Exhibit 1
Part 2 of 6

a) **Paper Statements:** Receiving only paper statements from BLMIS, on a time delay, and not being provided real-time access or electronic statements through 2008, despite BLMIS touting its technical expertise, as well as the customs and practices of the investment management industry towards electronic delivery of information;

b) **A Fee Structure that Made No Sense:** An extremely atypical fee structure at BLMIS;

c) **Impossible Prices:** Madoff buying and selling stocks and options in the mid-to-late 1980s at either impossible prices, or prices that were virtually impossible;

d) **Ponzi Insurance:** Learning that a business partner and friend bought insurance covering Madoff fraud, including Ponzi schemes (i.e. covering the possibility that Madoff was stealing their money);

e) **Public Questions About the Legitimacy of Madoff's Performance:** Financial industry articles questioning the legitimacy of Madoff's returns;

f) **A Strategy that Reaches an Unscalable Level:** Learning that BLMIS had billions of dollars in assets under management in a purported strategy that was unscalable to that level;

g) **Irrational Concerns About Disclosure:** Madoff being concerned about disclosures concerning Sterling's investments with BLMIS if Sterling Stamos filed to become a Registered Investment Advisor ("RIA");

h) **Total Returns for Sterling's BLMIS Investments v. The Market (2000-2002):** Sterling's cumulative returns are over 48 percent while the market's cumulative returns are down 27-44 percent for a 3-year period when the strategy should have produced returns significantly closer to the S&P 100 (i.e., Madoff's purported split-strike conversion strategy should have been more correlated to the S&P 100);

i) **Something Wasn't Right:** Tim Dick, a consultant, advised Sterling that he "couldn't make Bernie's math work- something wasn't right";

j) **Shifting Stories About How the Strategy is Implemented:** Being provided inconsistent information about how investment decisions were made at BLMIS, including the use or non-use of black boxes, and the use of a so-called investment committee;

k) **Targeting Bond Yields:** Madoff's returns were targeted to be a multiple of the 10-year bond yield, which is highly atypical in the industry;

l) **A Suspicious Transaction Outside Industry Custom:** Madoff offering to "loan" Sterling $54 million instead of returning money from Sterling's BLMIS accounts in response to a redemption request, as well as falsely documenting the transaction with minimal paperwork;

m) **The Bayou Ponzi Scheme:** Being provided with the reasons Sterling Stamos withdrew from Bayou and all of the red flags indicating Bayou was a fraud, many of which paralleled Sterling's BLMIS investments;

n) **Special Investment Opportunity:** Being offered, shortly after Bayou was revealed as a Ponzi scheme, a short-term "special investment" opportunity with a return that could be 50 percent better than current returns, but which required a new account and new money;

o) **Merrill Lynch and Sterling Stamos Say They Will Not Invest with Madoff:** Merrill Lynch would not invest with Madoff, and Sterling was told by Peter Stamos, a financial partner, that Sterling Stamos would not directly invest with Madoff;

p) **Lack of Credentials:** Madoff employed a limited number of people in BLMIS with no advanced education or training, purportedly managing and executing a highly sophisticated strategy with billions of dollars under management;

q) **Out-of-Range Trades:** Madoff buying and selling millions of shares of stock and options over an extended period of time at prices that could not have happened because no stock or option traded on that day at that price;

r) **Impossible Volumes:** Madoff buying and selling options at impossible volumes where the volume traded in Sterling's BLMIS accounts was more than the total daily traded volume in the options market;

s) **No Checks and Balances:** Lack of any third party controls such as a third party broker-dealer, custodian or administrator (i.e., BLMIS was its own "chief cook and bottlewasher");

t) **One Active Accountant Auditing Billions of Dollars:** BLMIS's auditor was a firm with one active accountant, purportedly auditing a multi-billion dollar investment management business;

u) **Above the Market:** Madoff generating an approximately 2 percent absolute return each time Madoff implemented the split-strike conversion strategy;

v) **Lack of Volatility:** The lack of volatility of Sterling's BLMIS returns being entirely inconsistent with the split-strike conversion strategy Madoff claimed to implement;

