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SUMMARY

1. J. Ezra Merkin betrayed hundreds of investors who entrusted him with their savings by recklessly feeding their funds into the largest Ponzi scheme in history, while falsely claiming he actively managed their funds. Merkin held himself out to investors as an investing guru, collecting more than \$470 million in management and incentive fees from his Ascot, Gabriel and Ariel funds. In reality, Merkin was but a master marketer, his efforts substantially directed only at convincing investors—including many charities—to invest in his funds. Merkin’s deceit, recklessness, and breaches of fiduciary duty have resulted in the loss of approximately \$2.4 billion.

2. Merkin’s Ascot funds, Ascot Partners L.P. and Ascot Fund Limited (together, “Ascot”) were formed in 1992 to be, and always were, “feeder” funds that entrusted Bernard L. Madoff with virtually all of their assets. Madoff then stole, dissipated or lost those funds in a massive Ponzi scheme. All the while Merkin deceived Ascot investors into believing Merkin, not a third party, was actively managing their investments. In fact, Merkin did little work for Ascot other than routine bookkeeping and engaging in occasional telephone conversations with Madoff. In the words of one investor who, like most, learned only in December 2008 that Madoff, not Merkin, managed Ascot’s assets, Merkin was just a “glorified mailbox.”

3. Merkin falsely marketed his funds Gabriel Capital L.P. (“Gabriel”) and Ariel Fund Limited (“Ariel”) as vehicles for investing in distressed debt and bankruptcy-related securities. However, beginning in or around 2000, Merkin surreptitiously handed over up to a third of the assets of Gabriel and Ariel to Madoff, even though Madoff’s purported strategy had nothing to do with distressed debt or investments in bankruptcies. And Merkin hid this shift of his funds’ assets from his funds’ investors. Indeed, even when investors told Merkin that they

did not want to invest with Madoff, Merkin failed to disclose that the investors were already invested with Madoff through the Ariel or Gabriel fund.

4. Charities and non-profit organizations were particularly susceptible to and victimized by Merkin's deceptive tactics. Merkin actively marketed his funds to such organizations, and lured many other investors to invest using his affiliations with those highly-respected institutions.

5. Merkin collected his customary fees from nonprofits that invested with him, but typically did not disclose, and actively obscured, that Madoff was actually managing some or all of the funds they invested. In one case, he collected the fees even though both he and Madoff sat on the Board of Trustees of the organization. Merkin also engaged in self-dealing once he was entrenched in the leadership of nonprofit organizations, recommending that they place money in ventures in which he had a financial interest without, in some instances, disclosing to the organization his clear conflict of interest.

6. Through his misrepresentations, concealment, self-dealing, reckless conduct, and gross negligence, Merkin abused the trust of investors in Ascot, Ariel, and Gabriel, and breached the fiduciary duties he owed them. Merkin collected hundreds of millions of dollars in fees for managing investors' funds, while turning all, or a substantial portion, of those funds over to Madoff and others, whose identity and strategy were not known to, understood by, or approved by the investors, and whom Merkin failed to adequately oversee, audit, or investigate. As a result, investors in Ascot, Gabriel, and Ariel have lost approximately \$2.4 billion.

JURISDICTION AND VENUE

7. The Attorney General has an interest in the economic health and well-being of investors who reside or transact business within the State of New York. In addition, the Attorney General has an interest in the financial well-being of non-profit organizations that operate within the State of New York. The Attorney General is also responsible for overseeing the activities of New York not-for-profit corporations and the conduct of their officers and directors. The State of New York, moreover, has an interest in upholding the rule of law generally. Defendants' conduct has injured these interests.

8. The State of New York brings this action in its sovereign and quasi-sovereign capacities as *parens patriae*; and pursuant to Executive Law §§ 63(1) and 63(12), General Business Law §§ 352 *et seq.* (the "Martin Act"), and Not-for-Profit Corporation Law ("N-PCL") §§ 112, 717, and 720.

9. Pursuant to Executive Law 63(12), the Attorney General is authorized to bring an action for restitution, damages, and other relief in connection with repeated fraudulent or illegal acts in the carrying on of any business.

10. Pursuant to the Martin Act, the Attorney General is authorized to bring an action for restitution of money obtained as the result of any fraudulent practices in connection with the sale of securities.

11. Pursuant to N-PCL § 720, the Attorney General is authorized to bring an action to require the directors and officers of a New York not-for-profit corporation to account for the management and disposition of corporate assets and for transfers, loss, or waste of corporate assets in violation of their duties and to recover all resulting damages from officers and directors.

12. The Attorney General also has common law *parens patriae* authority to protect the public interest.

13. The State seeks restitution, damages, costs, and equitable relief with respect to Defendants' fraudulent and otherwise unlawful conduct.

14. Defendants' actions originated from New York, New York, where Defendants reside and/or conduct business. Moreover, numerous New York investors, as well as the interests of the State of New York, were harmed by Defendants' conduct.

PARTIES

15. This action is brought by the Attorney General on behalf of the People of the State of New York pursuant to his authority under Executive Law §§ 63(1) and 63(12), General Business Law §§ 352 *et seq.*, and N-PCL §§ 112, 717, and 720, and the common law of the State of New York.

16. Defendant J. Ezra Merkin is an individual residing at 740 Park Avenue, New York, New York, and with a business office at 450 Park Avenue, New York, New York. Merkin is the General Partner of Ascot Partners, L.P. and Gabriel, the sole shareholder and sole director of GCC, and the non-member manager of Gabriel Assets LLC and Gabriel Alternative Assets LLC.

17. Defendant Gabriel Capital Corporation is a Delaware corporation with its principal place of business at 450 Park Avenue, New York, New York. GCC is the investment advisor to Ascot Fund Limited and Ariel.

18. Relief Defendant Ascot Partners L.P. is a Delaware limited partnership with its principal place of business at 450 Park Avenue, New York, N.Y.

19. Relief Defendant Ascot Fund Limited is an offshore fund incorporated in the Cayman Islands with its principal place of business at 450 Park Avenue, New York, N.Y.

20. Relief Defendant Gabriel Capital L.P. is a Delaware limited partnership with its principal place of business at 450 Park Avenue, New York, N.Y.

21. Relief Defendant Ariel Fund Limited is an offshore fund incorporated in the Cayman Islands with its principal place of business at 450 Park Avenue, New York, N.Y.

22. Relief Defendants Gabriel Assets LLC (“GALLC”) and Gabriel Alternative Assets LLC (“GAALLC”) are Delaware limited liability corporations with their principal places of business at 450 Park Avenue, New York, N.Y. GALLC and GAALLC are used by Gabriel and Ariel to make investments that are collectively managed by an outside money manager.

FACTUAL ALLEGATIONS

I. BACKGROUND

A. Merkin

23. Merkin is the general partner of Ascot and Gabriel, domestic hedge funds organized as limited partnerships. Investors in these funds are limited partners of the partnerships. Merkin is also the sole shareholder and sole director of GCC, which serves as the manager of Ascot Fund Limited and Ariel. Ariel’s investment strategy and investments closely mirror those of Gabriel.

24. In these capacities, as Merkin acknowledged in testimony before the Attorney General, “I had fiduciary responsibilities [to investors] for oversight of the portfolio.” (Ex. 1, at 101:9-10.) Merkin collected annual management fees equal to 1% of the capital invested in each of Ariel, Gabriel, and Ascot, and raised the Ascot management fee to 1.5% of invested capital in

2003. In addition, Merkin collected an annual incentive fee of 20% of any appreciation in the assets of Ariel and Gabriel.

25. Merkin, until December 2008, held himself out to be a pillar of the New York philanthropic community. Merkin is a graduate of Columbia College and Harvard Law School. After a few years in private law practice, he began working on Wall Street. In 1989, Merkin began running his own investment funds, creating the domestic fund Ariel Capital, L.P., which later became Gabriel, and its offshore twin, Ariel Fund Limited. Through his extensive network of connections in his community and in the philanthropic world, Merkin marketed his funds to numerous individuals and charities. Merkin also embedded himself in charitable boards and used those positions to solicit new investments. By mid-2008, Merkin had built up his funds to a stated net asset value of over \$4.4 billion.

B. Merkin and Madoff

26. Merkin first met Bernard L. Madoff in “the very late ‘80s, maybe 1990.” (Ex. 1, at 8:19-20.) Madoff, by the 1970s and 1980s, had pioneered electronic trading and founded his own trading firm, Bernard L. Madoff Investment Securities LLC (“BLMIS”), which became a major market-maker for stocks and options. Madoff also had a separate business as an investment manager.

27. Sometime in the very early 1990s, Madoff described to Merkin his purported trading strategy, known as a “split strike conversion” strategy. The strategy was to (a) buy stocks of selected corporations that were included in the blue-chip Standard & Poor’s 100 Index (the “Index”), and simultaneously (b) buy put options below the current stock price to protect against large declines, and (c) sell call options above the current price to fund the purchase of put options. The call options would also, to some degree, limit any gains that would be earned on the underlying stocks. Madoff claimed that under the right market conditions, he could achieve

steady returns of over ten percent per year regardless of whether the market as a whole had advanced or declined.

28. In 1990, Merkin decided to give Madoff some of Ariel's and Gabriel's capital to manage. In 1992, Merkin started Ascot for the sole, but undisclosed, purpose of serving as a conduit to Madoff.

29. Madoff's description of his purported strategy evolved only slightly over time. He soon began to claim that he was using a larger "basket" of stocks selected from the Index, combined with put and call options on the Index itself rather than options on individual stocks. The positions were supposedly held for a short period of time lasting from a few days to no longer than about two months, and then liquidated. Madoff claimed to execute the "split strike conversion" strategy six to eight times per year. At some point, Madoff purportedly adopted the practice of exiting the market entirely at the very end of each quarter and putting all funds in U.S. Treasury bills ("Treasuries"). For this reason, Madoff's quarterly statements to investors, and the end-of-year audits of investor holdings, would list only Treasuries.

30. In fact, Madoff only pretended to execute this strategy. The court-appointed Trustee liquidating Madoff's assets has stated that he has found no evidence that, from at least 1996 to the present, any stocks or options were traded by Madoff for investors. On March 12, 2009, Madoff pleaded guilty to securities fraud charges, admitting that beginning in the early 1990s, he stopped purchasing securities for his investment management clients, and began operating a Ponzi scheme. Investors' funds were placed and commingled in a Chase Manhattan Bank account, which Madoff used to cover the redemption requests of other investors, while also stealing some of those funds for his own use or other purposes. The trade confirmations and account statements that investors received, and the profits they reflected, were all fictitious,

manufactured from whole cloth by Madoff to give the appearance that he had executed his strategy with exquisite market timing—buying stocks when they were towards the bottom of the price range for a given day, and selling close to the top.

