received a Master's of Business Administration degree from Baruch College. In 1969, Bienes became a certified public accountant

("CPA"). Bienes has been affiliated with A&B and its predecessor entities since its inception. Bienes is also a partner in other businesses as well.

III. BACKGROUND

A. Development of A&B's Program

While A&B was in the accounting business (1962 - 1984), certain clients, friends and relatives began seeking investment advice. Since Avellino and Bienes were strictly accountants by profession, they established a discretionary trading account at Madoff.^{2/} The money A&B received from individuals for investment purposes was then invested, on behalf of A&B, at Madoff. According to Avellino, Madoff managed all of the accounts, determining what securities to buy and sell. In return, A&B paid the investors high interest rates, (13.5% to 20%). The interest rates were fixed, but varied among individuals.^{3/} The interest rates paid by A&B were not contingent upon the results obtained through Madoff's trading activities. A&B's profits were derived from the difference between the amount it returned to the investors in terms of interest and the amount A&B realized through Madoff's trading activities.

To supplement A&B's securities trading business, in 1980 A&B began borrowing money, on an unsecured basis, from Chemical Bank. The money obtained

^{2/} According to Avellino and Bienes, investment decisions are made solely by Madoff.

^{3/} According to Avellino, he and Bienes determine the interest rate at the time the investor begins investing. The interest rate remains consistent over time and is based on current economic conditions (*i.e.*, the rate banks are obtaining for unsecured loans).

from Chemical was given to Madoff to invest in the securities markets on behalf of A&B.^{4/}

By 1984, profits from A&B's securities trading business substantially eclipsed profits from the firm's accounting practice. Thus, in 1984 A&B relinquished its accounting practice and began exclusively focusing on A&B's existing securities trading business. Since 1984, A&B has steadily increased the amount of money raised through the sale of A&B's securities. The amount of money borrowed from Chemical Bank steadily increased between 1980 and 1988, ultimately reaching \$2.25 million. In 1988, however, A&B paid off its unsecured bank loan from Chemical Bank, and stopped borrowing any additional money from any bank. According to Avellino, A&B no longer wanted to submit detailed, annual, personal and business financial statements, preferring to maintain A&B's privacy to the greatest extent possible. As a result, since 1988 A&B has only raised additional money to supplement its securities trading business by selling A&B's securities to investors.

B. A&B's Investment Program Today

1. *Solicitation of Investors*

Investors who have invested with A&B through the purchase of A&B's securities have been solicited through two different types of referral networks. The first referral network, and by far the most prevalent, is contingent on referrals from existing investors. Most of the investors who have purchased A&B's instruments have been referred by other existing investors. According to Avellino, the only way

^{4/} With this money, Madoff established three different personal accounts. These accounts are considered A&B partnership accounts.

an investor can be accepted into A&B's investment program is if he or she is referred or recommended; even then, references are verified to corroborate the referral.

The second referral network, which is no longer in existence, was contingent on referrals from an investment adviser - Andrew Copperman ("Copperman"). From 1989 to 1990, Copperman referred over 100 investors to A&B. According to Avellino, Copperman was paid 1% commission on the amount of money his clients invested.^{5/} Copperman ceased his referrals in or about October 1990, because the California Department of Corporations notified Copperman that it thought that he was acting as an unregistered broker-dealer. Consequently, Copperman wrote a letter to every investor who he had referred to A&B indicating that he would no longer recommend or render any advice with respect to A&B's investment program.^{6/} Despite Copperman's absence from A&B's program since October 1990, the investors who were referred by Copperman have continued their investment in A&B.

2. *Information Given to Investors*

Investors are given minimal information concerning investing in A&B through the purchase of A&B's securities. A&B does not provide a prospectus or any other type of information regarding the specific use of investors' funds. Simply stated, when an investor calls A&B concerning the investment program, he or she is told that A&B pays investors a fixed rate of interest, between 13.5% and 20%, for money

^{5/} The staff has determined that Copperman earned approximately \$10,000 in commissions through his referral of customers to A&B.

