

JONES, SNEAD, WERTHEIM & WENTWORTH, PA

STATE OF NEW MEXICO
COUNTY OF SANTA FE
FIRST JUDICIAL DISTRICT COURT

ENDORSED
First Judicial District Court

MAY 12 2009

Santa Fe, Rio Arriba &
Los Alamos Counties
PO Box 2268
Santa Fe, NM 87504-2268

STATE OF NEW MEXICO ex rel.
NATIONAL EDUCATION ASSOCIATION OF
NEW MEXICO, INC., a domestic nonprofit corporation,
on behalf of the EDUCATIONAL RETIREMENT BOARD
and the STATE INVESTMENT COUNCIL,
agencies of the State of New Mexico,

Qui Tam Plaintiff,

vs.

No. *D10LCV200901492*
FILED UNDER SEAL

AUSTIN CAPITAL MANAGEMENT, LTD.,
a Texas limited liability company,

Defendant.

**COMPLAINT FOR VIOLATION OF THE NEW MEXICO FRAUD
AGAINST TAXPAYERS ACT AND, ALTERNATIVELY, FOR BREACH OF
FIDUCIARY DUTY, NEGLIGENCE AND PUNITIVE DAMAGES**

COMES NOW the STATE OF NEW MEXICO ex rel. the NATIONAL EDUCATION ASSOCIATION OF NEW MEXICO, INC., Qui Tam Plaintiff, on behalf of the EDUCATIONAL RETIREMENT BOARD and the STATE INVESTMENT COUNCIL, investing agencies of the State of New Mexico, by and through attorneys JONES, SNEAD, WERTHEIM & WENTWORTH, P.A. and RHODES & VELA, LLP and for this Complaint against AUSTIN CAPITAL MANAGEMENT, LTD., based upon personal knowledge for allegations as to itself and upon information and belief from investigation of counsel as to all other matters, states as follows:

NATURE OF ACTION

1. Pursuant to the New Mexico Fraud Against Taxpayers Act, NMSA 1978, Sections 44-9-1 to 44-9-14 (2007) ("FATA"), the Qui Tam Plaintiff brings this Complaint on behalf of the Educational Retirement Board (ERB) and the State Investment Council (SIC),

investing agencies of the State of New Mexico, against Defendant Austin Capital Management Ltd. (“Austin Capital”) for violation of Section 3 of FATA and, alternatively, for breach of fiduciary duty, negligence and punitive damages. This qui tam action seeks recovery of damages the investing agencies suffered when Austin Capital failed to perform due diligence on its underlying investments as promised, missed several red flags that other investment firms who did their homework noticed and, as a result, allowed public money to be lost in the giant Ponzi scheme contrived by fraudster Bernard L. Madoff.

2. Having admitted to bilking investors out of billions, Bernard L. Madoff (sometimes “Madoff”) has now pled guilty to federal criminal charges related to his scheme. Alongside money from other clients, Austin Capital directed significant amounts belonging to the ERB and the SIC into investment that wound up with Bernard L. Madoff and Bernard L. Madoff Investment Securities, LLC (“BLMIS”). Since Madoff’s arrest in December 2008, it has become clear that virtually all the money placed with him and BLMIS has been lost.

PARTIES, JURISDICTION AND VENUE

3. The State of New Mexico is a real party in interest and the plaintiff in interest.

4. The ERB is an agency of the State of New Mexico charged with investing the retirement funds of New Mexico’s public school employees, including public school teachers.

5. The SIC is an agency of the State of New Mexico charged with investing the Land Grant Permanent Fund, the Severance Tax Permanent Fund and the Tobacco Settlement Permanent Fund, among other funds, primarily to benefit public schools and public education, to augment the general fund for government operations and to service and retire debt from bond issues that have funded various capital projects.

6. Qui Tam Plaintiff National Education Association of New Mexico, Inc. (“NEA-New Mexico”) is a New Mexico domestic nonprofit corporation with its principal place of business at 2007 Botulph Road, Santa Fe, New Mexico, 87505. NEA-New Mexico

provides professional development, collective bargaining and other services to approximately 8,000 members across New Mexico who are public school teachers, other public school employees and higher educational public employees. NEA-New Mexico brings this action in the name of the State of New Mexico and on behalf of the ERB and the SIC.

7. Defendant Austin Capital Management, Ltd., describing itself as “a hedge fund of funds management firm,” is a Texas limited liability partnership with its principal office at 5000 Plaza on the Lake, Suite 250, Austin, Texas 78746. Founded in 1993, Austin Capital was acquired in 2006 by Ohio-based KeyCorp (NYSE:KEY), one of the nation’s largest financial services companies and a member of the *Fortune 500*. Austin Capital is part of KeyCorp’s asset management division, Victory Capital Management (“Victory Capital”).

8. This Court has jurisdiction over the subject matter of and parties to this Complaint, and venue is proper in the County of Santa Fe because the State of New Mexico is the plaintiff in interest.