w) **Best Returns on a Risk-Adjusted Basis for Two Decades:** Sterling's BLMIS returns on a risk-adjusted basis were better than any peer hedge fund or mutual fund (including Gateway, a fund implementing a SSC strategy) over every 10-year period where information is available;

x) **Better than Buffett:** Sterling's BLMIS returns on a risk-adjusted basis were better than elite investment advisers, including Warren Buffett, over the available period of every investment adviser's returns;

y) **Outperforming The Market in Periods of Market Stress:** Sterling's BLMIS returns significantly outperformed the market across multiple periods of market stress throughout the 1990s and 2000s; and

z) **Buying Low/Selling High:** Buying shares at low prices and selling shares at high prices with a nearly statistically impossible consistency.

B. Opinions

28. My opinions are as follows:

1. Opinion No. 1: There Were Numerous Facts and Circumstances Relating to Sterling's BLMIS Investments and Relationship That Were Red Flags. Based on These Red Flags, Industry Customs and Practices Would Have Been to Conduct Further Due Diligence.

29. The red flags related to Opinion 1 are discussed in Section VIII.

30. Such a large number of warning signs over such a long period of time, in my experience, and consistent with industry customs and practices, required further independent due diligence. The red flags about which I am opining were not narrowly concentrated in any one particular area, but rather, cut across a spectrum of operational, process and performance-related issues. Due diligence is designed to specifically address and analyze these issues, as well as to robustly analyze fraud risk.

31. One reason to perform due diligence on BLMIS (and Madoff) would be to investigate the cause and source of the red flags and to understand the risks of the investment. In addition, due diligence needed to be performed to analyze the possibility if not probability of fraud associated with Madoff and his purported strategy. Red flags raise serious concerns about the sustainability of investment performance and business operations as well as the possibility of fraudulent activity. When red flags, either in isolation or cumulatively, are an indicia of fraud there is a heightened need for due diligence to verify those indicia of fraud. The due diligence can be specific to a particular red flag, can cover some or all qualitative and/or quantitative areas, or can be an all-encompassing evaluation of the adviser and strategy.

32. When presented with red flags it is not necessary, nor even customary, that the investors perform all or some of the requisite due diligence by themselves. In my experience, and consistent with industry customs and practices, sophisticated investors, including high net worth individuals, have the business acumen to identify red flags and make informed decisions about what to do upon identifying them. In response to red flags, such investors will, in my experience, either perform due diligence themselves, or engage dedicated consultants, experts, and/or specialists to perform the due diligence functions on their behalf, or undertake some combination of both.

2. Opinion No. 2: Due Diligence Consistent With Industry Customs and Practices Would Have Confirmed in Real Time that Madoff Could Not Have Been Legitimately Engaged in His Purported Investment Strategy and Therefore Was Running a Fraudulent Investment Advisory Business.

33. In response to the aforementioned red flags, further due diligence, consistent with industry customs and practices would have confirmed that Madoff could not have been delivering returns to investors like Sterling via his purported strategy.

34. The due diligence analyses contained in this report are inclusive of the ones I performed for clients in 2005 and 2008 when I evaluated BLMIS feeder funds. In particular, the volatility and correlation analyses contained herein are calculations that I performed then, and also performed again in connection with this assignment. My analysis for this assignment further affirmed my prior conclusion that Madoff could not have been engaged in the split-strike conversion strategy he purported to implement.

VI. Investment Management Industry

35. At the most fundamental level, the investment management industry includes investors, managers/advisers and service providers.[35] Customs and practices in the investment management industry are generally all in support of the primary investment goal: to

[35] I have used the terms "investment manager" and "investment adviser" interchangeably in this report and these terms are meant to be synonyms in all respects.

maximize reward while simultaneously limiting risk. The industry maintains checks and balances through the use of independent third-party providers for various services in part to help protect against fraud in the industry. The industry also recognizes that these checks and balances are insufficient as the only mean of protecting investments. Therefore, due diligence performed by any investor prior to making an investment decision and during the life of an investment, whether buying a stock or investing in a billion dollar hedge fund, is necessary to ensure that investments are achieving the right amount of reward with the commensurate level of risk.[36]

A. Overview

36. In addition to investors, whether sophisticated, high net worth, institutional or otherwise, the investment management industry generally consists of intermediaries between investors as well as between investors and investments. The multitude of intermediaries serving this market exists to: (1) advise on the allocation of capital between the various investment options; (2) advise on selection of transactions within the investment option; (3) execute the transactions; and (4) provide custody and record keeping services. Intermediaries include the following: broker-dealers, investment advisers, RIAs, hedge funds, and mutual funds.

