

Personal Privacy

Subject

From: Investment Adviser #1 Portfolio Manager

Date: Thu, 13 Nov 2003 16:12:32 -0800

To: Investment Adviser #1 Risk Manager, Investment Adviser #1 Scientist, Personal Privacy

[Redacted]

Committee members,

We at [Personal Privacy] are concerned about our [Privacy] investment.. First of all, we spoke to an ex-Madoff trader (who was applying for a position at [Personal Privacy] and he said that Madoff cherry-picks trades and "takes them for the hedge fund". He said Madoff is pretty tight-lipped and therefore he didn't know much about it, but he didn't really know how they made money [Personal Privacy] heard a similar story from from a large hedge fund consultant who also interviewed an ex-trader. The head of this well-respected group told us in confidence that he believes that Madoff will have a serious problem within a year. We are going to be speaking to him in 11 days to see if we can get more specifics.

Another point to make here is that not only are we unsure as to how [Personal Privacy] makes money for us, we are even more unsure as to how [Privacy] makes money from us; i.e. why does he let us make so much money? why doesn't he capture that for himself? There could well be a legitimate reason, but I haven't heard any explanation we can be sure of. Additionally, there is a \$4 billion Madoff pass-through fund (Fairfield Sentry) that charges 0 and 20% and it's not clear why Madoff allows an outside group to make \$100 million per year in fees for doing absolutely nothing (unless he gets a piece of that). The point is that as we don't know why he does what he does we have no idea if there are conflicts in his business that could come to some regulator's attention. Throw in that his brother-in-law is his auditor and his son is also high up in the organization (imagine that!) and you have the risk of some nasty allegations, the freezing of accounts, etc., etc. To put things in perspective, if [Privacy] went to zero it would take out 80% of this year's profits.

Perhaps the best reason to get out is that we really don't expect to make an outsized return on this investment. Sure it's the best risk-adjusted fund in the portfolio, but on an absolute return basis it's not that compelling (12.16% average return over last three years). If one assumes that there's more risk than the standard deviation would indicate, the investment loses it's luster in a hurry.

It's high season on money managers, and Madoff's head would look pretty good above Elliot Spitzer's mantle. I propose that unless we can figure out a way to get comfortable with the regulatory tail risk in a hurry, we get out. The risk-reward on this bet is not in our favor.

Please keep this confidential.

Investment Adviser #1 Portfolio Manager

Personal Privacy

[Redacted]



Subject: Personal Privacy  
From: Personal Privacy  
Date: Thu, 13 Nov 2003 23:40:55 -0500  
To: Investment Adviser #1 Portfolio Manager  
CC: Investment Adviser #1 Scientist, Investment Adviser #1 Risk Manager, Personal Privacy