BACKGROUND AND SUMMARY OF ACTION

9. Austin Capital directed approximately 7.5% of invested capital into funds controlled by Madoff, and Austin Capital’s clientele, including the ERB and the SIC, lost approximately \$180 million in the Madoff scheme. Of this total, the two New Mexico investing agencies together lost approximately \$23 to \$25 million, with the ERB’s having suffered an \$8 to \$10 million Austin-Madoff related loss and the SIC’s having suffered about a \$15 million loss. Austin Capital exposed its clients to Madoff and BLMIS through a hedge fund managed by another company, Tremont Partners (“Tremont”).

10. A hedge fund is an investment fund open to a limited range of investors that undertakes a wider range of investment and trading activities than other investment funds, and a hedge fund of fund manager like Austin Capital, in turn, manages portfolios of hedge fund investments. To promote its middle position between investors like the ERB and the SIC and

underlying hedge funds like Tremont and BLMIS, Austin Capital markets expertise in performing an investigation into the suitability of an underlying hedge fund investment and into the risk associated with it. In the investment business, this process is known as “due diligence.” The truth about Austin Capital, however, stands in stark contrast against the way the firm sold itself, leading to catastrophic results in the case of Madoff.

11. A key purpose of due diligence—and therefore a critical reason to hire a firm like Austin Capital—is to detect and avoid fraud. Because engaging a fund of funds manager like Austin Capital entails a costly layering of fees—as underlying hedge funds as well as the fund of funds manager all charge fees on the same invested money—there is in truth little reason to engage a fund of funds manager but for the due diligence it should provide.

12. In this particular case, Austin Capital received a fee from its clients of 1.0% to 1.5% of the net value of assets under management annually in exchange for the due diligence and other services it claimed to provide. As with its other clients, Austin Capital billed the ERB and the SIC these fees monthly and received revenue monthly. As of mid-2008 Austin Capital had approximately \$2.8 billion under management, and, during the relevant time, Austin Capital’s total fee revenue was in the tens of millions of dollars per year.

13. Because of the importance of due diligence in the decision to hire a fund of funds manager, Austin Capital has, not surprisingly, emphasized such services in its marketing for years, and continues to do so. As early as 1999, the firm’s official web site promised: “Austin Capital provides continuous due diligence on these hedge funds, and their respective managers, for the funds it manages.” Austin Capital continues to call its main investment vehicle the Safe Harbor Fund, and the web site continues to trumpet the skills of Kyle McDaniel, Austin Capital’s Chief Risk Officer presently and at the relevant time, as **“architect of the firm’s proprietary risk model, which includes underlying funds in its correlation analyses and shock-test scenarios.”** According to Austin Capital, a centerpiece

to Mr. McDaniels' professional background is that, prior to joining the firm, **"he designed and implemented a due diligence system for evaluation of hedge fund managers."**

14. In addition to its web site, Austin Capital has continued to market its professed focus and expertise on safety and due diligence directly to clients like the ERB and the SIC. For example, a section of a client presentation in use in the 2003 time frame, with the title "An Overview of Austin Capital Management," contains the following false promise:

Not losing money is the best way to make money. This is the bedrock principle of our approach to absolute return investing and the foundation of everything we do.

Another portion of the client presentation, with the title "Process Behind Our Success," contains the following false or misleading statements:

We focus our analysis and decision-making on three tasks;

Getting the big picture right. That is we seek to understand how strategies perform and how their risk levels change under shifting economic conditions. Our goal is to invest in the right strategies and market sectors at the right times.

Knowing managers in depth. We work to find promising candidates, deconstruct their process, and pinpoint their competitive edge. This is coupled with a thorough due diligence process, including assessments of the character and integrity of key fund personnel.

Continuous monitoring and risk management. On a daily basis, we review and interpret performance, exposure, and risk characteristics of each fund in our portfolios, making sure they are in line with our expectations for each strategy. Based on these findings, we adjust portfolios and apply our risk control policies.

15. Drawing a sharp contrast to the portrait of professional due diligence Austin Capital paints in its marketing material, the firm's actual due diligence in regard to money that wound up with Madoff was largely, if not wholly, absent. In effect, Austin Capital charged management fees to the ERB and the SIC and yet performed no meaningful due diligence in return.

16. Worse yet, Austin Capital created the financial incentive for its executives to turn a blind eye to Madoff's operations, as it based bonus compensation on profitability rather than job performance relating to due diligence, even for employees supposedly charged with the task. KeyCorp's acquisition of Austin Capital in 2006 was part of a restructuring of the Victory Capital unit, which had \$58 billion in assets under management at the time of the acquisition. As part of the restructuring, Austin Capital came under a new bonus compensation package designed to separate Victory Capital from KeyCorp's traditional banking business and boost profits from money management.

17. Bringing to light some details of its bonus package, Austin Capital sued a former employee in April 2009, Justin Balthrop, to prevent his soliciting the firm's clients in a new job. As amply shown in court papers, not only does Austin Capital combine marketing and due diligence responsibility—according to the affidavit of a current executive, Mr. Balthrop was one of the three Senior Analysts at the company and maintained “responsibility for research and due diligence” as well as “investor relations” and “business development”—but also the Defendant based bonus compensation solely on profitability and fee generation. According to the lawsuit, Mr. Balthrop was the beneficiary of a grant of restricted stock in KeyCorp, and the suit's main purpose was to restrict Mr. Balthrop's use of “pricing and profitability information,” alongside other marketing information, in his new job.