^{6/} Since Copperman stopped recommending or giving advice on A&B's program and stopped receiving commissions in October 1990, the staff is not recommending enforcement action against Copperman.

invested with A&B. Investors are not told specifically what A&B does with the money; they are told only that A&B invests the money it receives from investors in the securities market. The investor is told that his or her money is safe because of the types of securities purchased and strategies employed to protect the securities.

Only on rare occasions does A&B send letters to prospective investors explaining A&B's investment program. The staff has obtained one such letter sent by A&B to a prospective investor after the prospective investor requested more information before investing. A&B's letter stated:

A&B invests with one particular Wall Street Broker (the same company since we first started doing business over 25 years ago) who buys and sells stocks and bonds in the name of A&B. The list of securities being traded are top corporations such as IBM, AT&T, etc. It's the mechanics being used to protect the portfolio that makes our business successful. . . . [T]his is a very private group and no financial statements, prospectus or brochures have been printed or are available. . . . The money that is sent to A&B is a loan to A&B who in turn invests it on behalf of A&B for which our clients receive quarterly interest payments.

In addition, the staff has obtained a fact sheet concerning A&B's program which was created and disseminated by Copperman to prospective investors. The fact sheet referred to A&B's investment program as the King Arthur Account. The fact sheet stated, among others things, that: (1) A&B paid 13.5% interest compounded quarterly; and (2) A&B's financial transactions profited from riskless trading, were 100% safe and at no time put an investor's money at risk.

The staff contacted and interviewed numerous investors. The investors interviewed by the staff were, for the most part, unsophisticated investors, and generally were not familiar with the exact nature of their investment. Several

investors told the staff that they had invested their IRA money and/or certificate of deposit money with A&B.^{7/} In addition, the staff discovered that most investors enrolled in A&B's program because of the remarkable interest rate that A&B offered - 13.5% to 20%. The investors told the staff that they could not obtain equivalent interest rates anywhere else.^{8/}

Many of the investors believed they had invested in an instrument which was similar to a mutual fund. These investors believed that their investment was long-term, even though they could withdraw their money on two weeks notice, because the interest could be rolled-over each quarter. Further, most investors believed that their investment was safe based on the limited information received. For example, Copperman indicated in the King Arthur fact sheet that A&B's program was 100% safe, and that at no time did a trade put the investor's money at risk. In addition, the fact that prospective investors had to be referred to A&B created an impression that A&B's program was somehow "special," and thus, perhaps subject to even less risk.^{9/}

^{7/} The staff has learned that in order for an investor to invest his or her IRA money with A&B's, he or she had to establish a self-directed IRA account. Since most IRA custodians do not administer self-directed IRA accounts, (*i. e.*, where the investor determines what will be done for investment purposes with his or her IRA money and the IRA custodian simply administers the account), A&B and Copperman referred investors to Retirement Account, Inc. ("RAI"). RAI, located in Florida, has administered numerous self-directed IRA accounts for investors who have invested their IRA money through A&B.

^{8/} These investors told the staff that they cashed in their certificate of deposits and/or withdrew money from their personal bank accounts and Individual Retirement Accounts ("IRA") in order to obtain a much better return on their money through A&B's investment program.

^{9/} In fact, one investor withdrew all of his money from A&B to test A&B's assertion that funds could be withdrawn on two weeks notice. After receiving his money, the investor re-invested his money back with A&B.

3. *Confirmation Letters and Quarterly Statements*

Once A&B has received money from an investor, A&B sends the investor a confirmation letter. The confirmation letter, which is a form letter, states that A&B is in receipt of the investor's funds and will calculate interest at the annual rate of *[insert interest rate]*, computed quarterly. The letter also confirms the investor's instruction with respect to the quarterly interest payments (*i.e.*, either to roll-over the quarterly interest payment into their account or to receive a check each quarter). Finally, the letter states that the investor can receive the return of his or her funds invested with A&B upon written request within two weeks.