Law Enforcement

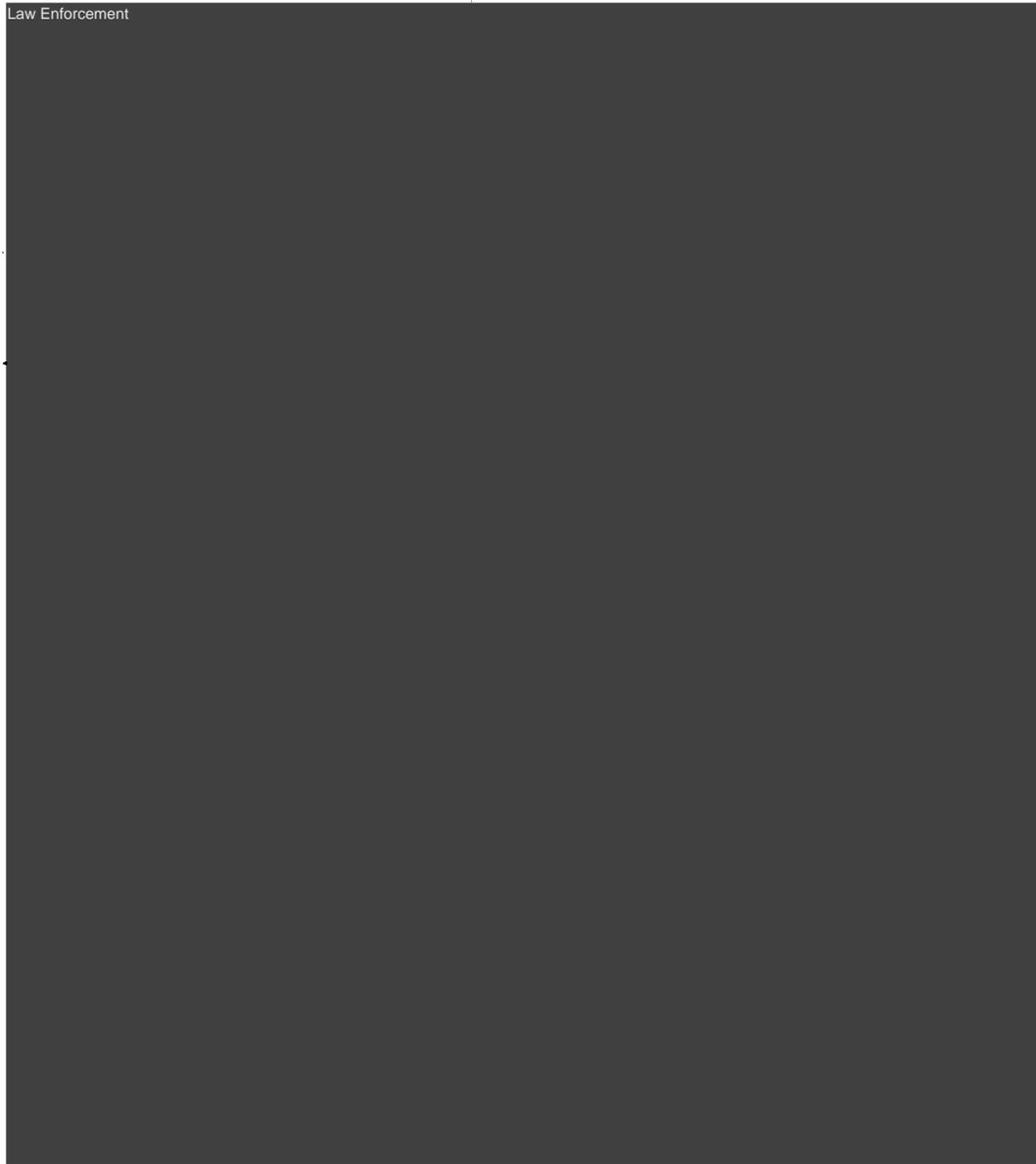
Investment Adviser #1 Portfolio Manager writes:

> Committee members,  
 > We at [Personal Privacy] are concerned about our [Personal Privacy] investment. First of all, we  
 > spoke to an ex-Madoff trader (who was applying for a position at [Personal Privacy] and he said that Madoff cherry-picks trades and "takes them  
 > for the hedge fund". He said Madoff is pretty tight-lipped and  
 > therefore he didn't know much about it, but he didn't really know how  
 > they made money. [Personal Privacy] heard a similar story from from a large  
 > hedge fund consultant who also interviewed an ex-trader. The head of  
 > this well-respected group told us in confidence that he believes that  
 > Madoff will have a serious problem within a year. We are going to be  
 > speaking to him in 11 days to see if we can get more specifics.  
 >  
 > Another point to make here is that not only are we unsure as to how [Personal Privacy] makes money for us, we are even more unsure as to how [Personal Privacy] makes money  
 > from us; i.e. why does he let us make so much money? Why doesn't he  
 > capture that for himself? There could well be a legitimate reason, but  
 > I haven't heard any explanation we can be sure of. Additionally, there  
 > is a \$4 billion Madoff pass-through fund (Fairfield Sentry) that charges  
 > 0 and 20% and it's not clear why Madoff allows an outside group to make  
 > \$100 million per year in fees for doing absolutely nothing (unless he  
 > gets a piece of that). The point is that as we don't know why he does  
 > what he does we have no idea if there are conflicts in his business that  
 > could come to some regulator's attention. Throw in that his  
 > brother-in-law is his auditor and his son is also high up in the  
 > organization (imagine that!) and you have the risk of some nasty  
 > allegations, the freezing of accounts, etc., etc. To put things in  
 > perspective, if [Personal Privacy] went to zero it would take out 80% of this year's  
 > profits.  
 >  
 > Perhaps the best reason to get out is that we really don't expect to  
 > make an outsized return on this investment. Sure it's the best  
 > risk-adjusted fund in the portfolio, but on an absolute return basis  
 > it's not that compelling (12.16% average return over last three years).  
 > If one assumes that there's more risk than the standard deviation would  
 > indicate, the investment loses it's luster in a hurry.  
 >  
 > It's high season on money managers, and Madoff's head would look pretty  
 > good above Elliot Spitzer's mantle. I propose that unless we can figure  
 > out a way to get comfortable with the regulatory tail risk in a hurry,  
 > we get out. The risk-reward on this bet is not in our favor.  
 >  
 > Please keep this confidential.