18. Mixing marketing and due diligence responsibilities in the same job description itself presents an inherent conflict of interest. Beyond that, to aggravate the conflict by placing bonus incentives on marketing prowess instead of due diligence performance is an invitation to disaster, a disaster that arrived in the form of Bernard L. Madoff. In effect, Austin Capital paid its people to get as much short-term profit as possible and not to ask questions, even if an employee was supposedly performing oversight.

19. Still worse, it appears Austin Capital made a conscious choice to give Madoff in particular a free pass on due diligence, given that past and present executives of Austin Capital have maintained a cozy relationship with Madoff for years. Austin Capital clearly knew that a large part of the money it invested with Tremont was being placed with Madoff and BLMIS.

20. A former executive of Austin Capital's, Pierre L. Schoenheimer, has maintained a close relationship with Bernard Madoff and the Madoff family for years. In the 1990s, Austin Capital marketed a fund of hedge funds called Austin Capital & Radix Sterling Fund, Ltd. ("Austin Capital Radix"). Pierre Schoenheimer co-founded Austin Capital Radix, and one of Schoenheimer's companies served as the managing partner of Austin Capital Radix. Pierre's wife, Idee German Schoenheimer, vanity published a 1996 cookbook with Ruth Madoff, Bernard's wife, and the Madoffs and Schoenheimers traveled in the same New York social circles, until Madoff's arrest in December 2008.

21. A relative of Pierre and Idee's, Linda Schoenheimer McCurdy, worked as a registered investment representative for Cohmad Securities Corporation ("Cohmad"), which Bernard L. Madoff partly owned and which shared office space with BLMIS, the main vehicle for the Ponzi scheme. The Massachusetts Securities Division filed an administrative complaint against Cohmad on February 11, 2009, charging the company with serving as a conduit for money directed into the scheme and listed Linda Schoenheimer McCurdy as an "involved and related party."

22. As recently as 2008, Pierre Schoenheimer publicly promoted his role as co-founder of Austin Capital Radix, and, in the mid-1990s, a trust in the name of Linda Schoenheimer McCurdy held common stock in another Pierre Schoenheimer company called Radix Ventures, Inc. In addition to the Schoenheimer connection, John Sauder, a former Austin Capital partner and co-founder who left the firm in 2004 after a ten-year stint, also

maintained a business relationship with BLMIS, until Bernard L. Madoff was arrested in December 2008.

23. Whether one blames Austin Capital's unwillingness to perform due diligence regarding Madoff on the longstanding relationship company executives had with the fraudster or on the perverse incentives the Defendant created with its bonus compensation package, the firm's obvious failure to act on numerous "red flags" evidences a reckless absence of due diligence. The "red flags" to Madoff's scheme included the following facts:

- (a) Madoff reported improbably smooth investment returns—the investment returns that Madoff reported followed an abnormally consistent and positive trajectory, in both up and down markets and with an absence of volatility that was difficult if not impossible to explain; Madoff had only five months of negative returns in the past twelve years, even through the bursting of the late 1990s stock market bubble;
- (b) Madoff adopted unusual practices that eliminated transparency—Madoff acted as his own prime broker, while most legitimate hedge funds use large investment banks, such as Goldman Sachs and JP Morgan as their prime brokers; ran his own back office operations instead of employing third party administrators and custodians; and limited access to his books and records;
- (c) Madoff's participation in the market did not match what he claimed—there was insufficient trading activity in the put and call options Madoff claimed to be using in great volume, making it not only impossible to corroborate his claims but also reasonably detectable that Madoff had never told the truth about his strategy;
- (d) Legitimate investment funds using the same strategy that Madoff supposedly used did not post similar results—other funds using a "split-strike conversion" strategy, which Madoff claimed was his approach and which entails the buying and selling of

put and call options on stock alongside stocks themselves, did not generate smooth returns comparable to Madoff's reported returns;

(e) Madoff's compliance measures were glaringly weak—despite the size and scale of the Madoff's operation, his auditors, Friebling & Horowitz, employed three people (only one was an active CPA, one was a secretary, and the third was retired and living in Florida) and operated out of a 13' by 18' storefront office in New City, New York; Madoff's comptroller was based in Bermuda, while most legitimate hedge funds have in-house comptrollers;

(f) Readily available media reports raised questions about Madoff—on May 7, 2001, *Barron's* published an article entitled "Don't Ask, Don't Tell: Bernie Madoff is so secretive, he even asks his investors to keep mum," which listed numerous "red flags" including dubious returns using the "split-strike conversion" strategy; also in May 2001, an article in *MAR/Hedge*, a hedge fund industry publication, entitled "Madoff Tops Charts; Skeptics Ask How," interviewed a dozen financial professionals who questioned the smoothness of and lack of volatility in Madoff's returns and also suggested Madoff may have been illegally subsidizing returns.