In addition, A&B sends each investor quarterly statements. These statements are accompanied by a quarterly interest payment check if the investor has elected to receive his or her quarterly interest. If the investor has elected to roll-over the interest, then he or she simply receives the quarterly statement. From in or about 1989 through in or about November 1990, these quarterly statements, which were form letters, stated: "for the period ended *[insert date]*, *[insert amount]* represents the return on your investment of *[insert amount]*." In addition, on the top left margin of the quarterly statements, the word "reinvested" appeared if the investor rolled-over the quarterly interest payments. Beginning in November 1990, however, A&B changed the wording of the quarterly statements. Specifically, A&B substituted the word "loan" for the word "investment." The quarterly statements, thereafter, stated that: "for the period ended *[insert date]*, *[insert amount]* represents the return on your loan of *[insert amount]*. **This interest will be added to your loan balance.**"

(Emphasis added.)

After receiving investors' funds, A&B periodically transfers investors' funds into A&B trading accounts at Madoff. These trading accounts are discretionary in nature and are managed solely by Madoff. Madoff then invests the money in bluechip equities and bonds, which are hedged according to Madoff's computer driven trading models.^{10/} A&B maintains that the investing strategy employed by Madoff makes it impossible to lose more than 4% of the money invested on any one transaction. If all of A&B's trades simultaneously lost the maximum 4%, and all investors decided to liquidate their investment in A&B, the partnership could cover the 4% loss from personal accounts it maintains as a cushion.^{11/}

The staff has analyzed A&B' trading accounts and Avellino's and Bienes' personal trading accounts at Madoff, verifying the equity value in these accounts. As of October 30, 1992, A&B had nine different trading accounts and Avellino^{12/} and Bienes^{13/} each had one personal trading account at Madoff. The equity value of A&B's nine different trading accounts and Avellino and Bienes personal trading accounts, as of October 30, 1992, was \$453,903,404; \$7,306,164; and \$29,360,553, respectively. According to information supplied from A&B's attorney, as of October 30, 1992, A&B has raised approximately \$441 million through the sale of A&B's

^{10/} Madoff hedges A&B's portfolio primarily by purchasing long-term equity anticipation securities ("LEAPS"), which are essentially long-term options (two year expiration) on underlying stocks or stock indexes. During the time period reviewed by the staff (*i.e.*, May through October 1992), Madoff purchased puts on the S&P 100 Index and utilized a "short vs. the box" trading strategy designed to lock in trading profits.

^{11/} As of the end of October 1992, the equity value in these personal accounts was approximately \$36 million.

^{12/} This account was opened up under the name "Frank Avellino Trustee."

^{13/} Bienes' personal account is held under his wife's name - Diane Bienes.

securities. Consequently, as of October 30, 1992, A&B's cushion, excluding Avellino's and Bienes' personal accounts, was approximately \$12 million.

To date, Avellino and Bienes maintain that investors are loaning money to A&B on an unsecured basis in the form of demand notes. A&B claims that investors loan A&B money for the operation of A&B's business (*i.e.*, trading in the securities market).^{14/} In return, investors receive a fixed interest rate.

A&B's profits are derived solely from the difference between the amount of money A&B earns through Madoff's employed trading strategies and the amount of money paid to investors in interest. For example, in a given year, if Madoff earns a 21% return, and A&B pays investors an average of 18% interest, then A&B's profit is 3% of the amount of money investors have invested in A&B through the purchase of A&B's securities. Accordingly, the more money A&B raises through the sale of A&B's securities, the more money A&B is likely to make or lose.

IV. VIOLATIONS OF THE FEDERAL SECURITIES LAWS

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As

described herein, A&B, Avellino and Bienes have offered and sold securities to more

^{14/} Although A&B claims that investors are loaning A&B money in the form of demand notes, no formal documents similar to a promissory note are signed. The only documentary evidence indicating that an investor has invested with A&B through the purchase of A&B's instrument is a confirmation letter.

than 1,000 individuals, raising in excess of \$441 million. These securities have never been registered with the Commission.


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Pages 17 through 29 redacted for the following reasons:

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V. NATURE OF RELIEF REQUESTED

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Pages 31 through 34 redacted for the following reasons:

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VI. EXPEDITED CONSIDERATION RECOMMENDED

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VII. WELLS SUBMISSIONS

VIII. RECOMMENDATION

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