37. These participants provide, or intermediate, a combination of advice and execution services in facilitating the invested capital to its destination. These entities may also manage client assets either on a pooled basis or on a separate account basis, where separate accounts can either be self-managed accounts (i.e., where an investor manages their own assets); or managed accounts (i.e., where an investor engages an adviser to manage its assets).

38. Service providers serve these intermediaries, managers, and investors in turn. Service

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36 In addition to market risk, investors are concerned with many other risks including, but not limited to credit, counter-party, liquidity, and default risk. *Sound Practices for Hedge Fund Managers*, Managed Funds Association § 4, 4-12 and Appendix III, 7-30 (2007); *Counterparty Risk Survey 2009* 34, The Credit/Fitch Solutions (December 2009); Sherree Decovny, *Reining in Liquidity Risk* 28-29, CFA Magazine (vol. 21, no. 4, July-August 2010).

providers include custodians, auditors, prime brokers, administrators, and transfer agents.

39. The size of the investment management industry is typically measured by the size of the AUM in the industry. The sum total of AUM is the currency amounts that investors place with a fund or investment adviser. In general there are three sources of AUM that, when added together, constitute the investment management industry: (i) funds (e.g., hedge funds and other commingled vehicles); (ii) self-managed accounts; and (iii) managed accounts.[37] Assets invested in mutual funds and hedge funds, which comprise the majority of industry AUM, grew from roughly $500 billion in 1985, to over $20 trillion in 2008.[38]

B. Custody of Funds

40. The firm that has the legal responsibility for holding assets owned by an investor is called the "custodian" of those assets. When an individual manages his own funds (i.e., determining when and where to invest), and uses a broker-dealer ("BD") for purposes of executing transactions, that BD acts as the custodian. However, if an individual or institution entrusts funds to another entity (e.g., an investment adviser) to manage, it is common industry practice for an independent third-party custodian to hold the actual funds. Even though the investment adviser is deciding how best to invest the client funds, the funds and/or securities are held by a different entity (i.e., the custodian).[39]

41. The benefit of using a third-party custodian in these instances is clear – it acts as a check on the investment adviser. The involvement of multiple parties in the management of assets helps reduce the potential misappropriation of those assets by any of those parties. It is extremely rare for investment advisers to also maintain custody of their clients' assets

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[37] There is some overlap in these categories to the extent that a managed account or self-managed account invests in a hedge fund, mutual fund, or other commingled vehicle.

[38] Barry Eichengreen & Donald Mathieson. Hedge Funds and Financial Market Dynamics. International Monetary Fund. May 1998. Michael L. Goldstein & Jonathan Freedman. *The Future of Money Management in America: Key Issues Facing the Mutual Fund Industry*. Bernstein Research. December 5, 1997. Barclay Hedge (last visited Oct. 31, 2011), http://www.barclayhedge.com/research/indices/ghs/mum/Hedge_Fund.html. 2010 Investment Company Fact Book, at 182. 50 ed. Investment Company Institute. 2010.

[39] Securities may be held either in certificate form, or in "street name," i.e. aggregated with the custodian with beneficial owners accounted for by the custodian.

for this reason.

C. Roles

42. The responsibility of a broker-dealer is limited to the execution of a transaction. An investment adviser, by contrast, has the more far-reaching responsibility of the ongoing implementation of an investment strategy. Madoff had the sole and broad-based authority and responsibility for, among other things, determining the strategy, selecting the individual stocks to purchase, determining which options to incorporate into the SSC strategy, as well as the timing for entering and exiting the market. These are examples of the functions of an investment adviser and extend well beyond the authority and role of a discretionary broker.[40] Madoff was functioning as and serving in the capacity of an investment adviser for BLMIS customers including Sterling.