24. Furthermore, simple but powerful evidence that Austin Capital did not perform meaningful due diligence is how easily those hedge fund professionals, who actually did their homework, detected and avoided the Ponzi scheme. Famously, whistle blower Harry Markopolos, who began reporting the Madoff fraud to the Securities and Exchange Commission ("SEC") back in 2000, originally detected Madoff's fraud with less than a day's quantitative analysis, according to his own account. Furthermore, several prominent hedge fund of funds managers steered clear of Madoff over the years, including Goldman Sachs Asset Management, Morgan Stanley, JPMorgan Asset Management and the asset management unit of BNY Mellon Bank.

25. At all material times and in reckless disregard of the truth, Austin Capital failed to disclose to the ERB and the SIC the true fact that it failed to perform meaningful due diligence with regard to investments placed with Madoff and BLMIS through Tremont. Because due diligence was a material reason to hire Austin Capital in the first place, the ERB and the SIC's reliance may be presumed. In addition to its omissions of material fact, Austin Capital affirmatively misrepresented its expertise and focus on due diligence, including in marketing material such as its official web site and offering memoranda, and the ERB and the SIC reasonably relied upon Austin Capital's professed expertise and focus on due diligence.

26. Austin Capital's failure to perform meaningful due diligence, its failure to disclose that fact and its affirmative misrepresentations regarding due diligence all contributed to bringing about the losses that the ERB and the SIC suffered in the Madoff scheme. As alleged in this Complaint, Austin Capital's acts and omissions were a cause of those losses and formed a significant link to them.

OTHER SUBSTANTIVE ALLEGATIONS

More on the Madoff Scheme and its Victims

27. Although probably unprecedented in size—right before Madoff's arrest, BLMIS had issued account statements reporting a fictitious total balance of nearly \$65 billion—Bernard L. Madoff's scheme was a typical affinity scam and Ponzi scheme in other respects. A Ponzi scheme, named after early twentieth century fraudster Charles Ponzi, pays returns on early investment with money obtained from new investment. An affinity scam exploits a particular ethnic or social group.

28. Much as Ponzi's scheme started with his own Italian immigrant community, Madoff's scheme claimed many of its victims among the American Jewish community, where he and his wife Ruth had established a sterling social reputation by extensive charitable work with various religious, artistic and educational institutions. Madoff also established a network

of skills in various Jewish country clubs in New York, Florida, Minnesota and elsewhere. For this reason, a vast majority of Madoff victims were individuals or families, rather than institutional investors like the ERB and the SIC. Importantly, it appears that Austin Capital's relationship with Madoff started on an affinity basis. The cookbook that Idee Schoenheimer and Ruth Madoff vanity published together in 1996 was titled *The Great Chefs of America Cook Kosher: Recipes From America's Greatest Restaurants*.

29. Madoff expanded the scope of the fraud through what were, in effect, institutional shells or feeder funds. Madoff marketed mostly through exclusive and highly lucrative arrangements with these feeder funds, coupling an air of exclusivity with powerful sales incentives. As of 2001, Madoff's publicly acknowledged feeder funds included Fairfield Greenwich and Tremont, through which Austin Capital made its Madoff related investment.

30. Because scams typically exploit affinity or reputation, which is to say gut decision making, basic standards of due diligence emphasize objective criteria and quantitative analysis, and any reasonably skilled fund of funds manager should use objective due diligence criteria. Most, if not all, investment managers in the U.S. that examined a potential investment with Madoff under an objective standard successfully avoided the fraud.

31. In an article entitled "Homework Saves Crying Over Madoff: Institutions heeded red flags raised by hedge funds of funds," *Pensions & Investments* magazine reported in its online edition on December 22, 2008:

Bernie Madoff stood little chance of luring U.S institutions into his alleged \$50 billion Ponzi scheme because elite U.S. hedge fund-of-funds managers stood solidly in the way.

The due diligence of hedge funds of funds that specialize in managing mandates for U.S. pension funds, endowments and foundations found too many inconsistencies in the trading strategy managed by Bernard L. Madoff Investment Securities LLC, New York. However, a few smaller

hedge funds of funds were invested in so-called feeder funds, single-manager funds managed by Mr. Madoff's firm.

"The fact that so many institutional investors' hedge fund-of-funds managers insisted on transparency and therefore avoided Bernie's is a testament to the quality of their due diligence. They protected institutional investors from getting involved in this fraud," said Eric Weber, chief operating officer and principal of Freeman & Co., New York, a boutique investment bank.

Among those steering clear were the largest hedge fund-of-funds managers of U.S. institutional assets, including Pacific Alternative Asset Management Co., K2 Advisors LLC, Mesirov Advanced Strategies Inc., Goldman Sachs Asset Management, Morgan Stanley, JPMorgan Asset Management, UBS Global Asset Management, BlackRock Inc., Harris Alternatives LLC and the asset management unit of BNY Mellon Bank.

(emphasis supplied.)

32. In an article entitled "Who Isn't a Madoff Victim? The List is Telling,"

Fortune magazine and CNNMoney.com jointly reported on December 19, 2008:

[c]ertain types of investors seem to be absent . . . from the casualty list.

