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# Wall Street Mystery Features a Big Board Rival

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Here's a tantalizing Wall Street mystery:

The Securities and Exchange Commission recently cracked down on one of the largest-ever sales of unregistered securities. Investors had poured $440 million into investment pools raised by two Florida accountants, who for more than a decade took in money without telling the SEC or making required financial disclosures to investors.

The pair had promised investors hard-to-believe annual returns of 13.5% to 20% -- to be obtained by turning the money over to be managed by an unnamed broker.

Regulators feared it all might be just a huge scam. "We went into this thinking it could be a major catastrophe," says Richard Walker, the SEC's New York regional administrator.

But when a court-appointed trustee went in, the money was all there. Indeed, the mystery money manager was beating the promised returns by such a wide margin that the two accountants ditched their accounting business in 1984 to concentrate on their more lucrative investing sideline.

Who was the broker with the Midas touch? The SEC, which last month went to court to shut down the operation, won't say. Neither will the lawyer for the two accountants, Frank J. Avellino and Michael S. Bienes of Fort Lauderdale.

But the mystery broker turns out to be 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.

Mr. Madoff is one of the masters of the off-exchange "third market" and the bane of the New York Stock Exchange. He has built a highly profitable securities firm, Bernard L. Madoff Investment Securities, which siphons a huge volume of stock trades away from the Big Board. The $740 million average daily volume of trades executed electronically by the Madoff firm off the exchange equals 9% of the New York exchange's.

Mr. Madoff's firm can execute trades so quickly and cheaply that it actually pays other brokerage firms a penny a share to execute their customers' orders, profiting from the spread between bid and asked prices that most stocks trade for.

In an interview, the 54-year-old Mr. Madoff says he didn't know the money he was managing had been raised illegally. And he insists the returns were really nothing special, given that the Standard & Poor's 500-stock index generated an average annual return of 16.3% between November 1982 and November 1992. "I would be surprised if anybody thought that matching the S&P over 10 years was anything outstanding," he says.

In fact, most investors would have been delighted to be promised such returns in advance, as the accountants' investors were. That's especially true since the majority of money managers actually trailed the S&P 500 during the 1980s.

The best evidence that the returns were very attractive: the size of the pools mushroomed by word-of-mouth, without any big marketing effort by the Avellino & Bienes partnership. The number of investors eventually grew to 3,200 in nine accounts with the Madoff firm. "They took in nearly a half a billion dollars in customer money totally outside the system that we can monitor and regulate," says the SEC's Mr. Walker. "That's pretty frightening."

An SEC civil complaint filed in New York federal court Nov. 17 charged that Messrs. Avellino and Bienes "have operated A&B as an unregistered investment company and have engaged in the unlawful sale of unregistered securities," and ordered the money returned to investors by a court-appointed trustee, New York attorney Lee Richards.

The two 56-year-old accountants declined to comment. Their attorney, Ira Lee Sorkin, says they didn't know that the notes they had issued to their clients should have been registered with the SEC, and he says that investors got their money back and haven't complained.

If the notes had been registered, they would have had to include a description of how the money was being invested, and by whom. In addition, Avellino & Bienes would have had to send investors annual reports and financial statements.

But how did Mr. Madoff rack up his big investment returns? Early investors in the late 1970s were told -- and Mr. Madoff confirms -- that their money was being used to engage in so-called convertible arbitrage in securities of such companies as Occidental Petroleum Corp., Limited Stores Inc. and Continental Corp. Promised annual returns in this period, one investor said, were 18% to 20%

In such a strategy, an investor buys a company's preferred stock or bonds that pay high dividends and are convertible into the company's common stock; the investor simultaneously sells borrowed common stock of the same company in a "short sale" to hedge against a stock-price decline.

The investor earns the spread between the higher dividend paid on the convertible securities and the lower dividend on the common stock, plus interest from investing the proceeds of the stock short sale. Using borrowed money, or leverage, to magnify returns, an investor can reap double-digit returns. But the strategy carries big risks if interest rates rise and stock prices go down.

Mr. Madoff said his investment strategy changed around 1982, when his firm began using a greater variety of strategies tied to the stock market, including the use of stock-index futures and "market-neutral" arbitrage, which can involve buying and selling different stocks in an industry group.

Mr. Madoff said, "The basic strategy was to be long a broad-based portfolio of S&P securities and hedged with derivatives," such as futures and options. Such a strategy, he said, allowed the investors "to participate in an upward market move while having limited downside risk." For example, he said, the Madoff firm made money when the stock market crashed in 1987 by owning stock-market index puts, which rose in value as the market declined.

In the mid-1980s, one investor says, the limited reports that Avellino & Bienes sent to investors changed, and investors stopped being told in which securities their money was invested. The interest rate on some new notes sold by the accountants was also lowered to 16% or less. One investor who complained about the vaguer reports and lower returns was told that if he didn't like them, he could withdraw his investment. He chose to remain.

Perhaps the biggest question is how the investment pools could promise to pay high interest rates on a steady annual basis, even though annual returns on stocks fluctuate drastically. In 1984 and 1991, for example, the stock market delivered a negative return, even after counting dividends. Yet Avellino & Bienes -- and Mr. Madoff -- maintained their double-digit returns.

The answer could be that Mr. Madoff's use of futures and options helped cushion the returns against the market's ups and downs. Mr. Madoff says he made up for the cost of the hedges -- which could have caused him to trail the stock market's returns -- with stock-picking and market timing.

Certainly, the investment pools' returns were less astounding by the standards of the early 1980s, when short-term interest rates briefly topped 20%. But the annual returns on Treasury bills hit a peak of 14.7% in 1981, and remained under 12% in the three other years that bills had double-digit returns, 1979-82, before falling later in the '80s.

One person familiar with the Avellino & Bienes case speculated that having the assets of the investment pools under management may have helped Mr. Madoff's firm by giving him an inventory of securities that could help him to execute other trades for his firm. Not true, said Mr. Madoff: "One thing has nothing to do with another."

As the investment pools swelled, two other accountants, Steven Mendelow of New York City and Edward Glantz of Lake Worth, Fla., started their own pool, Telfran Ltd., to invest in Avellino & Bienes notes. Telfran by itself sold $89.6 million in unregistered notes, a separate SEC civil lawsuit charges. The two men, also represented by Mr. Sorkin, declined to comment. The SEC said Telfran made money by investing in Avellino & Bienes notes paying 15% to 19% annually, while paying Telfran investors lower rates.

All the while, Mr. Madoff was scoring investment returns that comfortably exceeded the hefty returns Avellino & Bienes was promising its noteholders. That excess return generated big profits for the two accountants, the SEC suit indicates. The SEC has asked that those profits be returned as "unjust enrichment," a demand Mr. Sorkin calls "totally unwarranted." For his part, Mr. Madoff says he charged the investment pools only what he described as standard brokerage commissions. He termed turnover in the accounts "not very active," almost nil in some years.

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