Investment Adviser #1 Portfolio Manager

Personal Privacy

Law Enforcement



Investment Adviser  
#1 Portfolio Manager writes:

> Committee members,

> We at [Personal Privacy] are concerned about our [Privacy] investment. First of all, we  
> spoke to an ex-Madoff trader (who was applying for a position at [Personal Privacy]  
> and he said that Madoff cherry-picks trades and "takes them  
> for the hedge fund". He said Madoff is pretty tight-lipped and  
> therefore he didn't know much about it, but he didn't really know how  
> they made money [Personal Privacy] heard a similar story from a large  
> hedge fund consultant who also interviewed an ex-trader. The head of  
> this well-respected group told us in confidence that he believes that  
> Madoff will have a serious problem within a year. We are going to be  
> speaking to him in 11 days to see if we can get more specifics.

> Another point to make here is that not only are we unsure as to how [Personal Privacy]  
> makes money for us, we are even more unsure as to how [Personal Privacy] makes money  
> from us; i.e. why does he let us make so much money? Why doesn't he  
> capture that for himself? There could well be a legitimate reason, but  
> I haven't heard any explanation we can be sure of. Additionally, there  
> is a \$4 billion Madoff pass-through fund (Fairfield Sentry) that charges  
> 0 and 20% and it's not clear why Madoff allows an outside group to make  
> \$100 million per year in fees for doing absolutely nothing (unless he  
> gets a piece of that). The point is that as we don't know why he does  
> what he does we have no idea if there are conflicts in his business that  
> could come to some regulator's attention. Throw in that his  
> brother-in-law is his auditor and his son is also high up in the  
> organization (imagine that!) and you have the risk of some nasty  
> allegations, the freezing of accounts, etc., etc. To put things in  
> perspective, if [Privacy] went to zero it would take out 80% of this year's  
> profits.

> Perhaps the best reason to get out is that we really don't expect to  
> make an outsized return on this investment. Sure it's the best  
> risk-adjusted fund in the portfolio, but on an absolute return basis  
> it's not that compelling (12.16% average return over last three years).  
> If one assumes that there's more risk than the standard deviation would  
> indicate, the investment loses it's luster in a hurry.

> It's high season on money managers, and Madoff's head would look pretty  
> good above Elliot Spitzer's mantle. I propose that unless we can figure  
> out a way to get comfortable with the regulatory tail risk in a hurry,  
> we get out. The risk-reward on this bet is not in our favor.

> Please keep this confidential.