31. By recklessly turning over funds to Madoff, Merkin lost virtually all of the \$1.7 billion invested in Ascot (Ex. 2), and approximately 25% of the \$2.7 billion invested in Ariel and Gabriel (Ex. 3), totaling approximately \$2.4 billion in investor harm.

II. THE ASCOT FUNDS

32. Merkin created Ascot Partners, L.P., a Delaware limited partnership, and Ascot Fund Limited, an offshore fund incorporated in the Cayman Islands, in 1992 for the sole, but undisclosed, purpose of serving as a feeder to Madoff. From that time until 2008, virtually all of the funds' assets were turned over to Madoff. In his testimony before the Attorney General, Merkin stated that he formed Ascot “largely” for the purpose of investing with Madoff, and that, from the beginning, “substantially all” of Ascot’s assets were tendered to Madoff. (Ex. 1, at 36:15-37:22.) As of the end of the third quarter of 2008, Ascot had over 300 investors with a total of \$1.7 billion under management.

33. Merkin, however, concealed the fact that Ascot was a Madoff feeder fund from the vast majority of his investors. During the course of its investigation, the office of the Attorney General interviewed over half of Ascot’s U.S. investors. Approximately 85% of them did not know until after Madoff’s arrest that Madoff managed and had custody of virtually all of Ascot’s assets.

34. Until 2002, Merkin received an annual management fee from Ascot’s investors equal to of 1% of assets under management. As of January 1, 2003, Merkin increased his fee to 1.5% of assets under management. The assets under management included the gains reported by

Madoff, gains now known to have been nonexistent. By 2008, Merkin was receiving annual income of approximately \$25.5 million from his Ascot management fees.

35. Although Merkin entrusted billions of his investors' money to Madoff, and told one investor ("Investor A") that Ascot was so safe he "would put his own mother in it," Merkin's confidence in Madoff does not appear to have extended to his own investments. Merkin's Ascot management fees for the years 1995 to 2007, which totaled more than \$169 million, were paid directly to him, not reinvested in Ascot. Aside from these fees, Merkin invested, personally and through family trusts and foundations, approximately \$7 million in Ascot in its first six years, but less than \$2 million over the following decade. Merkin therefore realized cash earnings from Ascot of approximately \$169 million, and, through Ascot, lost only a small fraction of that amount to Madoff's Ponzi scheme.

36. As of May 2008, over \$215 million of the \$1.7 billion reportedly under management in Ascot, or approximately 12%, consisted of the appreciated investments of approximately 35 non-profit organizations. Merkin was therefore receiving annual income of over \$3.2 million in management fees from these organizations. Of the non-profits' investments, over \$115 million (nearly 7% of Ascot assets under management) consisted of investments held by organizations to which Merkin had a fiduciary duty on account of his positions as director, trustee, advisor, or member of the investment committee. Their investments were yielding over \$1.7 million in annual management fees for Merkin.

A. The Offering Memoranda for Ascot, and Other Written Disclosures, Were False and Misleading

37. Merkin hid Madoff's involvement from most of his investors by creating offering documents, reports, and other materials that failed to disclose Madoff's management of the fund and falsely conveyed that Merkin personally managed Ascot's assets on a day-to-day basis.

38. Ascot offered participation in its investment partnership to qualified investors primarily through a series of documents issued in 1992, 1996, 2002, and 2006, called Confidential Offering Memoranda (the “Ascot Memoranda”) (Exs. 4, 5, 6, and 7). Although the later Ascot Memoranda described an investment strategy for Ascot that was consistent with the “split-strike conversion” strategy, the 1992 Memorandum falsely stated that Merkin intended to invest Ascot’s assets along the same lines as his other funds, that is, using a strategy focused on distressed debt and businesses undergoing reorganization. It states that Ascot and Gabriel “will have similar investment objectives” (Ex. 4, at 9), and, under the heading “Investment Approach,” that:

Ascot . . . will engage primarily in risk arbitrage, investments in private debt claims and publicly traded securities of bankrupt and distressed companies and engage in indirect investments, including investment in mutual funds, private investment partnerships, closed-end funds, and other pooled investment vehicles which engage in similar investment strategies.

(*Id.* at 1.) However, as he acknowledged in his testimony, Merkin from the beginning intended Ascot to serve solely as a conduit to Madoff, and never intended that Ascot pursue the described strategy.

39. Madoff’s role as the manager of Ascot’s assets is concealed in all of the Ascot Memoranda. They falsely state that Merkin would be involved in the fund’s management on a day-to-day and transaction-by-transaction basis, and that the success of the fund depended on Merkin’s abilities as a money manager: “All decisions with respect to the management of the capital of the Partnership are made exclusively by J. Ezra Merkin. Consequently, the Partnership’s success depends to a great degree on the skill and experience of Mr. Merkin.” (Ex. 6, at 12-13; Ex. 7, at 17.) In fact, the performance of Ascot was entirely at the mercy of the “skill and experience”—and, of course, the honesty—of Madoff.

40. Merkin was evasive when asked, in testimony before the Attorney General, whether the language in the Ascot Memoranda was consistent with the fact that Madoff actually had control of Ascot's assets:

- Q. I'll finish the paragraph which ends on page thirteen: "Consequently, the Partnership's success depends to a great degree on the skill and [experience] of Mr. Merkin." Do you see that?
- A. I do.
- Q. Isn't it the skill and experience of Mr. Madoff that is important to the success of Ascot?
- A. That's not what this says. It doesn't say it does and it doesn't say it doesn't.

(Ex. 1, at 181:20-182:11.)

41. On its first page, the 1992 Ascot Memorandum refers to the personal attention and judgment that Merkin would bring to bear on individual transactions. It states:

The Managing Partner intends to the extent circumstances permit to adopt a selective approach in evaluating potential investment situations, generally concentrating on relatively fewer transactions he can follow more closely. He may often employ strategies involving derivative securities like options, futures and convertibles He expects to use hedging devices and will engage in short sales.

(Ex. 4, at 1.) This or a similar statement appears in each of the subsequent Ascot Memoranda.

(Ex. 5, at 6; Ex. 6, at 5; Ex. 7, at 13.)

42. Merkin's personal attention to individual trades is also repeatedly touted in the risk disclosures that take up a large portion of each memorandum:

- "The Partnership also may take positions . . . in options on stock of companies which may, *in the judgment of the managing partner*, be potential acquisition candidates . . ." (Ex. 4, at 3 (emphasis added); *see also* Ex. 5, at 7; Ex. 6, at 7; Ex. 7, at 18.)
- "Such purchases may include securities which *the Managing Partner believes* to be undervalued." (Ex. 4, at 5 (emphasis added); *see also* Ex. 5, at 8; Ex. 6, at 8; Ex. 7, at 18.)

- “Investments in debt claims and the securities of companies that have filed for bankruptcy . . . may be made at various stages in the bankruptcy process *based on the Managing Partner’s judgment that there is sufficient profit potential.* (Ex. 5, at 8 (emphasis added); Ex. 6, at 8.)
- “The imposition of controls by governmental authorities might also limit such forward (and futures) trading to *less than that which the General Partner would otherwise recommend*” (Ex. 7, at 19 (emphasis added).)
- Merkin has “ultimate responsibility for the management, operations and investment decisions made on behalf of the Partnership.” (Ex. 7, at 3, 13.)

43. The Ascot Memoranda further concealed the fact that Ascot was a Madoff feeder by representing to investors that Merkin would spend much of his time managing Ascot’s assets. The 1992 Memorandum states that “The Managing Partner is required to devote substantially his entire time and effort during normal business hours to his money management activities, including (but not limited to) the affairs of the Partnership.” (Ex. 4, at 13.) Later memoranda make similar representations. (Ex. 5, at 14; Ex. 6, at 14; Ex. 7, at 26-27; *see also* Ex. 6, at 10 (“[T]he General Partner will devote his best efforts to the management of the Partnership’s portfolio”); Ex. 7, at 21.) In fact, Merkin devoted very little time to the management of Ascot. In testimony before the Attorney General, Merkin admitted that his “monitoring” of Ascot consisted of, at best, general conversations with Madoff approximately once per month:

It was monitoring. It was talking to [Madoff]. It was a very long relationship. I spoke to him ten or 15 time[s] a year. I spoke to or saw him 10 or 12 times a year. It might have been as often as once a month depending on what was going on. It wasn’t so much second guessing. . . . Fifteen would be high in a given year, ten could be low in a given year, and my guess it was more in the beginning[,] then a bit less, and then it developed back up again.

(Ex. 1, at 101:24-102:22.)

44. The Ascot Memoranda disclosed that Ascot might make use of outside money managers. But the plural is always used in discussing such “Other Investment Entities”:

The Partnership will make investments through third-party managers, using managed accounts, mutual funds, private investment partnerships, closed-end funds and other pooled investment vehicles (including special purpose vehicles), each of which is intended to engage in investment strategies similar to the Partnership's (collectively, "Other Investment Entities").

(Ex. 7, at 12; *see also id.* at 17; Ex. 4, at 1; Ex. 5, at 5, 10; Ex. 6, at 4, 6.)

45. Beginning with the 1996 Ascot Memorandum, Merkin underscored that multiple money managers would be used, stating that the "independent money managers and Other Investment Entities will trade wholly independently of one another and may at times hold economically offsetting positions." (Ex. 5, at 11; Ex. 6, at 6; Ex. 7, at 17.) Such statements were false and misleading because, in fact, all funds were entrusted to a single manager, Madoff. This lack of diversification proved devastating.

46. The Ascot Memoranda each include an extensive section on "Risk Factors" which covers a wide variety of investment strategies that had nothing to do with Ascot's actual "split strike conversion" trading strategy. The warnings cover, among other irrelevancies, "Distressed Entities" (Ex. 4, at 2), "Arbitrage Transactions" where "a merger, exchange offer or cash tender offer transaction will be consummated" (*id.* at 4; Ex. 5, at 7; Ex. 6, at 7; Ex. 7, at 17), "participation in unfriendly transactions" (Ex. 4, at 6), "Bankruptcy Situations" (Ex. 5, at 8; Ex. 6, at 8), "Proxy Contests" (Ex. 5, at 9; Ex. 6, at 8), "Commodities" (Ex. 5, at 9; Ex. 6, at 9), "Futures Contracts" (Ex. 7, at 18-19), and "Forward Trading" (Ex. 7, at 19). On the other hand, there is *no* warning about the largest risk that Merkin took in his management of Ascot, and the one that ultimately caused Ascot to be a total loss to Merkin's investors: entrusting a single third-party manager with custody and trading discretion for the entire capital of the fund. As discussed in detail below, Merkin knew, or was reckless in not knowing, that this risk was more than theoretical.