That's no accident, argues James Hedges IV of LJH Global Investments, a boutique firm that invests in hedge funds and private equity for high-net-worth families. **In other words, score one for the big institutions that stick to standard rules rather than allowing their managers to invest on personal connections or hunches.**

"There's no Duke Endowment [among the list of Madoff investors]," Hedges says. "There's no Harvard management, there's no Yale, there's no Penn, there's no Weyerhaeuser, no State of Texas or Virginia Retirement system."

The reason is simple, in Hedges' view. **Letting Madoff manage your money "wouldn't pass an institutional-quality due diligence process,"** he says. **"Because when you get to page two of your 30-page due diligence questionnaire, you've already tripped eight alarms and said 'I'm out of here.'"**

(emphasis supplied.)

33. But for Austin Capital's failure to perform due diligence regarding Madoff as promised, its failure to perform due diligence to standards of reasonably skilled fund of funds managers and its failure to disclose the truth about these facts, the ERB and the SIC would have avoided losing money in the Madoff scheme.

More on Austin Capital's Investing with Madoff

34. On or about December 11, 2008, far too late for anyone to act on the information, Austin Capital began to tell investors that part of their investment had been run by Madoff. The Madoff related investments through Tremont occurred as early as 1997 and as late as March 2008. Austin Capital in fact did not perform the on-site checks, background checks and business practices due diligence that it had promised to clients in offering memoranda and marketing communications.

35. On December 16, 2008, Austin Capital publicly announced that it had invested a "limited amount in a fund managed by Tremont Holdings, a registered investment advisor, which engaged the firm controlled by Bernard L. Madoff." *Austin American Statesman*, December 17, 2008. Although the December 2008 disclosures were the first time Austin Capital had disclosed the fact to the ERB and the SIC, Austin Capital knew all along that Tremont was invested with Madoff.

36. By investing in Madoff through Tremont, Austin Capital made an already opaque transaction even less transparent and also exposed clients to an unconscionable triple layering of costs and fees, with Madoff, Tremont and Austin Capital each getting a piece of the action, even if things had gone according to plan and no scam had occurred. The triple layer arrangement was in itself dishonest. The best that can be said of Austin Capital's conduct was that it hoped to pawn off due diligence responsibility to Tremont, without ever disclosing the true structure of the arrangement to clients. Yet, Austin Capital never told clients it was going to delegate due diligence to Tremont and any attempted delegation would itself constitute a failure to disclose a material fact, again linking Austin Capital's acts and omissions to the Madoff related losses in a significant way.

More on Austin Capital's Failure to Perform Meaningful Due Diligence

37. For years, there had been numerous warning signs that caused Madoff to fail the due diligence inquiries of many other fund of funds managers.

—The 1992 SEC Litigation

38. In 1992, the Securities and Exchange Commission (SEC) filed a lawsuit against accountants Frank Avellino and Michael Bienes, who sold \$441 million in unregistered securities to 3,200 people beginning in 1962, promising them returns of 13.5% or higher, and invested the money entirely with Madoff. As a result of the SEC investigation, Avellino and Bienes agreed to shut down their business and reimbursed their clients. No action was taken against Madoff.

—The 1999 Markopolos Warnings

39. In May 1999, Harry Markopolos, an investment consultant with experience managing the “split-strike conversion” strategy supposedly used by Madoff, sent a letter to the SEC describing how Madoff could not have generated the returns Madoff claimed using the split-strike conversion strategy. Markopolos detected the Madoff operation as suspect with less than a day’s quantitative analysis. To Markopolos, it appeared virtually impossible to legitimately achieve the lack of volatility in returns that Madoff reported, which is to say the abnormal smoothness in Madoff’s claimed returns.

—The May 2001 *MAR/Hedge* Article

40. In May 2001, the article “Madoff Tops Charts; Skeptics Ask How” appeared in *MAR/Hedge*, a semi-monthly newsletter reporting on the hedge fund industry. The article reported:

What is striking to most observers is not so much the annual returns—which, though considered somewhat high for the strategy, could be attributed to the firm’s market making and trade execution capabilities—but the ability to provide such smooth returns with so little volatility.

The best known entity using a similar strategy, a publicly traded mutual fund dating from 1978 called Gateway, has experienced far greater volatility and lower returns during the same period.

41. The *MAR/Hedge* article also identified Tremont as one of Madoff's largest feeder funds.

42. Responding to questions posed by *MAR/Hedge* reporter Michael Ocrant, including an accusation that Madoff may have been subsidizing returns from other parts of his brokerage business, an illegal practice on its own, Bernard Madoff ended his answer with the statement: "The strategy is the strategy and the returns are the returns."

—The May 2001 *Barron's* Article

43. On May 27, 2001, *Barron's*, one of America's leading financial publications, published the article titled "Don't Ask, Don't Tell: Bernie Madoff is so secretive, he even asks his investors to keep mum." *Barron's* reported:

[Private accounts managed by Madoff] have produced compound average annual returns of 15% for more than a decade. Remarkably, some of the larger, billion-dollar Madoff-run funds have never had a down year. When *Barron's* asked Madoff how he accomplishes this, he says, "It's a proprietary strategy. I can't go into it in great detail." Nor were the firms that market Madoff's funds forthcoming.