D. Investment Strategies

43. The ultimate goals for any investment strategy are to preserve capital and generate returns through cash flow received from the investment and/or capital appreciation. In general, within efficient and informed capital markets, the return of an asset or portfolio tends to be highly correlated to its underlying risk.[41] In this context, risk is typically defined as the variability of expected returns. Therefore the investor, whether high net worth, institutional or otherwise, typically weighs the added income and/or return against the incremental risk of a particular investment.

VII. Evaluating Investment Advisers

44. The evaluation of an investment adviser is critical because it allows investors to understand

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[40] Sterling characterized its BLMIS accounts as "discretionary brokerage" accounts in draft marketing materials for the 401(k) plan they sponsored for their employees. Discretionary Brokerage Account at Bernard L. Madoff Investment Securities, Arthur Friedman Dep. Ex. AF-34 (June 24, 2010) (STESAA0011998). A discretionary brokerage account is one in which the customer permits the broker to act on the customer's behalf in buying and selling securities. David L. Scott, Wall Street Words 108 (Boston, Ma.: Houghton Mifflin Company 2003).

[41] Geoffrey Hirt & Stanley Block, Fundamentals of Investment Management 7 (New York: McGraw Hill, 7th ed. 2003).

the adviser's investment process and determine whether the resulting investment fits their goals and risk tolerance. In addition, it allows the investor to make a determination about the longevity of the investment adviser and/or the strategy. Ultimately the investor is investing in a business, and evaluating the stability of that business is important, especially as it relates to sustainable operations. In this respect, the basic evaluation of an investment adviser is expected to identify signs or indicia of fraud.

45. The evaluation process is not limited to "unknown" investment advisers. The investment management industry is built on relationships, but it is not an industry where "blind trust" prevails. In my experience, high net worth and institutional investors typically follow the "trust but verify" approach given the risk to which an investor exposes himself or herself by investing money with an investment adviser. For example, if an investor, like Sterling, is invested predominantly with a single adviser the lack of diversification increases risk, and the need for ongoing and thorough evaluation increases in proportion. Sterling Stamos's marketing materials remind investors of the risks of investing with a single hedge fund manager.[42]

46. A key component of the evaluation process is due diligence. Due diligence is not a one-time event for investors. It has both an initial and an ongoing component. Ongoing due diligence monitoring is important in part because the adviser has the investor's money and because it is important to evaluate whether the performance is consistent with expectations and representative of what the investor was told before investing. In this manner, due diligence independently verifies what an investment adviser has told investors. Independent verification is a cornerstone of all aspects of due diligence.

47. In order to maintain consistent supervision over their investments, investors like Sterling perform monitoring activities. Typical monitoring activities include:[43]

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[42] "Sterling Stamos Security Fund, L.P." (February 2005) (SSMSAA00026027-59 at 32), stating that investing with Sterling Stamos will "mitigate the risk of [having a] single hedge fund manager."

[43] *Managing the Investment Managers*, CIBC Due Diligence Process (November 2009), http://www.renaissanceinvestments.ca/en/portfolio-managers/Due_Diligence_Whitepaper_e.pdf.

- Regular meetings with the investment advisers;
- Regular peer reviews and benchmarking;
- Performance analyses against other advisers with the same investment management style;
- Periodic on-site visits;
- Completion of quarterly questionnaires; and
- Monthly portfolio analysis.