47. Only beginning with the March 2006 Offering Memorandum did Merkin mention the name Madoff at all—and there, he mischaracterized Madoff’s role, stating that Madoff was one of Ascot’s two prime brokers and suggesting that Ascot traded using an even larger number of brokers: “Morgan Stanley & Co., Inc. and Bernard L. Madoff Investment Securities, LLC . . . currently serve as the principal prime brokers and custodians for the Partnership, and clear . . . the Partnership’s securities transactions that are effected through *other* brokerage firms.” (Ex. 7, at 8, 28 (emphasis added).) In fact, in 2006, approximately 98% of Ascot’s transactions were both effected and cleared by Madoff, and Madoff had custody of over 99% of Ascot’s purported securities holdings.

48. Further, Merkin misrepresented the role of Morgan Stanley & Co. by referring to it as Ascot’s “principal prime broker.” From at least 1999 through 2008, Madoff, not Morgan Stanley, held virtually all securities purportedly acquired by Ascot. The account statements for Ascot’s Morgan Stanley accounts show that Morgan Stanley’s role was almost entirely limited to acting as a bank to transfer cash between Ascot and investors, and between Ascot and Madoff’s Chase Manhattan Bank account. By asking investors to wire their funds to the Morgan Stanley account, and describing Morgan Stanley as a prime broker, Merkin further concealed Madoff’s role in Ascot, and misleadingly gave comfort to investors by claiming that some or all of Ascot’s assets were held at a major brokerage firm.

49. When asked during testimony before the Attorney General whether the Ascot Memoranda disclosed Madoff’s role in Ascot, Merkin pointed to the 2006 disclosure that Madoff was one of Ascot’s two principal prime brokers, but strained to explain how that disclosure was adequate:

Q. . . . the disclosure of your affiliation and relationship with Mr. Madoff. Where is that disclosure?

...

A. I'm not sure what page to go to or what section to go to, but there's a discussion of Bernie and a discussion of Bernie playing a role of prime broker in the Ascot document.

Q. And is there a discussion of . . . the relationship you have with Bernie where he is doing the six to eight trades a year . . . ?

A. I'm sure the six to eight trades is not in the document. I'm sure the basic strategy, that is the split strike . . . , whether in those words or other words are in the document.

....

Q. Describing Mr. Madoff as a prime broker wouldn't fully describe the relationship you had with him, that Ascot had with Mr. Madoff; is that fair?

A. I'm not sure. Describing Mr. Madoff as the prime broker would certainly convey some sense that the accounts were custodied there or could be custodied there which I would think of as a fairly important risk factor.

Q. Mr. Madoff, his trading was absolutely central to what Ascot did; is that fair?

A. Yes.

(Ex. 1, at 166:19-168:15.)

50. In a PowerPoint document used in making presentations to potential investors, Merkin described Ascot as having "Actively Managed Strategies," but nowhere in the document is Madoff's role in Ascot disclosed. In contrast, with respect to Merkin's other investment vehicles, a "strategic relationship with Cerberus" is disclosed. (Ex. 8, at 42269.)

51. As further described below, numerous investors viewed the identity of the manager of Ascot to be a material fact, and invested on the understanding that Merkin was the day-to-day manager. In addition to the affirmative misstatements listed above, the Ascot Memoranda were materially false and misleading in that they failed to disclose that virtually all Ascot funds were invested with, and at the discretion of, Madoff.

52. Ascot's quarterly statements to investors disclosed only the value of each investor's account and the purported appreciation during the prior quarter. (Ex. 9.) Annual financial statements for Ascot were sent to investors, but they listed only the Treasuries purportedly held by Ascot, without revealing that these were held in an account managed and held by Madoff. (Ex. 10, at 5.) Thus, none of the written materials sent to investors or prospective investors properly disclosed the fact that Ascot was a conduit to Madoff, and that Madoff had complete custody and control of Ascot's assets.

B. Merkin Concealed Madoff's Management of Ascot and Made Other False and Misleading Statements to Investors

1. Merkin Concealed Madoff's Role when Speaking to Investors

53. Many investors invested with Merkin because they knew him personally, through family, or through one of the non-profit organizations with which Merkin was affiliated. For example, Merkin's investors include five of the sixteen members of the Investment Committee of a non-profit organization ("Non-Profit Organization A") which he chaired. Many individual investors who did not know Merkin personally visited his offices at 450 Park Avenue before making any investment in order to meet him and familiarize themselves with his business. Institutions that invested with Merkin often asked him to make presentations concerning his funds both before they invested and periodically afterwards. Based on their personal interactions and experience with Merkin, investors incorrectly believed Merkin was protecting their assets. Merkin's personal representations in these meetings and conversations were material and false.

54. Merkin acknowledged in his testimony that he generally would not volunteer the information that Ascot was a Madoff feeder fund. He claimed he would disclose this fact if asked, however:

Q. Did you take steps to conceal your relationship with Mr. Madoff? . . . Like not telling them that Ascot is affiliated with Mr. Madoff.

A. I did not have a policy of not disclosing a relationship with Mr. Madoff I certainly had a policy of answering all questions about Ascot as fully as I possibly could. . . . There were investors who may not have gotten to ask questions

(Ex. 1, at 171:17-172:12.)

55. In fact, not only did Merkin generally fail to disclose Madoff's role, but he also led investors to believe that he, with the help of his staff, personally managed Ascot's assets on a day-to-day basis. If investors asked who carried out Ascot's trading activity, Merkin would sometimes deceive them by explicitly indicating that he and his employees at the 450 Park Avenue office did so. Merkin told one investor ("Investor B") that his staff "right here" was doing the trading, and pointed to the trading area outside a glass partition in Merkin's office. Similarly, when a representative of a non-profit organization ("Non-Profit Organization B") met with Merkin prior to an investment in Ascot in 2006, Merkin falsely answered the question with words to the effect that "it's all done by them," pointing towards two employees visible through the glass partition. The traders seated in this area, however, were involved only in managing Ariel's and Gabriel's assets, not Ascot's, and Ascot's trading was almost entirely carried out by Madoff.

56. When an investor explicitly asked about Madoff's role, Merkin or his employees would regularly deny that Ascot was managed by Madoff, or minimize Madoff's role. For example:

- In approximately 2007, Merkin told two investors ("Investor C" and "Investor D"), during a meeting they requested after hearing rumors that Madoff managed Ascot, that all but an insubstantial portion of Ascot was managed directly by Merkin and that he had not given Madoff any Ascot assets to invest.

- In 2005, an investor (“Investor E”) was told by an employee at another hedge fund that Ascot’s assets were invested with a third party, Madoff. Investor E had never heard of Madoff. When he asked Merkin about this, Merkin acknowledged that when Ascot started, it was managed by Madoff, but told Investor E that Merkin and his staff learned what Madoff did, and were now able to produce the results without Madoff. Merkin claimed that while a small amount was still being managed by Madoff, all the rest of Ascot was being managed in-house by Merkin and his staff.
- A member of the Investment Committee of a non-profit organization (“Non-Profit Organization C”) noticed that Ascot’s returns were similar to those reported by another hedge fund that was widely known to be a feeder to Madoff. After being told by a Merkin employee that Ascot assets were “held” at Madoff’s firm and that Madoff had some management role, the committee member directly asked Merkin if he was investing Ascot funds with Madoff. Merkin responded that he was not, but that Ascot used a strategy similar to Madoff’s.
- An investor (“Investor F”) who invested in Ascot in approximately 1997 was also a direct investor with Madoff. Investor F invested in Ascot without knowing that he was simply placing more money with the same manager—and, in doing so, paying an unnecessary management fee to Merkin. In early 2008, Investor F heard from a third party that Ascot was engaging in the same strategy as Madoff. He called his contact at GCC, the chief financial officer, and asked him if this is what Ascot was doing. The CFO told him, falsely, “we’re not doing the same thing as Madoff.”
- Investor B and a business associate met with Merkin in November 2008. Merkin told Investor B that his analysts and staff were doing the investing for Ascot. The business associate, upon hearing Merkin’s description of the Ascot trading strategy, told Merkin that it sounded like Madoff’s strategy. Merkin replied that he had family money with Madoff, but did not disclose that Ascot itself was managed by Madoff. Merkin also misleadingly told Investor B that Madoff was only a “clearing broker” for Ascot.

57. Merkin at times concealed the fact that Ascot engaged in the “split strike conversion” strategy by misrepresenting Ascot’s investment strategy as well as its management.

For example:

- An investor (“Investor G”) met with Merkin in approximately 2001 to discuss investments by his family in Merkin’s funds. Merkin falsely told Investor G that both Ascot and Gabriel invested in distressed debt. Since Investor G was seeking to make diversified investments, he asked Merkin why there were two separate funds. Merkin stated that Ascot had a slower, less volatile, strategy. Merkin did not mention Madoff, and Investor G never heard Madoff’s name until after Madoff’s arrest. Investor G and his family invested in both funds.

- Merkin falsely told another investor (“Investor H”) that Ascot was not invested directly in equities but was a hedge against the volatility of equities, and that Ascot invested in distressed securities.

58. The full panoply of lies and misrepresentations that Merkin used to convince investors to invest in Ascot was on display at a November 14, 2006 meeting of the finance committee of Non-Profit Organization B, at which Merkin made a presentation concerning Ascot. The minutes of this meeting (Ex. 11), recorded by an investment professional who advised the organization, reflected a number of Merkin’s false statements, including the following:

- “Ezra explained that he tries to exploit short-term pricing discrepancies in the options market. Proprietary, computer driven models guide him and his team” But neither Merkin nor any “team” of his was involved in Ascot’s trading, and Merkin did not have any “computer-driven” models relating to Ascot’s strategy.
- “About 15% of the fund utilizes longer duration options (‘Leaps’) which he trades through Bernie Madoff.” In his testimony before the Attorney General, Merkin admitted that “we were not doing any Leaps traded through Bernie Madoff.” (Ex. 1, at 192:15-17.)
- “Ezra noted that up to 60% of Ascot’s assets come from his personal family trusts.” In his testimony, Merkin admitted “nothing like 60 percent of Ascot’s total assets” came from those trusts. (Ex. 1, at 191:11-12.)
- “[A]sked why this [strategy] is not exploited by other banks and managers[,] Ezra replied that the strategy is not scaleable.” But Merkin knew that Madoff purported to exploit the strategy on a far larger scale than just Ascot’s assets.