* * *

Still, some on Wall Street remain skeptical about how Madoff achieves such stunning double-digit returns using options alone. Three options strategists for major investment banks told *Barron's* they couldn't understand how Madoff churns out such numbers using this strategy. Adds a former Madoff investor: "Anybody who's a seasoned hedge-fund investor knows the split-strike conversion is not the whole story. To take it at face value is a bit naïve."

* * *

The lessons of Long-Term Capital Management's collapse are that investors need, or should want, transparency in their money manager's investment strategy. But Madoff's investors rave about his performance—even though they don't understand how he does it. "Even knowledgeable people can't really tell you what he's doing," one very satisfied investor told *Barron's*. "People who have all the trade confirms and statements still can't define it very

well.” This investor declined to be quoted by name. Why? Because Madoff politely requests that his investors not reveal that he runs their money.

What Madoff told us was, “If you invest with me, you must never tell anyone that you’re invested with me. It’s no one’s business what goes on here,” says an investment manager who took over a pool of assets that included an investment in a Madoff fund. “When he couldn’t explain to my satisfaction how they were up or down in a particular month,” he added, “I pulled the money out.”

—The 2005 Markopolos Warning

44. Based on more or less publicly available information and on information certainly available to Austin Capital, on November 7, 2005, Markopolos submitted another letter to the SEC, entitled “The World’s Largest Hedge Fund is a Fraud,” in which he set forth in detail how Madoff’s returns could not be real. Markopolos reported 29 red flags, each of which Austin Capital reasonably should have been capable of detecting. The red flags, as excerpted from the letter, include among others:

- [W]hy would B[ernard] M[adoff] settle for charging only undisclosed commissions when he could earn standard hedge fund fees of 1% management fee + 20% of the profits?

* * *

- The third party hedge funds and fund of funds that market this hedge fund strategy that invests in BM don’t name and aren’t allowed to name Bernie Madoff as the actual manager in their performance summaries or marketing literature Why the need for such secrecy? If I was the world’s largest hedge fund and had great returns, I’d want all the publicity I could garner and would want to appear as the world’s largest hedge fund in all the industry rankings.

* * *

- It is mathematically impossible for a strategy using index call options and index put options to have such a low correlation to the market where its returns are supposedly being generated from. This makes no sense!

* * *

- BM's performance numbers show only 7 extremely small [monthly] losses during 14 1/2 years and these numbers are too good to be true. The largest one month loss was only -55 basis points (-0.55%) or just over one-half of one percent! And BM never had more than a one month losing streak!

* * *

- Madoff does not allow outside performance audits.

* * *

- Madoff returns are not consistent with the one publicly traded option income fund with a history as long as Madoff's.

* * *

- And why do these third parties fail to mention Bernie Madoff in their marketing literature? After all he's the manager, don't investors have a right to know who's managing their money?

* * *

- BM goes to 100% cash for every December 31st year-end according to one FOF invested with BM. This allows for "cleaner financial statements" according to this source. Any unusual transfers or activity near a quarter-end or year-end is a red flag for fraud.

—The 2007 Aksia Investigation and Other Red Flags

45. In 2007, investment adviser Aksia LLC urged clients not to invest in Madoff feeder funds after performing due diligence and discovering several red flags, which include:

- Madoff's comptroller was based in Bermuda, whereas most mainstream hedge funds have their own in-house comptrollers
- Madoff's auditor, Friehling & Horowitz, operated out of a 13x18-foot location and included one partner in his late 70s who lived in Florida, a secretary, and one active accountant, whereas most hedge funds are audited by a name accounting firm.
- Aksia discovered the 2005 letter from Markopolos to the SEC described above.

46. Aksia prepared its client advisory after, among other things, reviewing the stock holdings of Madoff Securities that were publicly reported in quarterly statements filed with the SEC. Aksia concluded that the holdings appeared to be too small to support the size of the assets Madoff claimed to be managing.

47. Additionally, in a December 13, 2008 article in *The New York Times*, Robert Rosenkranz, principal of hedge fund adviser Acorn Partners, was quoted as saying, “Our due diligence, which got into both account statements of [Madoff’s] customers and the audited statements of Madoff Securities, which he filed with the S.E.C., made it seem highly likely that the account statements themselves were just pieces of paper that were generated in connection with some sort of fraudulent activity.”

48. A December 13, 2008 article in *The Wall Street Journal* quoted Chris Addy, founder of Castle Hall Alternatives, which screens potential hedge fund investments for clients, as follows: “There was no independent custodian involved who could prove the existence of assets. . . There’s a clear and blatant conflict of interest with a manager using a related-party broker-dealer. Madoff is enormously unusual in that this is not a structure I’ve seen.”

49. The secrecy that Madoff required alone was sufficient reason to avoid investing with him. On January 17, 2009, the *New York Times* reported:

“It’s a very strange set-up, since most prospectuses disclose the names of the actual portfolio managers,” said Drago Indjic, a project manager at the Hedge Fund Center of the London Business School. “If you’ve been in the industry, this doesn’t pass the smell test.”