48. These activities are also consistent with the activities undertaken by Sterling's hedge fund Sterling Stamos as part of its ongoing monitoring of investments. For example, Sterling Stamos stated that its ongoing monitoring includes quarterly visits,[44] as well as analyses where: "monthly or bi-monthly performance is compared with the performance of the associated market/asset class to monitor Portfolio Manager performance against the opportunity set. Regression analysis, style drift analysis, and value-at-risk analysis are performed."[45]

49. Generally, the due diligence process (both before and after an investment is made) is designed to: (i) identify (as early as possible) any potential "red flags" or changes in the adviser and/or his organization, investment process, or philosophy, and (ii) identify and understand any indicia of fraud or changes to the risk profile of the invested assets. Whether investors (including high net worth and institutional) perform due diligence themselves or engage consultant to perform analyses for them, a common approach is to categorize the areas of focus for the due diligence. A comprehensive template or framework for conducting due diligence centers around the "Five Ps," where each P relates to a particular element of due diligence. The Five Ps are: People, Process, Portfolio, Performance, and Price.[46] The following is a discussion of the types of due diligence

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44 "DeMarche Associates, Inc. Hedge Fund Manager Questionnaire," Sterling Stamos (SSMSAA018407-31 at 28)

45 Sterling Stamos Security Fund, L.P., Marketing Supplement (October 2004) (SSMSAA00052064).

46 The People category is sometimes referred to as Personnel, and the Process category is sometimes referred to as Philosophy. The origins of this framework were developed during the 1970s by Russell Investments, a leading advisory firm servicing individual and institutional investors. *Russell's Group Philosophy*, Russell Investment Group (October 2006). Other frameworks use the "P" acronym, though the number of "Ps" may differ.

typically performed in connection with each of these categories.

A. The Five Ps

1. People

50. Investors evaluate the personnel and qualifications of the investment adviser as much as the investment itself. This assessment includes the individuals with key roles, the reporting structure of the business, the hiring and termination processes, and whether all team members understand the philosophy and process they are supposed to be implementing. Adviser tenure, and team tenure, is also important as investment returns reported in an adviser's early years may no longer be relevant to the team currently in place. Aspects of people, or staff, typically considered include, but are not limited to:[47]

- Number of employees;
- Position description (e.g., portfolio managers, strategists, research analysts, economists, operational, compliance, marketing, management);
- The number and each type of employee; and
- Average years of professional experience.

2. Process

51. The extent to which investment performance can be repeated over time depends, at least in part, on whether a well-defined investment process is in place. It is important for investors to evaluate whether an investment adviser's process is indeed well-defined and whether they as investors understand it.[48] Key elements considered in the evaluation of the investment process include: investment management style; implementation of investment ideas; buy and sell disciplines; risk management (including hedging downside risk); investment research; team approach (e.g., committee, individual decision maker); technology; and infrastructure. Any changes to these elements over time are expected to

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[47] *See Russell's Group Philosophy,* Russell Investment Group (October 2006); *See also* Brian Tipple, *Avoiding the Pitfalls: Best Practices in Manager Research and Due Diligence* 46-47 (CFA Institute June 2010).

[48] G. Timothy Haight, Stephen O. Morell, & Glenn E. Ross, How to Select Investment Managers & Evaluate Performance 31 (Hoboken: John Wiley & Sons, Inc. 2007).

be identified through periodic monitoring activities.

52. In addition, investment advisers are evaluated to ensure their actions adhere to their stated investment philosophy or management style, their professional investment experience, market focus, and portfolio objectives over time and through various market cycles. For example, if an adviser were to suddenly or without warning change investment strategies (i.e., "style drift"), it could change the investor's risk profile.

3. Portfolio

53. Consistent, ongoing due diligence determines whether the approach described by the adviser actually reflects the reality of the portfolio constructed.[49] This feeds back into process, as an investor wants to be sure it is compensating an adviser for performance and adhering to the stated investment objective and strategy. In addition, transaction level (i.e. securities) due diligence includes, among other things, reviews and analyses of what has been bought and sold as well as understanding the risks of how trades are executed.

54. Performing reverse engineering is a customary component of due diligence for assessing portfolio risks and characteristics. The reverse engineering process includes modeling the strategy based on information known about the strategy, and provides an investor with information about the returns that could be expected from executing the strategy, how those returns may be correlated with market exposure, as well as information related to key risk measures associated with any strategy, such as volatility, or standard deviation.