59. The reactions of Ascot investors to the news that Ascot had been almost entirely invested with Madoff illustrate how completely in the dark Merkin had kept them. After Madoff’s arrest, Merkin received several emails from worried investors who, having heard rumors of a connection between Madoff and Ascot, asked if they had any Madoff exposure. (Ex. 12.) After Merkin informed investors that Ascot was entirely invested with Madoff, he received many emails expressing shock and anger at his dishonesty. One such email read: “We never

knew that . . . ASCOT FUND was not [itself] investing its money [but] giving it to third-party people to invest.” (Ex. 13.) Another wrote “Are you serious? Why was Ascot trading with one fund?” (Ex. 14.) Another investor, a personal friend of Merkin’s, at first could not believe that Merkin had deceived him concerning who was managing Ascot. He wrote on December 14, 2008, “It would be dishonest of me to hide our deep sense of shock, disappointment and frustration in you and your fund but we cannot accept the basis of the claims that are being bandied about”—claims that Merkin was “at best a charlatan.” (Ex. 15.) But after speaking with Merkin on the phone, this investor took a different view of him, writing on January 7, 2009: “[Y]ou took substantial management fees when you were not managing the funds; you were nothing more than a glorified mailbox who took upside payments when there simply wasn’t any upside.” (*Id.*)

2. *Merkin Made Misrepresentations Concerning the Safety of Ascot*

60. Merkin made false and misleading statements to investors to foster the impression that Ascot’s funds were held with a sound, creditworthy broker. After the failure of Bear Stearns in early 2008, a member of the Investment Committee of Non-Profit Organization A, concerned about the potential loss of Ascot assets, asked Merkin about counterparty risk. Merkin falsely told the committee member that Morgan Stanley held Ascot’s assets. Similarly, when a representative of a non-profit organization (“Non-Profit Organization D”), just after the collapse of Lehman Brothers in September 2008, asked in an email about counterparty risk that Ascot and Ariel might be exposed to, a GCC employee falsely responded that “We try to maintain multiple banking and brokerage relationships which allows for flexibility during times of market turmoil.” (Ex. 16.) In fact, Ascot had only one brokerage relationship, with Madoff. The employee also stated, falsely, that “We . . . monitor the creditworthiness of each counter party we deal with.” (*Id.*)

61. A few of Merkin's investors were aware that Ascot was a conduit to Madoff. But Merkin misled at least some of these investors too, falsely telling at least three of them that although Madoff made the trading decisions, the assets of the fund were held in a Morgan Stanley account controlled by Ascot. This made sense to these investors because investors in Ascot were instructed to wire their funds to a Morgan Stanley account in Ascot's name, and redemptions were made from that account. In fact, Madoff had custody of virtually all of Ascot's assets, and Morgan Stanley, for the most part, served only as a conduit to transfer cash between investors and Madoff. Merkin's misrepresentations concerning custody of the assets were highly material because, without a third-party custodian, there could be no independent verification of Madoff's trading activity, substantially increasing the risk of fraud.

62. An investment company ("Investor I") made an investment in Ascot in 2002 based on Merkin's assurance that the Ascot assets were held in a Morgan Stanley account rather than by Madoff. (This investment was withdrawn for reasons unrelated to Madoff in 2005.) Investor I's principal, based on this understanding, recommended Ascot to a non-profit organization ("Non-Profit Organization E"). Similarly, Merkin falsely told the managers of another investment company ("Investor J") that when Madoff was out of the equities market, Ascot's cash was held in a Morgan Stanley account controlled by Merkin. (Ex. 17, at 1, 3.) Investor J's principals also served as advisors to the Investment Committee of Non-Profit Organization A, and relied on this misinformation when they advised Non-Profit Organization A to maintain its investment in Ascot. Merkin also falsely told Investor J in 2005 that there had been a time when Merkin himself managed a significant portion of Ascot's assets and that only more recently had Madoff begun to execute "a majority" of the trades.

63. Merkin told an investor (“Investor K”) that Merkin required Ascot’s auditor, BDO, to visit Madoff’s offices two or three times a year to perform standard operational due diligence. The manager took comfort in this fact. However, this representation was false. BDO did not perform standard operational due diligence, or any other kind of examination, on Madoff’s operation, and Merkin had no reason to believe otherwise.

3. Merkin Made Misrepresentations Concerning the 2003 Increase in Ascot Fees

64. In 2002, Merkin decided to raise the management fee he received from Ascot, as of January 1, 2003, from 1% to 1.5% (a difference of \$5.3 million per year based on the \$1.06 billion under management in 2003). This change required investor approval. To obtain approval, Merkin gave different justifications to different investors, and made false or misleading statements to justify the increase. In a letter to investors seeking approval of the increase, Merkin vaguely cited “rising expenses.” (Ex. 18, at 2.) This misrepresentation perpetuated and reinforced Merkin’s falsehood that he was doing work related to the management of the Ascot assets. In testimony before the Attorney General, Merkin similarly claimed that the fee increase was due to increased general operating costs, but could not give specifics:

Q. What was the specific cost that went up?

A. I’m not sure of the specific cost. Broadly speaking, it was the back office cost of monitoring the portfolio, constructing a P and L, watching the strategy, and communicating with investors. I can’t remember off the top of my head what was covered or not so I don’t want to say for sure.

(Ex. 1, at 161:13-22.) Because Merkin did not actually manage Ascot, there were no Ascot expenses that would have remotely justified a fee increase of this magnitude.

65. When Merkin discussed the fee increase at a meeting of the Investment Committee of Non-Profit Organization A, Merkin justified it by falsely claiming Ascot was

going to trade long-term equity options (“LEAPS”), which he said would require \$20 million in new software and hardware. (Ex. 19, at 5.) However, Ascot did not use software to carry out its trading strategy: Ascot simply turned over investors’ assets to Madoff.

III. THE ARIEL AND GABRIEL FUNDS

66. Merkin created Ariel Fund Limited and Gabriel Capital, L.P. (known at first as Ariel Capital, L.P.) in 1988. Gabriel, a Delaware limited partnership, is a domestic fund for U.S. investors, while Ariel, an offshore fund incorporated in the Cayman Islands, is a separate but parallel fund for foreign investors and others, including non-profit organizations, not subject to certain U.S. taxes. As of the end of the third quarter of 2008, Gabriel had nearly 200 investors with a total of \$1.4 billion under management, while Ariel had some 78 investors with a total of \$1.3 billion under management.

67. Merkin caused investors in Ariel and Gabriel to believe, based on the offering materials, quarterly statements, and other statements by Merkin and his employees, that Ariel and Gabriel were hedge funds whose assets were managed principally by Merkin and his employees. In fact, Merkin turned Ariel’s and Gabriel’s assets over to several other fund managers, including Madoff, who made all investment decisions. As of June 1, 2008, over 95% of Gabriel’s assets were managed by outside money managers.

68. The fact that a significant portion of Ariel and Gabriel’s assets were invested with Madoff was completely hidden from their investors, who believed that Ariel and Gabriel focused exclusively on investments in distressed debt and companies involved in bankruptcy or some other kind of restructuring such as a merger or a spinoff. During the course of its investigation, the office of the Attorney General interviewed half of the U.S. investors of Ariel and Gabriel. Of those interviewed, only one knew of the Madoff investment.

69. Merkin's compensation under his agreements with Ariel and Gabriel included an annual management fee of 1% of assets under management, and an incentive fee of 20% of any profits. From 1989 to 2007, Merkin's fees from Gabriel totaled approximately \$277 million, and from Ariel, \$242 million. The incentive fee Merkin collected included 20% of the profits reported by Madoff, which, of course, were fictitious. Even after subtracting expenses and fees paid to other outside managers, Merkin's fees for Ariel and Gabriel totaled more than \$280 million. Apparently for tax reasons, Merkin elected to defer all fees payable from the offshore Ariel fund, and paid all Gabriel and Ariel expenses out of his Gabriel fees. As of the end of 2008, Merkin's deferred fee account with Ariel had a stated value of approximately \$169 million.

70. From the time Merkin created Ariel and Gabriel in 1988, he occupied himself primarily with raising money for the funds using his extensive social and professional network, relying on third parties to actually manage the investment activity. For the first decade, his primary money manager was Victor Teicher ("Teicher") who, through his management company Victor Teicher & Co ("VTC"), ran three hedge funds specializing in merger arbitrage.

71. Since 1985, Merkin had fostered a relationship with Teicher whereby Merkin found investors for Teicher's funds, working from Teicher's offices. In July 1986, the *Wall Street Journal* reported that Teicher was under investigation for theft of information and insider trading concerning corporate takeovers in connection with Teicher's "merger arbitrage" investments, the very type of investments that Teicher continued to engage in as he began accepting money from investors introduced to him by Merkin. Merkin continued to raise money for Teicher, but insisted that Teicher's name be removed from the office door, and that the phones be answered without using the Teicher name.

72. When Merkin created Ariel and Gabriel in 1988, Merkin had Teicher manage the funds in tandem with Teicher's own funds and investments, paying Teicher half of the incentive fees Merkin received. Merkin himself had no employees, and Teicher's analysts and traders handled all aspects of Ariel's and Gabriel's investment activity. Teicher and his employees viewed Merkin as an investor, not a fund manager.

73. In late 1988, Teicher was indicted for insider trading. He was tried and convicted in 1990, and after his appeal was denied in 1993, was sentenced to sixteen months in prison, which he began serving in January 1994. While in prison, Teicher was permitted to make unlimited numbers of 15-minute phone calls and in that way continued to give advice concerning the management of Ariel's and Gabriel's assets.

74. Upon Teicher's release in 1995, Merkin stopped using Teicher's services, and hired several of Teicher's analysts and traders. However, in Teicher's absence, Ariel and Gabriel did poorly. After a particularly disastrous performance in 1998, Merkin decided to unload a large portion of the assets that had been acquired in Teicher's absence, and re-engaged Teicher to oversee that project. Merkin agreed to pay Teicher guaranteed compensation of \$1 million per year plus an incentive fee, and gave Teicher responsibility for hiring, firing, and compensating GCC employees, as well as managing the portfolio. (Ex. 20.) In the words of one of Merkin's employees ("Employee A"), "Mr. Teicher took over everything that was going on at 450 Park." (Ex. 21, at 100:5-6)

75. In testimony before the Attorney General, Merkin flatly denied that Teicher performed any services for GCC after the SEC ordered Teicher barred from the industry:

Q. Did Mr. Tiecher [sic] perform any services for Gabriel after the issuance of [the SEC] order?

A. No.

Q. Did he perform any services for Gabriel unofficially?

- A. What does that mean?
- Q. Meaning not working out through your offices but working in some other capacity.
- A. No.

(Ex. 1, at 203:23-204:9.) In truth, however, Teicher did not stop working for Merkin until January of 2000, when an SEC bar from the industry became effective. In 2002, Merkin decided to completely wind down the portfolio that was managed in-house, a process that continues to this day, and began turning over nearly all new money from investors to third-party managers.

76. Since the early 1990s, Merkin had relied on outside managers besides Teicher to manage some portion of the Ariel and Gabriel assets. From 1990 to 1992, he gave a significant portion of the assets to Madoff to manage. In 1993, after creating Ascot as a feeder fund to Madoff, Merkin temporarily discontinued placing Ariel and Gabriel assets with Madoff, and entered into an agreement with Cerberus Capital Management (“Cerberus”) under which Cerberus would manage a large portion of Ariel’s and Gabriel’s funds (the “Cerberus Account”). The Cerberus Account exists to this day, and in recent years, has held the majority of Ariel’s and Gabriel’s assets. (Ex. 22, at 1.) All due diligence, research, and trading decisions for the Cerberus Account were made by Cerberus with little input from Merkin other than occasional conversations between Merkin and the principals of Cerberus. Cerberus also incurred millions of dollars in legal fees and other expenses in managing assets in the Cerberus Account, which Merkin reimbursed from Ariel’s and Gabriel’s assets. (*Id.* at 3.)