Investment Adviser #1 Portfolio Manager

Personal Privacy



Law Enforcement

> > > make an outsized return on this investment. Sure it's the best  
> > > risk-adjusted fund in the portfolio, but on an absolute return basis  
> > > it's not that compelling (12.16% average return over last three years).  
> > > If one assumes that there's more risk than the standard deviation would  
> > > indicate, the investment loses it's luster in a hurry.  
> > >  
> > > It's high season on money managers, and Madoff's head would look pretty  
> > > good above Elliot Spitzer's mantle. I propose that unless we can figure  
> > > out a way to get comfortable with the regulatory tail risk in a hurry,  
> > > we get out. The risk-reward on this bet is not in our favor.  
> > >  
> > > Please keep this confidential.  
> > > Investment Adviser #1 Portfolio Manager  
> > >  
> > >  
> > >  
> > >  
> > >

Personal Privacy

Law Enforcement



> > Investment Adviser #1 Portfolio writes:  
 > > > Committee members,  
 > > > We at Personal Privacy are concerned about our Personal Privacy investment. First of all, we  
 > > > spoke to an ex-Madoff trader (who was applying for a position at  
 > > > Personal Privacy and he said that Madoff cherry-picks trades and "takes them  
 > > > for the hedge fund". He said Madoff is pretty tight-lipped and  
 > > > therefore he didn't know much about it, but he didn't really know how  
 > > > they made money. Personal Privacy heard a similar story from from a large  
 > > > hedge fund consultant who also interviewed an ex-trader. The head of  
 > > > this well-respected group told us in confidence that he believes that  
 > > > Madoff will have a serious problem within a year. We are going to be  
 > > > speaking to him in 11 days to see if we can get more specifics.

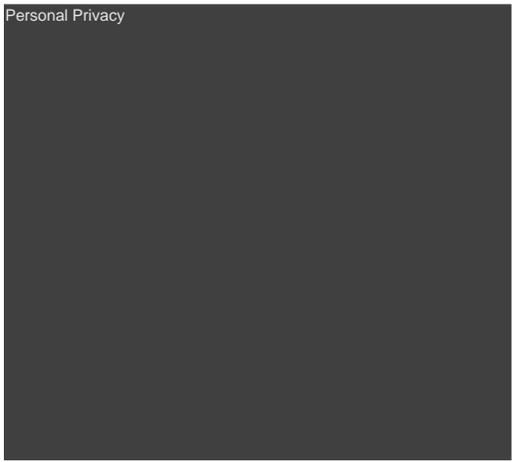
> > > Another point to make here is that not only are we unsure as to how Personal Privacy  
 > > > makes money for us, we are even more unsure as to how Privacy makes money  
 > > > from us; i.e. why does he let us make so much money? why doesn't he  
 > > > capture that for himself? There could well be a legitimate reason, but  
 > > > I haven't heard any explanation we can be sure of. Additionally, there  
 > > > is a \$4 billion Madoff pass-through fund (Fairfield Sentry) that charges  
 > > > 0 and 20% and it's not clear why Madoff allows an outside group to make  
 > > > \$100 million per year in fees for doing absolutely nothing (unless he  
 > > > gets a piece of that). The point is that as we don't know why he does  
 > > > what he does we have no idea if there are conflicts in his business that  
 > > > could come to some regulator's attention. Throw in that his  
 > > > brother-in-law is his auditor and his son is also high up in the  
 > > > organization (imagine that!) and you have the risk of some nasty  
 > > > allegations, the freezing of accounts, etc., etc. To put things in  
 > > > perspective, if Privacy went to zero it would take out 80% of this year's  
 > > > profits.

> > > Perhaps the best reason to get out is that we really don't expect to  
 > > > make an outsized return on this investment. Sure it's the best  
 > > > risk-adjusted fund in the portfolio, but on an absolute return basis  
 > > > it's not that compelling (12.16% average return over last three years).  
 > > > If one assumes that there's more risk than the standard deviation would  
 > > > indicate, the investment loses it's luster in a hurry.  
 > > > It's high season on money managers, and Madoff's head would look pretty  
 > > > good above Elliot Spitzer's mantle. I propose that unless we can figure  
 > > > out a way to get comfortable with the regulatory tail risk in a hurry,  
 > > > we get out. The risk-reward on this bet is not in our favor.

> > > Please keep this confidential.