4. Performance

55. In evaluating the performance of an investment adviser, whether initially or during ongoing due diligence, both qualitative and quantitative measures are considered, and all analyses must be consistent with the adviser's stated investment style. For example, in assessing performance it is customary to perform quantitative analysis to compare the

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[49] Brian Tipple, *Avoiding the Pitfalls: Best Practices in Manager Research and Due Diligence* 46-47 (CFA Institute June 2010).

returns of an investment adviser to comparable market indices and/or a peer group of advisers (i.e., "peer analysis").[50] Performance analysis is typically performed on a risk-adjusted or style-adjusted basis[51] so that the other investment options that have more risk associated with them can still be compared to the subject investment strategy.

5. Pricing

56. Finally, the fees charged by an investment adviser are key components of the investment management process. Fees for investment advisers typically consist of management fees and/or performance fees. It is both customary and essential that the compensation structure be created in a way so as to align the interests of the adviser and the investor.[52]

B. Information Gathering

57. Due diligence can be performed using information from a variety of sources. For example, investors will collect information from publicly-available sources including databases[53] and marketing materials. There are numerous firms that specialize in due diligence.[54]

58. Sterling's own hedge fund, Sterling Stamos, used Due Diligence Questionnaires ("DDQs")

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[50] This type of due diligence was specifically identified by Sterling's own hedge fund, Sterling Stamos. *See* Sterling Stamos Letter to Investors (October 5, 2005) (SSMSAC0000181-83).

[51] Many statistical techniques are used to identify investment advisers' sources of return. Risk-adjusted returns evaluate returns in light of the risks assumed, either by investing in more volatile securities or employing leverage. Style-based analyses incorporate the sectors or asset classes invested in as part of their analysis.

[52] As it relates to aligning interests, within the hedge fund and fund of funds industry, it is not just common, but expected, for advisers to have their "skin in the game." This is to insure an alignment of interests between the investor and the adviser not just in good times, but bad times as well. Since hedge funds typically have performance fees, which allow the advisers excess compensation commensurate with their positive performance, it is considered only fair and hence expected, that they be willing to suffer personal losses in the event that their investments decline. It would have been a significant red flag, therefore, if Madoff was not invested in his own strategy.

[53] For example, databases such as Bloomberg contain trading and market information, while BarclayHedge contains performance-related as well as operational-related information on hedge funds.

[54] There are dozens of firms that specialize in due diligence, including Aksia LLC and Albourne. These particular firms were consulted and determined well prior to December 11, 2008, that BLMIS was too good to be true. David Glovin, Karen Freifeld & David Voreacos, *Investment Adviser Aksia Warned Clients of Madoff 'Red Flags'*, Bloomberg (December 13, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afr_KQndJUUs; Matthew Goldstein, *The Madoff Case Could Reel in Former Investors*, Bloomberg Businessweek (December 31, 2008), http://www.businessweek.com/magazine/content/09_02/b4115025606347.htm.

to collect information,[55] and was familiar with the due diligence process having been on both sides of the investigation: both as one conducting due diligence and one who is the subject of due diligence. Sterling Stamos performed systematic due diligence on potential investments on behalf of investors, including Sterling, and its own capital. Sterling Stamos also responded to inquiries from potential investors in Sterling Stamos, and would reply to these investors with a completed DDQ.[56]

59. The documents listed in Appendix IV are documents that Sterling Stamos either received from another investment adviser as part of its due diligence, or documents Sterling Stamos completed itself in response to one of its prospective or current investors. Sterling Stamos's consistent, and thorough due diligence processes demonstrate their core competencies including conducting proper and industry custom due diligence. Repeated due diligence was performed by Sterling Stamos on various funds in different years, sometimes in connection with new investments into a fund.

VIII. OPINION NO. 1

THERE WERE NUMEROUS FACTS AND CIRCUMSTANCES RELATING TO STERLING'S BLMIS INVESTMENTS AND RELATIONSHIP THAT WERE RED FLAGS. BASED ON THESE RED FLAGS, INDUSTRY CUSTOMS AND PRACTICES WOULD HAVE BEEN TO CONDUCT FURTHER DUE DILIGENCE.