77. Upon Teicher’s final departure in 2000, Merkin again turned to Madoff to manage a significant portion of Ariel’s and Gabriel’s assets, notwithstanding that Madoff’s ostensible strategy had nothing to do with the stated strategy for Ariel and Gabriel set forth in offering documents and quarterly reports to investors. By mid-2002, fully one-third of Ariel’s \$385,703,794 portfolio was invested with Madoff (\$125,089,730), and 48% with Cerberus

(\$203,947,900). In 2002, Merkin also opened a managed account with fund manager Cohanzick Capital, L.P. (“Cohanzick”), which partially moved into Merkin’s offices.

78. As of the end of 2002, over 80% of Ariel’s and Gabriel’s assets were managed by Cerberus, Madoff, and Cohanzick, and by mid-2008, over 95% were so managed. The remaining assets were those acquired prior to 2001 that were still being disposed of, a process now in the hands of Employee A—who, by the end of 2003, was the only investment professional employed full-time by Merkin. No traders worked for Merkin or GCC, and another analyst ostensibly employed by GCC was shared with Cohanzick.

79. Thus, Merkin’s role was primarily to market his funds to investors and determine how to allocate any new funds invested among the three active managers. The following table, showing the portion of Gabriel’s assets allocated to Madoff, Cerberus, and Cohanzick shows how the allocation evolved from just before Teicher’s departure to the middle of 2008:

Gabriel Capital, L.P. – Allocation of Assets to Outside Managers

Date	Total Equity (Long Value)	Madoff	Cerberus	Cohanzick
12/31/1999	\$ 511,724,236.00*	0.00%	59.76%	0.00%
12/31/2000	\$ 570,329,021.00*	7.07%	50.38%	0.00%
12/31/2001	\$ 557,227,424.41	19.80%	45.25%	0.00%
12/31/2002	\$ 436,242,850.00	28.86%	48.06%	6.48%
12/31/2003	\$ 411,137,294.00	21.12%	49.06%	12.32%
12/31/2004	\$ 539,435,221.00	19.54%	59.44%	13.04%
12/31/2005	\$ 807,665,702.77	15.52%	59.58%	11.65%
12/31/2006	\$ 1,218,533,653.00	22.73%	56.56%	7.61%
12/31/2007	\$ 1,580,044,307.00	21.30%	61.72%	7.16%
6/1/2008	\$ 1,210,858,522.27	24.65%	62.59%	7.79%

*Net long and short value

80. Merkin’s incentive to invest Ariel and Gabriel funds with Madoff is clear from the compensation arrangements he had with the other managers: of the outside managers he used, Madoff was the cheapest, since Madoff charged no management fee or incentive fee, and simply took a \$0.04 per share brokerage commission already built into the reported stock and option prices for Madoff’s trades. Thus, on the Madoff portion of the portfolio, for doing almost

nothing, Merkin could keep his full 20% incentive fee in addition to the 1% management fee—a much better deal for Merkin even than Ascot, where he took only a 1% to 1.5% management fee. In contrast, Cerberus charged Merkin an annual management fee of 1% for the assets it managed, plus an annual incentive fee of 9% of profits. Cohanzick received an annual management fee of 1% plus an incentive fee of 10% less the current money market return. Thus, the assets given to Cerberus yielded Merkin only an 11% incentive fee after paying Cerberus’s 9% fee, and Cohanzick even less.

81. Merkin also increased his fees by double dipping: Ariel invested \$1.6 million in Ascot, permitting Merkin to earn a fee on this sum both from Ariel (which paid both a 1% management and a 20% incentive fee) and from Ascot (which paid an additional 1.5% management fee).

A. The Offering Memoranda for Ariel and Gabriel Were False and Misleading

82. Ariel and Gabriel offered participation to qualified investors primarily through prospectuses or “Confidential Offering Memoranda.” These offering documents were false and misleading because they included statements inconsistent with the fact that Madoff managed and had custody of a significant portion of Ariel’s and Gabriel’s assets. In particular, the documents stated, in effect, that Ariel did not use any self-clearing money managers when, in fact, Madoff managed, executed, and had custody of up to a third of Ariel’s assets.

83. The November 2002 Prospectus of Ariel stated:

The Investment Advisor selects brokers to effect transactions for the Fund which receive commissions in connection with the brokerage services, including clearing and settling functions, provided to the Fund. *Such brokers will not perform managerial or policy-making functions for the Fund.*

(Ex. 23, at 18 (emphasis added); *see also* Ex. 24, at 16; Ex. 25, at 18.) In fact, Madoff effected, cleared, and settled a substantial portion of the transactions for the fund, and also managed those funds.

84. The March 2006 Confidential Offering Memorandum for Ariel stated:

Morgan Stanley & Co., Inc. (the “Prime Broker”) currently serves as the principal prime broker for the Fund, *and clears . . . the Fund’s securities transactions that are effected through other brokerage firms. The Prime Broker also acts as custodian of the Fund’s securities.*

(Ex. 26, at 44 (emphasis added); *see also* Ex. 27, at 32.) However, Morgan Stanley was *not* the custodian for the securities managed by Madoff, and did not clear Madoff’s trades.

85. These misstatements were material, among other reasons, because they concealed Madoff’s role and the fact that Madoff was self-clearing, which substantially increased the risk of fraud.

B. Merkin’s Quarterly Statements and Investor Presentations Were False and Misleading

86. At the end of each quarter, Merkin sent Ariel and Gabriel investors a lengthy report, in the form of a letter, that discussed the overall state of the markets and the performance of Ariel and Gabriel. Because Ariel and Gabriel had similar portfolios, the text of Merkin’s reports was the same for both funds. These reports described the investment strategies Merkin purportedly used for Ariel and Gabriel in greater detail than the offering memoranda, and made specific representations about the allocations of the funds’ assets among those strategies. Merkin also distributed past quarterly reports to prospective investors for marketing purposes.

87. The quarterly reports were deceptive because they persistently gave investors the impression that Merkin and his staff were directly managing Ariel’s and Gabriel’s portfolios, when in fact they managed very little of them. Cerberus and Madoff are not mentioned:

Madoff's name never appears, and Cerberus's name rarely and only in passing. The reports, signed by Merkin and printed on Gabriel Capital Group stationery, consistently use the first person to describe investment strategy and decisions:

- The April 22, 2004 report stated: "Having spoken of our general location in the parking lot, we would like to give you a glance at a couple of the spots in which we have parked recently." (Ex. 28, at 4.) It concluded, "We want our [investors] to have a sense of . . .the approach we take to investing, and how we try to control risk. . . .The last thing we want is for you to park a Lexus in the morning and leave in the evening with a Ford Focus." (*Id.* at 6.)
- The July 20, 2005 report stated: "We are particularly enthusiastic about some large positions that we put on at the end of the first quarter. Thus far, they have contributed nothing to our profitability. . . .We have every reason to hope that the new positions will drive the results for a good quarter (or quarters) down the road, at which point we will take a brief bow and immediately resume searching for additional opportunities." (Ex. 29, at 6.)
- The January 20, 2007 report stated: "Our effort has been to migrate from increasingly efficient markets to our private positions, where we enjoy both much more complete information about our investments and, thanks to our sourcing network, much less competition for our ideas. There, we have worked diligently to establish a reputation for creativity and reliability, which further enhances the access to ideas conferred by our sourcing advantage." (Ex. 30, at 6.)
- The October 20, 2008 report stated: "Our favorite hedge is to sell some of a position and thereby reduce risk. We prefer that to finding and selling a vaguely corresponding short that increases the aggregate broad exposure of the fund while weakening the power of an idea." (Ex. 31, at 6.)

These lengthy letters were clearly designed to convey that Merkin was actively, deeply, and intensely managing the funds, and in a long-term conservative manner. Merkin thus engaged in a persistent fraud on Ariel/Gabriel's investors.

88. All of the strategies described in the reports related to Ariel's and Gabriel's purported strategy of investing in businesses that were distressed or involved in some kind of reorganization. More recent reports stated that Merkin was moving towards private deals that were less liquid, such as Merkin's participation with other investors in the acquisition of a controlling stake in GMAC. In his quarterly report dated October 20, 2006, Merkin wrote:

[W]e have built our firm to establish an edge in sourcing, analyzing, negotiating, structuring, drafting, and closing deals. As these letters have emphasized for some years now, we have migrated from an emphasis on distressed investing and merger arbitrage into more of a deal shop, placing special emphasis on our private, illiquid positions.

(Ex. 32, at 5.)

89. In recent years, the reports increasingly detailed the allocation of Ariel's and Gabriel's assets among various categories of investment strategy. None of the strategies resembled Madoff's "split strike conversion" strategy, and they were wholly inconsistent with any short-term trading strategy involving S & P 100 companies. These statements were, therefore, misleading. In January 2001, for example, Merkin stated that the portfolio consisted of "approximately 60% distressed positions and 40% [merger] arbitrage." (Ex. 33, at 1.) This statement was false since, at that time, approximately 20% of the portfolios were invested with Madoff. In April 2005, Merkin introduced greater detail by describing his investment strategy for Ariel/Gabriel as "a tapestry of six threads of different colors, each representing one of the full range of debt-related asset classes in our repertoire." (Ex. 34, at 2.) The six "threads" were described as (a) "'dented' high-yield bonds"; (b) "public distressed names"; (c) "asset-based lending"; (d) "'private' distressed" debt; (e) "private equity, usually with a distressed flavor"; and (f) "U.S. distressed credits *sourced* in Japan." (*Id.* at 3-4.) A Merkin employee who assisted Merkin in drafting the quarterly reports ("Employee B"), testified that none of these "threads" described the Madoff component of Ariel's and Gabriel's portfolio:

Q. As of April '05, would you have been able to classify the Madoff components in one of these six threads?

A. My understanding of what these threads were meant to represent is that these were active investment strategies in which the fund participated, which is not the case with respect to the money that was entrusted to Mr. Madoff.

(Ex. 35, at 75:21-76:5.) Employee B also admitted that he knew of no investor materials that made such a distinction between “active investment strategies” and money “entrusted” to others. The April 2005 report itself makes clear that the tapestry metaphor was intended to encompass the entire Ariel and Gabriel portfolio. In introducing the tapestry metaphor, Merkin wrote that “we would like to provide a more detailed outline of our evolving portfolio” and stated that “We regularly update our view of how much capital . . . should be allocated among the threads” (Ex. 34, at 2-3.)