> > > Investment Adviser #1 Portfolio  
 > > > Manager

> > > Personal Privacy



Subject: Personal Privacy  
From: Investment Adviser #1 Risk Manager  
Date: Fri, 14 Nov 2003 12:33:19 -0500  
To: Personal Privacy  
CC: Investment Adviser #1 Scientist, Investment Adviser #1 Portfolio Manager, Personal Privacy

Like background radiation my concern about Madoff has never really gone away. Law Enforcement  
But if cherry picking is the reason for highly-favourable fills - who is taking the hit on the other side? Law Enforcement

Law Enforcement

Investment Adviser #1 Portfolio Manager writes:

>>> Committee members,  
>>> We at Personal Privacy are concerned about our Personal Privacy investment. First of all, we  
>>> spoke to an ex-Madoff trader (who was applying for a position at  
>>> Personal Privacy and he said that Madoff cherry-picks trades and "takes them  
>>> for the hedge fund". He said Madoff is pretty tight-lipped and  
>>> therefore he didn't know much about it, but he didn't really know how  
>>> they made money. Personal Privacy heard a similar story from from a large  
>>> hedge fund consultant who also interviewed an ex-trader. The head of  
>>> this well-respected group told us in confidence that he believes that  
>>> Madoff will have a serious problem within a year. We are going to be  
>>> speaking to him in 11 days to see if we can get more specifics.  
>>> Another point to make here is that not only are we unsure as to how Personal Privacy  
>>> makes money for us, we are even more unsure as to how Personal Privacy makes money  
>>> from us; i.e. why does he let us make so much money? Why doesn't he  
>>> capture that for himself? There could well be a legitimate reason, but  
>>> I haven't heard any explanation we can be sure of. Additionally, there  
>>> is a \$4 billion Madoff pass-through fund (Fairfield Sentry) that charges  
>>> 0 and 20% and it's not clear why Madoff allows an outside group to make  
>>> \$100 million per year in fees for doing absolutely nothing (unless he  
>>> gets a piece of that). The point is that as we don't know why he does  
>>> what he does we have no idea if there are conflicts in his business that  
>>> could come to some regulator's attention. Throw in that his  
>>> brother-in-law is his auditor and his son is also high up in the  
>>> organization (imagine that!) and you have the risk of some nasty  
>>> allegations, the freezing of accounts, etc., etc. To put things in  
>>> perspective, if Privacy went to zero it would take out 80% of this year's  
>>> profits.  
>>> Perhaps the best reason to get out is that we really don't expect to  
>>> make an outsized return on this investment. Sure it's the best  
>>> risk-adjusted fund in the portfolio, but on an absolute return basis  
>>> it's not that compelling (12.16% average return over last three years).  
>>> If one assumes that there's more risk than the standard deviation would  
>>> indicate, the investment loses it's luster in a hurry.  
>>> It's high season on money managers, and Madoff's head would look pretty  
>>> good above Elliot Spitzer's mantle. I propose that unless we can figure  
>>> out a way to get comfortable with the regulatory tail risk in a hurry,

> > > we get out. The risk-reward on this bet is not in our favor.  
> > >  
> > > Please keep this confidential.  
> > > Investment Adviser #1 Portfolio Manager  
> > >  
> > >  
> > >

Personal Privacy



Investment Adviser #1 Risk Manager

wrote:

Like background radiation my concern about Madoff has never really gone away.

Law Enforcement

But if cherry picking is the reason for highly-favourable fills - who is taking the hit on the other side?

Law Enforcement

Investment Adviser #1 Risk Manager

Law Enforcement

Investment Adviser #1 Portfolio Manager writes:

>>> Committee members,  
 >>> We at [Personal Privacy] are concerned about our [Personal Privacy] investment. First of all, we  
 >>> spoke to an ex-Madoff trader (who was applying for a position at  
 >>> [Personal Privacy] and he said that Madoff cherry-picks trades and "takes them  
 >>> for the hedge fund". He said Madoff is pretty tight-lipped and  
 >>> therefore he didn't know much about it, but he didn't really know how  
 >>> they made money. [Personal Privacy] heard a similar story from from a large  
 >>> hedge fund consultant who also interviewed an ex-trader. The head of  
 >>> this well-respected group told us in confidence that he believes that  
 >>> Madoff will have a serious problem within a year. We are going to be  
 >>> speaking to him in 11 days to see if we can get more specifics.