50. Austin Capital not only acquiesced to the conspiracy of silence among members of the Madoff feeder network but also contributed to it by, among other actions, failing to disclose to clients the longevity and depth of its knowledge of and relationship with Madoff. Austin Capital reasonably should have been capable of performing the same due diligence that Aksia, Acorn Partners and others performed. Had Austin Capital done so, the company would have either detected the Madoff fraud as Markopolos and others did or at least avoided investing with Madoff, as so many fund of funds managers and investment consultants did.

51. During the time Austin Capital had directed monies belonging to the ERB and the SIC into investments with Madoff and BLMIS, Austin Capital collected management fees on those monies and thus benefited financially as part of Madoff's lucrative feeder network.

COUNT I

For Violation of Section 3 of the New Mexico Fraud Against Taxpayers Act

52. The Qui Tam Plaintiff realleges and incorporates Paragraphs 1 through 51 by reference.

53. By receiving management fees partly in exchange for due diligence services it never performed with regard to the Madoff investment, or performed inadequately and in a materially different way from that represented to clients, Austin Capital knowingly presented, or caused to be presented, to the ERB and the SIC a false claim for payment or approval, in violation of NMSA 1978, Section 44-9-3(A)(1).

54. By also failing to disclose the material truth to the ERB and the SIC about its lack of meaningful due diligence regarding Madoff while receiving management fees, Austin Capital knowingly presented, or caused to be presented, to the ERB and the SIC a false claim for payment or approval, in violation of NMSA 1978, Section 44-9-3(A)(1).

55. By also failing to disclose the material truth about its longstanding relationship with Madoff, by failing to disclose the very fact of the investment with Madoff, by failing to disclose the unconscionable triple-layer fee arrangement with Madoff and Tremont and by failing to disclose its lack of meaningful due diligence regarding Madoff and BLMIS, Austin Capital knowingly made or used, or caused to be made or used, a false or misleading statement to obtain approval from the ERB and the SIC to manage money, in violation of NMSA 1978, Section 44-9-3(A)(2).

56. In addition to omissions of material fact, Austin Capital also made affirmative misrepresentations of material fact regarding its expertise and focus on due diligence in

marketing material, such as its official web site, and in offering memoranda, and thus Austin Capital knowingly presented, or caused to be presented, to the ERB and the SIC a false claim for payment or approval, in violation of NMSA 1978, Section 44-9-3(A)(1) and used, or caused to be used, a false or misleading statement to obtain approval from the ERB and the SIC to manage money, in violation of NMSA 1978, Section 44-9-3(A)(2).

57. Both the management fees Austin Capital charged the ERB and the SIC and the approval Austin Capital obtained to manage money in the first place constitute claims against the state, which means they were requests or demands for money when the money requested or demanded issues from or is provided or reimbursed by the state, as defined by NMSA 1978, Section 44-9-2(A).

58. Throughout this Complaint, “knowingly” means that Austin Capital acted at all relevant times (1) with actual knowledge of the truth or falsity of the information described in those paragraphs and this Complaint generally; (2) in deliberate ignorance of the truth or falsity of the information; or (3) in reckless disregard of the truth or falsity of the information, as defined by NMSA 1978, Section 44-9-2(C).

59. Austin Capital’s bonus compensation package, which created incentives to turn a blind eye toward Madoff’s operations, further evidences that the Defendant knowingly failed to disclose material facts to the ERB and to the SIC and knowingly misrepresented the truth about the absence of meaningful due diligence with regard to Madoff and BLMIS.

60. Austin Capital’s acts, omissions and violations of statute, as alleged in Paragraphs 53 through 56 and in this Complaint generally, contributed to and formed a significant link to damages that the ERB and the SIC sustained in the Madoff scheme, including interest as an element of damage and in an amount to be proven at trial.

61. As alleged, Austin Capital’s acts and omissions constitute multiple violations of FATA and entitle the Qui Tam Plaintiff to recover, on behalf of the ERB and the SIC, three

times the damages sustained by them, civil penalties, the cost of action and attorneys' fees, as provided by NMSA 1978, Section 44-9-3(C).

COUNT II

**For Breach of Fiduciary Duty
(In the Alternative to Counts I and III)**

62. The Qui Tam Plaintiff realleges and incorporates Paragraphs 1 through 61 by reference.

63. During the time Austin Capital managed money on behalf of the ERB and the SIC, the Defendant owed the investing agencies a fiduciary duty, and remained in a fiduciary relationship throughout that time, because Austin Capital handled the financial affairs of the ERB and the SIC with regard to the money invested with the company, because Austin Capital collected fees based on the amount of money it handled on behalf of the ERB and the SIC, because Austin Capital knew, or should have known, that the ERB's money is held in trust for the pension benefit of New Mexico's public school teachers and other school employees and because Austin Capital knew, or should have known, the SIC's money is held in trust for the public benefit of all New Mexicans.