90. From at least 2005, Merkin used a PowerPoint presentation describing all three of the funds he managed when he made marketing presentations to potential investors. The presentation was updated at least once per year. In this presentation, Merkin used the tapestry metaphor to describe Ariel’s and Gabriel’s portfolios. (Ex. 8, at 0042272.) This metaphor and the accompanying diagram were misleading because they concealed the fact that a significant portion of Ariel’s and Gabriel’s portfolios were invested with Madoff. In contrast to this description of Ariel and Gabriel, the document describes Ascot’s strategy as “Options Arbitrage,” a description consistent with Madoff’s strategy. (*Id.* at 0042269.) No part of Ariel or Gabriel’s portfolio is described in the document as “Options Arbitrage,” even though up to 33% of each had been invested with Madoff at various times.

91. Starting in 2004, Merkin provided a detailed table in each quarterly report and in his PowerPoint presentations showing the precise percent distribution of Ariel’s and Gabriel’s assets among seven categories: “Distressed Debt,” “Debt or Equity Subject to a Deal or Legal Process,” “Arbitrage of Related Securities,” “Long-term Equity,” “Credit Opportunities,” “Short Securities Outright and Portfolio Hedges,” and “Cash (Including Proceeds From Short Sales).” (Ex. 36, at 1.) The percentages reported always added up to 100% and thus purported to fully

describe the portfolios. Accompanying the reports was an Appendix defining each of these categories. Each of the categories, with the exception of “Cash,” was expressly tied to the general strategy of investing in distressed companies or companies subject to some kind of reorganization, and none of the categories is consistent with Madoff’s tactical short-term trading strategy. (*Id.* at 10.) In fact, some twenty to thirty percent of the funds were invested with Madoff from 2006 on. Merkin’s precise allocations were therefore fraudulent because they failed to disclose, and in fact concealed, this Madoff exposure.

92. In testimony taken by the Attorney General, Merkin claimed not to know which of the seven categories used in his quarterly letters included the Madoff investment, and stated that he “wouldn’t think” that it would be included in the “cash” category. (Ex. 1, at 212:14-19.) He continued “I would have thought it was an ‘arbitrage of related securities.’” (*Id.* at 212:23-24.) GCC’s chief financial officer confirmed this, stating in his testimony before the Attorney General that “[t]he capital allocated to the Madoff accounts” had been allocated as “arbitrage of related securities” from the time that the tabulation had been introduced. (Ex. 37, at 200:17-18, 202:9-15.)

93. But the Madoff investment could not be classified as “arbitrage of related securities,” because Merkin defined that category as follows:

[T]here are opportunities for *Arbitrage of Related Securities*. This happens when securities that the [bankruptcy] reorganization plan brings into existence are available to trade. The package of securities may include senior secured debt, senior subordinated debt, new mezzanine debt, junior debt, preferred stock, and common stock. At this stage, one can hold the original debt while shorting fully valued or unattractive components of the package, or perhaps acquire a new long position while doing internal hedging.

(Ex. 36, at 10.) Thus, by Merkin’s own definition, “arbitrage of related securities” involved securities of bankrupt companies. Such a category has no resemblance to Madoff’s stated

strategy of investing in the stocks of S & P 100 companies and options on the Index. Asked whether this paragraph accurately describes Madoff's strategy, GCC's chief financial officer admitted in his testimony that "[i]t doesn't seem to." (Ex. 37, at 202:6.) Employee B also admitted in testimony before the Attorney General that "arbitrage of related securities," as defined in the reports, did not accurately describe the assets held at Madoff or Madoff's trading strategy:

Q. Again, it's your understanding . . . today that the Madoff component was included in 'arbitrage of related securities?'

A. That's my understanding today.

. . . .

Q. '[A]rbitrage of related securities,' as described here, relates to companies that are at least in serious trouble, if not actually in bankruptcy, and probably in bankruptcy; is that right?

A. That's what it appears to say.

Q. That is not the type of equities that Madoff used in his options arbitrage strategy; is that correct?

A. My understanding is that your statement is correct.

(Ex. 35, at 101:16-20, 105:3-13.)

94. After Madoff's arrest on December 11, 2008, Merkin was forced to reveal to Ariel and Gabriel investors that the funds had significant Madoff exposure. Investors promptly flooded Merkin with phone calls and emails expressing their shock and anger at the deceptive quarterly statements, and other misrepresentations made by Merkin. An investor wrote: "Please inform us since when ARIEL FUND invested with MADOFF 27% of its capital? ARIEL FUND invests in DISTRESSED securities. What MADDOF [sic] has to do with DISTRESSED DEBT?" (Ex. 38.) Another wrote "Gabriel Capital-is ALSO affected by Madoff?" (Ex. 39.)

95. Some of Merkin's own investment professionals did not know that a significant portion of Ariel and Gabriel were invested with Madoff. Employee A, for example, did not find out until after Madoff's arrest:

Q. So when exactly did you find out that Ariel and Gabriel did have an investment with Mr. Madoff?

A. I'm not sure.

Q. How did you find out?

A. Okay, I'm sure that I found out subsequent, right after December 11th.

....

[Counsel]: This is in 2008?

THE WITNESS: In 2008, yes.

....

Q. Were you surprised?

A. Shocked.

(Ex. 21, at 120:21-121:12.)

96. In contradiction to Merkin's sworn testimony, Merkin told several investors after Madoff's arrest that the sums managed by Madoff were reflected in what had been referred to as "cash" in Merkin's quarterly letters or that he had used Madoff as a "cash management" tool. But including the Madoff funds in the "cash" category is as inappropriate and misleading as putting it in the "arbitrage of related securities" category. Funds invested with Madoff were purportedly subject to his "split strike conversion" strategy. Madoff ostensibly exited the equities market at the end of each quarter and placed the proceeds into Treasuries, whereas a bona fide cash position would be available for use at the discretion of Ariel or Gabriel, or distribution to investors. Merkin could not have believed that cash invested with Madoff was available at Ariel's discretion for further use. Madoff told investors that he would be out of the

market “intermittently,” and therefore Merkin understood that Madoff’s position in Treasuries at, among other times, the end of each quarter, was a fleeting one.

97. By investing “cash” with Madoff, and adding Madoff’s purported double-digit returns on the “cash” to the overall gains reported by Ariel/Gabriel, Merkin fraudulently exaggerated the performance of Ariel’s and Gabriel’s non-cash assets, while understated the risk taken by the funds. Investors would expect the “cash” portion of the portfolio to obtain annual returns close to prevailing money market rates, with near-zero risk to principal. Merkin knew that investors would attribute Madoff’s purported excess return to the non-cash, distressed debt and special situations portfolio, and thereby get an inflated view of its return. Merkin also understated the risk of an investment in Gabriel and Ariel by telling investors that a certain portion of the portfolio was invested as cash, when in fact it was invested in a purported “split strike” strategy. Indeed, in one of his quarterly letters, Merkin referred to Ariel’s and Gabriel’s cash position as a way of moderating risk:

Lately, and to a more pronounced extent in the most recent quarters, our traditional chart on the distribution of positions has shown a buildup of cash. That is not an accident. It is a statement of how much risk we are willing to take with your money. . . . To the extent we can control risk, we try to create circumstances where there won’t be a fire at all. . . . We will have been good fiduciaries for your capital, and that has a certain nobility of its own.

(Ex. 32, at 6.)

98. The misrepresentation that the sums invested with Madoff were “cash” was particularly useful to Merkin in years when his distressed debt and special situation portfolio did less well, since the purported Madoff returns served to raise the return and “smooth out” Ariel’s and Gabriel’s returns year over year. For example, in 2002, without the Madoff returns, the

Gabriel return for the year would have been only 1.15%. Merkin was able to claim a return of 3.62% since more than two-thirds of Gabriel's profits were attributable to Madoff that year.

99. The public invested in Ariel and Gabriel to benefit from the risks and rewards associated with investing in securities of distressed companies and companies undergoing reorganization. Merkin misled his investors by relying instead on Madoff and his "split strike conversion" strategy to generate a significant portion of the funds' returns. The investors were thus unaware of the nature of the investment they were actually making.

100. Ariel/Gabriel investors were provided with financial statements audited by BDO. These statements did not reveal that Ariel/Gabriel assets were being managed by Madoff pursuant to his "split strike conversion" strategy, since they reflected only a position in Treasuries. (Ex. 40, at 8.) Furthermore, because Merkin falsely represented that Madoff was a mere broker, the financial statements did not reveal that Madoff had custody of the Treasuries. Thus investors had no indication that Madoff was in any way involved with Ariel and Gabriel.

C. Merkin Made Additional False and Misleading Statements to Investors

101. Like Ascot investors, Ariel and Gabriel investors often met with Merkin at his offices to discuss the funds' strategy and performance. At these meetings, Merkin described the funds' investments as consisting of distressed debt and securities of companies subject to reorganization, and failed to disclose that a significant portion of the funds were invested with Madoff or according to a tactical "split strike conversion" trading strategy.

102. When investors expressed interest in both Ascot and Gabriel/Ariel, Merkin treated them as complementary funds with markedly different investment strategies, and did not disclose that as much as one-third of Gabriel was invested exactly the same way as Ascot:

- One investor ("Investor L") spoke to Merkin because he felt he had too much exposure to Ascot. Merkin convinced Investor L to move the funds into Gabriel, saying that the funds had completely different investment objectives. Merkin did

not mention Madoff's role in either Ascot or Gabriel, and Merkin did not disclose that a substantial portion of Gabriel was invested in exactly the same way as Ascot, and carried an additional incentive fee as well.

- An employee of Non-Profit Organization D met with Merkin in New York prior to investing in both Ascot and Ariel. An email from GCC to Non-Profit Organization D explained that Ariel and Ascot had “different risks and strategies.” (Ex. 41.) At the meeting, Merkin told Non-Profit Organization D that Ariel's strategy was event-driven and focused on private equity. Merkin did not mention Madoff or his “split strike conversion” trading strategy.
- An investor (“Investor M”) met with Merkin in late 2005 prior to making equal investments in Ascot and Gabriel. Merkin told Investor M that Gabriel invested in distressed securities and sought out “special situations” and “work outs.” He described Ascot as an “income fund” that held short-term instruments and some additional investments that increased the yield. Merkin did not mention Madoff in connection with either fund.
- An investor (“Investor N”) met with Merkin prior to making an investment in Gabriel and an investment half as large in Ascot. Merkin did not mention Madoff. Investor N had sought to invest in Cerberus but the fund was closed. Merkin told him that Gabriel invested “side by side” with Cerberus and that investing in Gabriel was the “next best thing” to investing in Cerberus.