60. Based on my experience, my independent review of documents and testimony in the record to date, my own independent analysis, as well as customs and practices of the investment management industry, as I noted above, it is my opinion that numerous facts and circumstances relating to Sterling's BLMIS investments were red flags that: (i) Madoff was not engaged in the strategy he purported to follow and were by their nature indicia of

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55 A due diligence questionnaire is a document that potential investors provide to investment advisers prior to investing. The questionnaire requests information regarding background, investment philosophy, historical performance, and other due diligence-related issues.

56 *See, e.g.,* Sterling Stamos DDQ response to Redacted (October 2006) (SSMSAA0001487); Sterling Stamos DDQ response to Redacted (July 2007) (SSMSAA0001932).

fraud that required additional qualitative and quantitative due diligence; (ii) were rife with the opportunity for Madoff to commit fraud; and/or (iii) were virtual impossibilities where the only rational or reasonable explanation was fraud.

Red Flags

1. All paper statements / No electronic access (1985-2008)

61. A critical red flag associated with BLMIS's operations relates to the use of paper statements, and the lack of any electronic access by Sterling. Despite typical investment management industry operating procedures of allowing clients to obtain account statements, balances, and other details through the internet, Sterling was never provided real-time access to any account data or electronic statements.[57]

62. For decades, the common medium for communication between financial institutions and their clients was written notices (i.e., delivered via hard copy). Exactly when financial institutions on the whole made the switch to electronic correspondence is difficult to pinpoint. But records show that discount brokerages such as E-Trade, Fidelity, and Schwab had electronic platforms designed to give clients the ability to manage their accounts and receive electronic monthly statements as early as 1997.[58] Money managers such as T. Rowe Price had similar electronic platforms to monitor account activity available as early as January 1998.[59] By June of 2000, the practice of granting clients electronic access to their accounts would appear to be mainstreamed given the enacted legislation at the time.[60] Yet long after industry-comparable companies had begun

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57 Friedman Dep. 557, June 24, 2010.

58 *E-Trade* (April 1997), Internet Archive: WayBackMachine (last visited November 21, 2011), http://wayback.archive.org/web/*/http://www.etrade.com; *Fidelity (April 1997)*, Internet Archive: WayBackMachine (last visited November 8, 2011), http://wayback.archive.org/web/*/http://www.fidelity.com; *Schwab (April 1997)*, Internet Archive: WayBackMachine (last visited November 8, 2011), http://wayback.archive.org/web/*/http://www.schwab.com.

59 *T. Rowe Price (January 1998)*, Internet Archive: WayBackMachine (last visited November 8, 2011), http://wayback.archive.org/web/*/http://www.troweprice.com (January 1998).

60 On June 30, 2000, the Electronic Signatures in Global and National Commerce Act (referred to herein as the "E-Sign Act") was signed into law by Congress. 15 U.S.C. § 7001. The implementation of this law "[allowed for] the use of electronic records to satisfy any statute, regulation, or rule of law requiring that such information

allowing electronic access Sterling still did not have electronic access to any account data up until December 11, 2008.[61] Unlike consumers, who began performing increasing numbers of their own, individual banking transactions throughout the 2000s through online access to checking and savings accounts, BLMIS's operations continued to be paper-based, without any electronic access to statements.

63. From its inception through 2008, BLMIS sent all monthly statements and trading documentation to investors, including Sterling, in hard copy form, with time delays. For a firm that claimed to use "cutting-edge technology" in its operations and with such a small employee base to handle the enormous logistical task of mailing documentation to investors, it was a warning sign of fraud that paper documents continued to be Madoff's standard operating procedure for BLMIS instead of electronic documents.

64. Madoff was touted in the media as a leader in trading technology, in publications including *Securities Week*, *New York Times*, and *Wall Street & Technology*.[62] For example, in the

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be provided in writing, if the consumer has affirmatively consented to such use and has not withdrawn such consent." Another portion of the E-Sign Act focuses on required record retention. Specifically it requires "[a] financial institution to maintain electronic records accurately reflecting the information contained in applicable contracts, notices or disclosures and that they remain accessible to all persons who are legally entitled to access for the period required by law in a form that is capable of being accurately reproduced for later reference." Given that the law requires maintenance of electronic records, it would be reasonable for clients to be granted access to their own records electronically. Federal Deposit Insurance Corporation, "The Electronic Signatures in Global and National Commerce Act (E-Sign Act)," FDIC Compliance Manual, Sec. X-3.1-X-3.4 (June 2009).