Personal Privacy

>>> Another point to make here is that not only are we unsure as to how  
 >>> makes money for us, we are even more unsure as to how [Personal Privacy] makes money  
 >>> from us; i.e. why does he let us make so much money? [Personal Privacy] why doesn't he  
 >>> capture that for himself? There could well be a legitimate reason, but  
 >>> I haven't heard any explanation we can be sure of. Additionally, there  
 >>> is a \$4 billion Madoff pass-through fund (Fairfield Sentry) that charges  
 >>> 0 and 20% and it's not clear why Madoff allows an outside group to make  
 >>> \$100 million per year in fees for doing absolutely nothing (unless he  
 >>> gets a piece of that). The point is that as we don't know why he does  
 >>> what he does we have no idea if there are conflicts in his business that  
 >>> could come to some regulator's attention. Throw in that his  
 >>> brother-in-law is his auditor and his son is also high up in the  
 >>> organization (imagine that!) and you have the risk of some nasty  
 >>> allegations, the freezing of accounts, etc., etc. To put things in  
 >>> perspective, if [Personal Privacy] went to zero it would take out 80% of this year's  
 >>> profits.

>>> Perhaps the best reason to get out is that we really don't expect to



**Subject:** madoff

**From:** Investment Adviser #1 Risk Manager

**Date:** Fri, 21 Nov 2003 11:28:50 -0500

**To:** nat

**CC:** Investment Adviser #1 Scientist, Investment Adviser #1 Portfolio Manager, Personal Privacy

I have kept this note to a restricted circulation:

I had some further conversation with [redacted] on the Madoff data. I also looked at some daily volume data on and around the OEX option transaction dates as indicated by Madoff's statements.

I was specifically trying to address the question of how big a fund base can madoff trade with this strategy - numbers were thrown out the other day between \$5bln and \$15bln - by focussing on the option volume numbers.

1. Recall that Madoff's strategy involves a collar, that is a put and a call. The volume numbers provide total calls executed on the OEX and total puts. In the two independent set of statements which [redacted] analysed the strikes were always the same for both accounts. Make the generous assumption that 50% of the volume was in the most liquid strike (it seems to average 25-25%).

Law Enforcement

By this measure Madoff could only do \$750m. That is with him doing 100% of the option volume in his chosen strike (with the generous 50% assumption). Lets assume that he spreads it over 3 days - so we get to 2.1bln - still far short of the target numbers.

2. Another important point: In every case that [redacted] examined the option strike (call) is the one closest to the close in the underlying market. Of course the market close is not known until the close!! Does this mean that all the options are done almost at the close?

3. The volume does seem to spike on the days that Madoff is executing, on the days we examine by a factor of 3-4. This must produce a deterioration in execution prices - and for 15bln!

4. When we examined this issue before, we concluded that maybe he does the options in the OTC market. We have spoken to several market makers in OTC equity options, none of them claim to see any significant volume in OEX options. Recall that [redacted] stated that Madoff had said it was necessary to spread trades over several days - why if you are doing OTC?

5. Recall point 2. This would indicate that the OTC options would also have to be done at the end of the day (to get a strike near the close). Are we to believe that the market makers would take on \$15bln of market risk at the close? Of course they might (might!!!) be willing to take the option risk if Madoff provided the market hedge in the underlying (ie they did the whole package with Madoff) but we already know that the trades in the underlying, compared with the closing prices, would leave the OTC counterparty showing losses (as our account always shows gains).

6. Of course ALL of our trades are with Madoff as the principal - so our option positions are OTC with Madoff so he can choose to use any strike, and any total volume he chooses, but the risk must be covered somewhere if he is doing these trades at all?

So we need an OTC counterparty (not necessarily a bank) who is willing to do the basket of the options plus the underlying with Madoff at prices unfavourable for the OTC counterparty - in 10-15bln!!!

Any suggestions who that might be

None of it seems to add up.

Investment Adviser #1 Risk Manager