64. Furthermore, Austin Capital acknowledges that it owes all clients a fiduciary duty in, among other documents, the company's Code of Ethics, which all senior personnel must certify that they have read. An excerpt from Austin Capital's Code of Ethics follows:

All Access Persons [senior personnel] owe a fiduciary duty to Austin's clients Access Persons must place the interest of clients first and avoid activities, interests and relationships that might interfere with the duty to make decisions in the best interest of clients.

65. As part of its fiduciary duty, Austin Capital had a duty to disclose material facts to the ERB and the SIC.

66. By receiving management fees partly in exchange for due diligence services it never performed with regard to the Madoff investment, or performed inadequately and in a

materially different way from that represented to clients, Austin Capital breached its fiduciary duty.

67. By also failing to disclose the material truth about its longstanding relationship with Madoff, by failing to disclose the very fact of the investment with Madoff, by failing to disclose the unconscionable triple-layer fee arrangement with Madoff and Tremont and by failing to disclose its lack of meaningful due diligence regarding Madoff and BLMIS, Austin Capital also breached its fiduciary duty.

68. In addition to omissions of material fact, Austin Capital also made affirmative misrepresentations of material fact regarding its expertise and focus on due diligence in marketing material, such as its official web site, and in offering memoranda, once again breaching its fiduciary duty.

69. Finally with regards to breach, Austin Capital breached its fiduciary duty to the ERB and the SIC by failing to perform meaningful due diligence with regard to Madoff and BLMIS.

70. Austin Capital's breaches of fiduciary duty as alleged in Paragraphs 66 through 69, and in this Complaint generally, contributed to and formed a significant link to damages that the ERB and the SIC sustained in the Madoff scheme, including interest as an element of damage and in an amount to be proven at trial.

COUNT III

For Professional Negligence (In the Alternative to Counts I and II)

71. The Qui Tam Plaintiff realleges and incorporates Paragraphs 1 through 70 by reference.

72. In providing services to the ERB and the SIC as a hedge fund of funds manager, Austin Capital owed the investing agencies a duty to possess and to apply the

knowledge, care and skill of a reasonably well-qualified hedge fund of fund manager, and due diligence forms a part of the services to which the duty applies.

73. Austin Capital, if it performed any due diligence with regard to the Madoff investment at all, negligently performed such due diligence, in breach of its duty.

74. Austin Capital's negligence contributed to and formed a significant link to damages that the ERB and the SIC sustained in the Madoff scheme, including interest as an element of damage and in an amount to be proven at trial.

COUNT IV

For Punitive Damages (In the Alternative to Count I)

75. The Qui Tam Plaintiff realleges and incorporates Paragraphs 1 through 74 by reference.

76. When, among other actions, it failed to disclose the material truth about its longstanding relationship with Madoff, failed to disclose the very fact of the investment with Madoff, failed to disclose the unconscionable triple-layer fee arrangement with Madoff and Tremont and failed to disclose its lack of meaningful due diligence regarding Madoff and BLMIS, Austin Capital acted intentionally and with knowledge that withholding such information from its clients was wrong. Austin Capital thus acted maliciously.

77. When it failed to perform meaningful due diligence on the Madoff investment, Austin Capital knew that harm could result. Austin Capital thus acted willfully.

78. By failing to perform meaningful due diligence with regard to the Madoff investment, while promoting its skill and focus on due diligence and while understanding that an important reason to hire a fund of funds manager is to perform due diligence, Austin Capital acted with an utter indifference to the consequences of its conduct. Austin Capital's failure to heed the warning signs about Madoff that were readily available, such as the 2001

Barron's and *MAR/Hedge* articles, further evidences an utter indifference to the consequences of its conduct. Austin Capital thus acted recklessly.

79. Because Austin Capital acted maliciously, willfully or recklessly, while putting profit before client interest, the ERB and the SIC are entitled to an award of punitive damages, in an amount to be determined at trial.

PRAYER FOR RELIEF

WHEREFORE, on behalf of the Educational Retirement Board and State Investment Council, agencies of the State of New Mexico, the Qui Tam Plaintiff prays that the Court:

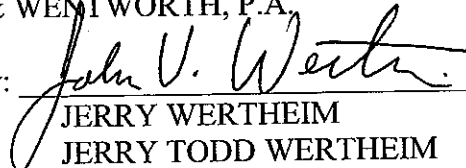
- A. Award three times compensatory damages in favor of the State of New Mexico for all damages sustained by the ERB and the SIC, including interest as an element of damage, in an amount to be proven at trial and as provided by FATA;
- B. Award civil penalties as provided by FATA;
- C. Award the Qui Tam Plaintiff its share as provided by FATA;
- D. Award in the alternative, if not three times compensatory damages as provided by FATA, single compensatory damages in favor of the State of New Mexico for all damages sustained by the ERB and the SIC, including interest as an element of damage, in an amount to be proven at trial;
- E. Award, in the alternative to recovery under FATA, punitive damages in an amount to be determined at trial;
- F. Award pre- and post-judgment interest as provided by law;
- G. Award the Qui Tam Plaintiff and the State of New Mexico their reasonable attorneys' fees and cost of action as provided by law; and

H. Such further relief as the Court deems just.

Respectfully submitted,

JONES, SNEAD, WERTHEIM
& WENTWORTH, P.A.

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