Electronic account information had become so prevalent that the U.S. Office of the Comptroller issued an advisory letter in November 2004 to the chief executive officers of all national banks stressing the importance of having investor records retained within an online platform. The advisory letter states explicitly that "[f]ailure to provide such electronic disclosures in a proper manner can expose the bank to significant compliance, transaction, and reputation risk." Office of the Comptroller of the Currency, AL 2004-11, *Electronic Consumer Disclosures and Notices* (October 1, 2004), http://www.occ.gov/static/news-issuances/memos-advisory-letters/2004/advisory-letter-2004-11.pdf.

61 In 2008 Sterling responded to a request from Bank of America for electronic access to BLMIS accounts in connection with Sterling's "double up" accounts, stating "[u]nfortunately, Madoff does not offer this service to their clients." Email from Cynthia Bernstein to Gibaldi Rosemarie (Bank of America) re: electronic access to monthly statements (March 11, 2008) (STESAO0003000).

62 *NYSE Price Material Raises Eyebrows at Madoff*, Securities Week (McGraw Hill, Inc. September 3, 1990); *3 Firms Plan to Develop New System for Trading*, New York Times (June 8, 1999) (STESAP0000231); Anthony Guerra, *Family Influence*, Wall Street & Technology (July 07, 2000); *Madoff Seeks Edge with Pre-Opening Price Improvement Plan*, Securities Week (May 31, 1999); Susan Rodetis, *Third Market Man*, Equities

late 1990s, Madoff initiated the creation of PRIMEX, a company that would become a new stock trading system eventually adopted by the NASDAQ.

65. The lack of electronic statements provided was a strong red flag, particularly given the technological advances made on the broker-dealer side of Madoff's business. The delivery of paper statements on a time delay creates an opportunity for fraud as it allows for the backdating of transaction information--exactly what occurred here.[63]

2. The Fee Structure Is Extremely Rare (1985-2008)

66. Based on my experience, the atypical investment management operation run by Madoff and especially the fees he purportedly charged were a structural red flag. Though often compared to a hedge fund (and described by Sterling as a hedge fund manager),[64] BLMIS did not technically fit the model of a hedge fund, a mutual fund, or any other traditional investment advisory model.

67. Madoff chose to run his investment advisory operations through the use of what are called managed accounts, where each investor received their own account number, account statement, and related communications.

68. One of the primary benefits of a managed account is that it offers an investor a high degree of customization and transparency. That is, the investment adviser, or money manager, has the ability to customize an investment strategy for a particular investor. As a result, managed accounts typically have different strategies, each reflecting the risk profile of the investor. However, Madoff's purported investment strategy was not customized or unique

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(October 1993); Press Release, NASDAQ, SEC Grants Permanent Approval of NASDAQ's Primex Auction System (New York: March 3, 2003), http://www.nasdaq.com/newsroom/news/pr2003/ne_section03_015.html.

63 As evidence that paper statements could be manipulated, Sterling's BLMIS account statements never reflected the underlying name change for the Fidelity money market fund. The Fidelity Spartan U.S. Money Market Fund (Ticker: FDLXX) officially changed its name to Fidelity U.S. Money Market Fund, effective August 15, 2005. Sources: Supplement to the Spartan U.S. Treasury Money Market Fund, Spartan U.S. Government Money Market Fund, and Spartan Money Market Fund June 29, 2005 Prospectus. *See also* Saul B. Katz Customer Statement, account number 1-KW024-3-0, July 31, 2006 (MDPTPP03832231).

64 Fred Wilpon Dep. 144: 9-10, July 20, 2010. *See also* Chachra Dep. 116, October 8, 2010 and Stamos Dep. 146, August 19, 2010.