103. In some cases, Merkin found out that investors had refused to invest with Madoff, or had withdrawn an investment from Madoff, because they were not comfortable with his lack of transparency and/or were suspicious of his consistently stellar reported returns. Merkin did not reveal to these investors that they were, in fact, already invested with Madoff through Ariel or Gabriel:

- A non-profit organization (“Non-Profit Organization F”) invested in Ariel. At a meeting with an employee of Non-Profit Organization F in October 2008, Merkin initiated a discussion of other possible investments that, in light of the turmoil in the markets at that time, had a good history of consistent positive results. Merkin recommended three possibilities: Madoff, Millennium Partners, and Spring Mountain Capital, L.P. In response to these recommendations, the employee told Merkin that Madoff was an inappropriate investment because Madoff cleared his own trades and had custody of any cash or securities invested with him. Merkin did not disclose that Non-Profit Organization F had already invested with Madoff through Ariel.
- As described below, Merkin did not disclose to a long-time Gabriel investor (“Investor O”), with whom Merkin sat on a charitable board, that 25% of

Gabriel's assets were invested with Madoff, notwithstanding that when Merkin on a number of occasions pointed out that many charities were doing very well by investing with Madoff, Investor O repeatedly told him that he did not trust Madoff.

- Merkin had lunch with a longtime Gabriel investor ("Investor P"), in the spring of 2008. Investor P understood that Gabriel invested primarily in the debt of companies in bankruptcy and similar distressed assets. Because Investor P had a large cash position, he and Merkin discussed a possible additional investment by Investor P in Gabriel. Merkin raised the possibility of investing with Madoff. Investor P told Merkin that because he was unable to understand how Madoff's strategy worked, he would never invest with him. Merkin did not disclose that Investor P was already invested with Madoff through Gabriel.

104. On at least one occasion, Merkin specifically denied Madoff's role in Ariel and Gabriel, representing to an Ariel investor, who like all others did not know that a substantial portion of Ariel's assets were invested with Madoff, that Ariel did not have a brokerage account with Madoff's firm. (Ex. 42.)

105. Some investors had, as part of a prudent strategy to limit risk, invested both in Ariel/Gabriel and directly with Madoff, believing that these were distinct and diverse investment strategies. For example, before investing in Gabriel, one investor ("Investor Q") was heavily invested with Madoff. After deciding to diversify, he approached Merkin for investment advice. Investor Q told Merkin that he wished to diversify away from his existing investment with Madoff. He and Merkin discussed a number of alternative investments, and Investor Q ultimately decided to reduce his Madoff investment substantially and put the proceeds into Gabriel and one other hedge fund, basing his decision in part on the Gabriel quarterly reports Merkin provided him with. Merkin did not disclose that, by investing in Gabriel, Investor Q was actually re-investing some of his funds with Madoff, and with the added cost of Merkin's management and incentive fees. Investors like Investor Q were surprised to discover in December 2008 that their Madoff exposure was a far larger than they had desired or planned. Another such investor wrote to Merkin: "I was very distressed to hear that Madoff was in our

Gabriel portfolio. . . . [W]e never, ever would have invested in Gabriel had we been properly advised of the Madoff investment. The last thing we expected was to add to our present Madoff holdings. I certainly should have been advised from the beginning of our investments and also in subsequent annual reports. In addition, we paid a charge of 1.5% which we never paid at Madoff.” (Ex. 43.)

IV. MERKIN FAILED TO CONDUCT ADEQUATE DUE DILIGENCE IN THE FACE OF CLEAR WARNING SIGNALS FOR FRAUD

106. Merkin, in a pattern of conduct that, viewed in the most charitable light, was reckless, ignored numerous warning signs that investing with Madoff presented a high risk of fraud. By failing to do adequate due diligence on Madoff’s operations and ignoring these warning signs, Merkin (a) breached his fiduciary duties to Non-Profit Organizations A, C, and G as a board member or investment advisor; (b) breached his fiduciary duties to all the investors in the Merkin Funds as investment advisor to the funds; and (c) caused representations he made to investors concerning his ongoing due diligence and oversight of outside money managers to be false and misleading.

107. Merkin admitted in his testimony that he was aware of a number of people who were suspicious of the returns Madoff claimed to achieve, stating that “[t]here were over time persons who expressed skepticism about one or another aspect of the Madoff strategy or the Madoff return.” (Ex. 1, at 23:7-10.)

108. Three of Merkin’s closest and most respected associates told Merkin repeatedly, throughout the time he invested with Madoff, that Madoff’s returns were too good to be true and therefore suspicious. They were also troubled by Madoff’s secrecy and other features of his money management business that were classic warning signs for fraud. Teicher, whom Merkin respected and trusted enough to manage Ariel’s and Gabriel’s portfolio for most of the period

from 1988 to 1999, strongly advised Merkin against investing money with Madoff in the early 1990s, and repeated his views many times thereafter. Teicher believed that the combination of low volatility and high returns that Madoff reported was inconsistent with what could possibly take place in reality, and was therefore suspicious that the returns weren't real. At least one of Merkin's employees recall hearing Teicher tell Merkin, in words or substance, that Madoff might be a scam or a Ponzi scheme. (Ex. 21, at 52-54.) Teicher also told Merkin that he was troubled by the fact that Madoff's trade confirmations, rather than arriving on a daily basis for each day's trades, were sent several days later. But Merkin's financial incentive to keep funds with Madoff blinded him. After Madoff's arrest on December 11, 2008, Teicher wrote to Merkin that "I guess you did such a good job in fooling a lot of people that you ultimately fooled yourself," notwithstanding the "obvious clues" for fraud. (Ex. 44.) Teicher reflected in another email that Merkin had "paid a big price for a lesson on the cost of being greedy." (Ex. 45.)

109. Two investors—one, a former chairman of a major Wall Street firm and major figure in the hedge fund industry ("Investor R"), and his son, Investor O, repeatedly told Merkin through the 1990s and 2000s that they were suspicious of Madoff, having earlier liquidated their own brief investment with Madoff. Investor R, now deceased, invested some family funds in Gabriel in the 1990s, and later invested additional personal funds on behalf of family members. At least a portion of those funds remain invested with Merkin to the present. Investor O has served with Merkin on the Investment Committees of more than one charity. Investor O did not know anything about Merkin's Ascot fund until after Madoff's arrest.

110. Unrelated to his investment with Merkin, Investor R was introduced to Madoff in approximately 1991, and made an investment directly with him. About a year later, he asked his son to review the account statements and trading tickets from Madoff to try to understand how

Madoff earned profits for his investors. Neither Investor R nor O, despite their extensive investment experience, was able to get comfortable with how and why Madoff's strategy worked. They visited Madoff at his office in 1992 or 1993 to obtain information about how Madoff managed their money and achieved his reported returns. Madoff was clear in discussing his market-making operation, but Investors R and O were troubled by Madoff's vague answers to questions concerning his money management strategy. For example, Madoff answered questions about the allocation of profits among investors with words to the effect that "it works out in the end."

111. Based on these warning signs, Investor R cashed out his investment from Madoff, despite having realized a return of approximately 18% in less than two years.

112. Later, Investor O learned that Madoff had begun the practice of exiting all investments and holding only Treasury bills at the end of each quarter. He viewed this as an important warning sign, since he could see no reason why any trading strategy would involve consistently exiting the market at the end of every quarter other than to reduce transparency. At least some of the time, investment conditions and opportunities would be expected to span the days between the end of one quarter and the beginning of the next.

113. Investors R and O told Merkin many times the reasons that they would not invest with Madoff. When Merkin would express confidence that Madoff was trustworthy, both had asked Merkin why Madoff used a small, unknown accounting firm if that was indeed the case. In the context of Investor O's service with Merkin on investment committees of non-profit organizations, Merkin would sometimes point out that other non-profit organizations were getting excellent returns by investing with Madoff. When Investor O started to raise his

objections to investing with Madoff, Merkin would end the discussion by saying he had already heard the objections from Investor O's father.

114. Despite knowing that Investors R and O strongly objected to investing with Madoff, Merkin never told Investors R and O that a substantial portion of Gabriel's assets were held by Madoff. Indeed, Investor O learned only after Madoff's arrest that Gabriel had any money invested with Madoff, notwithstanding his careful scrutiny of the quarterly reports he received from Merkin. And despite these repeated warnings, Merkin failed to take appropriate steps to safeguard the billions he was feeding to Madoff.

115. Within the investment community, suspicions about Madoff's strategy and returns were widely reported. In May 2001, Barron's published an article discussing the remarkably steady returns purportedly achieved by Madoff. (Ex. 46.) The newsletter MAR/Hedge published a similar article, entitled "Madoff tops charts; skeptics ask how," the same month. (Ex. 47.) The Barron's article discussed the belief of many hedge fund professionals and options strategists that Madoff could not achieve the returns he reported—an average annual return of 15% for the preceding decade—using the strategy that Madoff described. In addition to the suspicious consistency of Madoff's high returns, the article discussed several other warning signs that suggested Madoff might be committing fraud, including Madoff's secrecy and the inability of "more than a dozen hedge fund professionals, including current and former Madoff traders" to duplicate Madoff's returns using his strategy. Merkin's in-house counsel emailed Merkin a copy of the Barron's article on May 6, 2001 (Ex. 46), and Merkin also had a copy of the MAR/Hedge article. Seven years later, Merkin still had copies of both of these articles in his files.

116. Merkin, to a greater extent than many of Madoff's direct investors, had personal knowledge of the many warning signs for fraud:

- Merkin knew that Madoff reported trades using paper trade confirmations sent to investors by mail, without providing any form of electronic real-time access, even though Madoff's firm pioneered electronic screen-based trading in the 1970s and 1980s and claimed that it used the most advanced technology. This practice made it possible for Madoff to manufacture trade tickets reflecting near-perfect market timing.
- Merkin knew Madoff's family, and knew that Madoff family members occupied the most senior positions in Madoff's firm, including Bernard's brother Peter (director of trading and general counsel); his sons Mark and Andrew (Directors of Trading), and his niece Shana (a compliance lawyer).
- Merkin knew that Madoff maintained strict secrecy about his management of money entrusted to him.
- Merkin knew that Madoff consistently converted all holdings to Treasuries at the end of each quarter, a practice that, in light of Madoff's claim that his strategy depended on entering and exiting the market when the conditions were likely to render his strategy profitable, had no legitimate purpose other than to reduce transparency.
- Merkin knew of the unusual long-term stability of Madoff's alleged returns, and that other sophisticated investors had themselves been unable to achieve those returns using Madoff's stated strategy.
- Merkin knew the identity of Madoff's accounting firm, and knew (or was reckless in not knowing) that it was a small, unknown accounting firm in Rockland County occupying a 13' by 18' office and employing only two professionals—a 78-year-old living in Florida and a 47-year-old accountant whose wife worked for Madoff—rather than a recognized audit firm.
- Merkin knew that Madoff was self-clearing, that is, that he initiated and executed all trades and had custody of the securities he purchased, a failure to segregate responsibilities that increased the risk of fraud.

117. Merkin knew that Madoff charged no fees of any kind for his money management services, and that Madoff claimed that his only compensation was the normal commissions generated by his trades—commissions he could have earned if his clients directed the trading themselves:

Q. How did you, given . . . your understanding of the business as someone who runs one, how did you understand Mr. Madoff to make money just on charging commissions?

- A. I'm not sure what the question is, but Mr. Madoff charged commissions, was paid the commissions and like any other broker-dealer made money off of those trades, off of the execution of those trades.

(Ex. 1, at 44:12-22.) Merkin, who himself charged the standard hefty management and incentive fees for the money he purported to manage, should have recognized that a willingness to do something for nothing was suspicious.

118. Merkin is a graduate of Columbia College and Harvard Law School and an experienced money manager with a long history in the industry. The significance of these warning signs should have been apparent to him. Yet Merkin did no due diligence on Madoff beyond talking to Madoff on the phone and reviewing the trade confirmations and monthly statements Madoff created.

119. Thus although Merkin was fully aware of the many warning signs that caused investors to be concerned about investing with Madoff, and although Madoff did not provide reasonable answers to those concerns, Merkin continued to let Madoff secretly control approximately \$2.4 billion in funds entrusted to him.

V. MERKIN'S SELF-DEALING

120. Merkin also has an economic interest in several investment funds other than Ascot, Ariel, and Gabriel. He is a limited partner of Spring Mountain Capital, L.P. ("SMC"), which manages the Spring Mountain family of hedge funds, and receives 47% of the profits of SMC. Since July 2002, GCC has managed an account for Millennium Partners, L.P. ("Millennium"), the manager of the Millennium family of hedge funds. As of 2008 the account had a value of approximately \$250 million. In return for managing this account, GCC receives an annual management fee of 1.5% of assets under management and an annual incentive fee of

15% of profits. Millennium was also an investor in Ascot from 2002 through 2005, and Merkin received a management fee in connection with that investment.

121. Merkin sat on the investment committees of Non-Profit Organizations A and C, and served as an investment advisor for another non-profit organization (“Non-Profit Organization G”). As a fiduciary of these organizations, Merkin had a duty to disclose any conflict of interest he had in connection with investments they made. However, Merkin did not disclose the conflict of interest he had, in the form of additional compensation or profits he would receive, with respect to investments these organizations made in SMC and Millennium funds.

122. Non-Profit Organization A made investments in both SMC and Millennium while Merkin was on its investment committee, but Merkin did not disclose his conflict of interest and did not recuse himself from discussions of or voting on those investments. Indeed, when pointing out that Non-Profit Organization A was benefiting from the advice of some of New York’s most successful fund managers by having them sit on the Investment Committee, Merkin went so far as to state at one meeting of the committee that “sometimes conflicts of interest are good because you want competent investment professionals to serve as Committee members.” (Ex. 48, at 4.)

123. Merkin also did not disclose his conflict of interest when Non-Profit Organization G made an investment in an SMC fund. Merkin informally advised Non-Profit Organization G concerning its investments, becoming such a regular presence at Investment Committee meetings that he was referred to as the Chair in the minutes, whether or not he had formally been elected to that position. The organization generally followed Merkin’s advice in the investments it made, including with respect to his recommendation that they invest in Ascot. By serving as an

investment advisor to this organization, Merkin created a special relationship of trust such that he was its fiduciary. In 2003, Merkin recommended approximately 13 funds to Non-Profit Organization G, including Ascot and two Spring Mountain funds. Merkin did not disclose to Non-Profit Organization G his financial interest in the Spring Mountain funds.

124. Madoff and Merkin were friends, and both were on the Board of Trustees of Non-Profit Organization A, which had a large investment in Ascot. Investors in Merkin's Ascot funds paid Merkin an annual management fee, but those who invested with Madoff directly did not. Merkin breached his fiduciary duty to Non-Profit Organization A by accepting its investment in Ascot, and the management fees that came with it, when Merkin and Madoff could easily have arranged for a direct investment with Madoff.

125. Merkin completely controlled and dominated GCC and each of the Relief Defendants. He also commingled his personal funds with the funds of GCC. Management and incentive fees from the domestic funds Ascot and Gabriel are payable to Merkin personally, but Merkin routinely deposited these fees—totaling approximately \$185 million—into GCC brokerage and bank accounts. The fees Merkin deposited included fees based upon Madoff's fictitious returns on Ascot and Gabriel funds. Merkin also moved tens of millions of dollars unrelated to Ascot, Ariel, and Gabriel fees and expenses through the GCC accounts, depositing other personal and family monies, making loans to himself or family trusts, making investments on his own behalf, and depositing income from other funds and ventures in which Merkin plays a role. Merkin used GCC funds to make purchases for his personal benefit, including purchases of over \$91 million of artwork for his apartment. Merkin also used his fees from the domestic funds to pay expenses and fees related to the management of the offshore fund, Ariel, in order to avoid the tax consequences of recognizing offshore income. As a result of this commingling of

funds and the use of corporate funds to pay for personal items, the Attorney General does not have a complete accounting of the financial benefit Merkin received and will receive from Ascot, Ariel, and Gabriel, of Merkin's financial condition, or of Merkin's ability to provide restitution to defrauded investors.

CLAIMS

FIRST CAUSE OF ACTION

(Securities Fraud – General Business Law § 352 and 353)
(As to Defendants Merkin and Gabriel Capital Corporation)

126. The Attorney General repeats and re-alleges paragraphs 1 through 120 herein.

127. The acts and practices of the Defendants alleged herein violated Article 23-A of the General Business Law, in that they constituted fraudulent practices as defined in General Business Law § 352.

SECOND CAUSE OF ACTION

(Securities Fraud – General Business Law § 352-c(1)(a))
(As to Defendants Merkin and Gabriel Capital Corporation)

128. The Attorney General repeats and re-alleges paragraphs 1 through 122 herein.

129. The acts and practices of the Defendants alleged herein violated Article 23-A of the General Business Law, in that they involved the use or employment of a fraud, deception, concealment, suppression, or false pretense, where said uses or employments were engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation, or purchase within or from this state of securities.

THIRD CAUSE OF ACTION

(Securities Fraud – General Business Law § 352-c(1)(c))
(As to Defendants Merkin and Gabriel Capital Corporation)

130. The Attorney General repeats and re-alleges paragraphs 1. through 124 herein.

131. The acts and practices of the Defendants alleged herein violated Article 23-A of the General Business Law, in that Defendants made, or caused to be made, representations or statements which were false, where (i) they knew the truth, or (ii) with reasonable efforts could

have known the truth, or (iii) made no reasonable effort to ascertain the truth, or (iv) did not have knowledge concerning the representations or statements made, where said representations or statements were engaged in to induce or promote the issuance, distribution, exchange, sale, negotiation, or purchase within or from this state of securities.

FOURTH CAUSE OF ACTION
(Non-Profit Corporation Law §§112, 717, and 720)
(As to Defendant Merkin)

132. The Attorney General repeats and re-alleges paragraphs 1 through 126, above.

133. Defendant J. Ezra Merkin failed to discharge his duties as an officer or director of the Merkin-Affiliated Non-Profits with that degree of care, diligence and skill that an ordinary prudent person in his position would exercise when he (a) collected a personal benefit from the Ascot out of investments made by Non-Profit Organizations A, C, and G; (b) failed to disclose that, rather than earning his management fee by actively managing these investments, he simply turned over all or a significant portion of those investments to others, including Madoff and/or BMIS; (c) failed to make diligent inquiry into the risks of investing with Madoff and/or BMIS; (d) ignored numerous indications that Madoff and/or BMIS were engaging in fraud; and (e) failed to disclose conflicts of interest in connection with investments by non-profit organizations in funds managed by SMC and Millennium.

134. By engaging in the foregoing conduct, defendant Merkin breached his fiduciary duties in violation of Sections 112, 717, and 720 of the N-PCL and is liable for damages caused by his breaches of duty.

FIFTH CAUSE OF ACTION
(Breach of Fiduciary Duty to Investors)
(As to Defendants Merkin and Gabriel Capital Corporation)

135. The Attorney General repeats and re-alleges paragraphs 1 through 129, above.

136. Defendant Merkin, as the General Partner and Manager of the Funds, utterly failed to supervise, monitor and manage the investments of Ascot, Ariel, and Gabriel when he failed to disclose that, rather than earning his management fee by actively managing these investments, he simply turned over all or a significant portion of those investments to others, including Madoff and/or BLMIS; (b) failed to make diligent inquiry into the risks of investing with Madoff and/or BLMIS; and (c) ignored numerous indications that Madoff and/or BMIS were engaging in fraud.

137. By engaging in the foregoing conduct, defendant Merkin breached his fiduciary duties to his investors under New York common law, and is liable for disgorgement of compensation and damages caused by his breaches of duty.

SIXTH CAUSE OF ACTION
(Persistent Fraud or Illegality – Executive Law § 63(12))
(As to Defendants Merkin and Gabriel Capital Corporation)

138. The Attorney General repeats and re-alleges paragraphs 1. through 132 herein.

139. The acts and practices alleged herein constitute conduct proscribed by § 63(12) of the Executive Law, in that Defendants engaged in repeated fraudulent or illegal acts or otherwise demonstrated persistent fraud or illegality in the carrying on, conducting or transaction of business.

WHEREFORE, Plaintiff demands judgment against the Defendants as follows:

A. Enjoining and restraining Defendants, their affiliates, assignees, subsidiaries, successors and transferees, their officers, directors, partners, agents and employees, and all other persons acting or claiming to act on their behalf or in concert with them, from engaging in any conduct, conspiracy, contract, or agreement, and from adopting or following any practice, plan, program, scheme, artifice or device similar to, or having a purpose and effect similar to, the conduct complained of above;

B. For an accounting of all fees or other compensation received, directly or indirectly, in connection with managing, advising, or consulting with any investment fund, or the marketing of any investment fund to investors.

C. Directing that Defendants, pursuant to Article 23-A of the General Business Law and Section 63(12) of the Executive Law and the common law of the State of New York, pay all restitution and damages caused, directly or indirectly, by the fraudulent and deceptive acts complained of herein;

D. Directing that Defendants pay Plaintiff's costs, including attorneys' fees as provided by law;

E. Enjoining Defendant Merkin from serving as a Board Member, Trustee, Director, or Officer of any non-profit organization, or from serving in any manner, formal or otherwise, as an investment manager or advisor to any non-profit organization;


F. Enjoining Merkin from any employment, consultation, or unpaid service as an investment manager or advisor, and enjoining Merkin from serving as a general partner, managing partner, officer, or director of any investment fund, or otherwise managing the investments of others;

G. Directing such other equitable relief as may be necessary to redress Defendants' violations of New York law; and

H. Granting such other and further relief as may be just and proper.

Dated: May 28, 2009
New York, New York

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