JPMorgan Exited Madoff-Linked Funds Last Fall

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Bernard Madoff arrived at court on Jan. 14. Months before Mr. Madoff's arrest, JPMorgan Chase took money out of hedge funds linked to him.

JPMorgan Chase says that its potential losses related to Bernard L. Madoff, the man accused of engineering an immense global Ponzi scheme, are "pretty close to zero." But what some angry European investors want to know is when the bank cut its exposure to Mr. Madoff — and why.

As early as 2006, the bank had started offering investors a way to leverage their bets on the future performance of two hedge funds that invested with Mr. Madoff. To protect itself from the resulting risk, the bank put $250 million of its own money into those funds.

But the bank suddenly began pulling its millions out of those funds in early autumn, months before Mr. Madoff was arrested, according to accounts from Europe and New York that were subsequently confirmed by the bank. The bank did not notify investors of its move, and several of them are furious that it protected itself but left them holding notes that the bank itself now says are probably worthless.

JPMorgan Chase's headquarters in Manhattan. A spokeswoman said the bank "became concerned about the lack of transparency" as it reviewed its investments linked to Bernard Madoff.

A spokeswoman, Kristin Lemkau, said the bank withdrew from the Madoff-linked funds last fall after "a wide-ranging review of our hedge fund exposure." Ms. Lemkau acknowledged, however, that the bank also "became concerned about the lack of transparency to some questions we posed as part of our review."

Investors were not alerted to the move because, under sales agreements, the issues did not meet the threshold necessary to permit the bank to restructure the notes, she said. Under those circumstances, she added, "we did not have the right to disclose our concerns."

That doesn't satisfy some investors. As they see it, they were the first people who should have been alerted to the bank's concerns. "Instead, we continued to pay our fees to the bank and remained the only ones exposed to the risks that JPMorgan did not want to assume," said the chief asset manager of an Italian investment firm, who declined to be identified because of potential litigation.

The tale began several years ago when a unit of JPMorgan Chase in London issued a series of complex derivatives that gave investors a way to triple their bets on the Fairfield funds, whose solid consistency mirrored the track record that had quietly — and ruinously — drawn investors to Mr. Madoff for decades.

Leveraged notes issued by big banks like JPMorgan Chase and Nomura became conduits through which fresh money flowed from institutional investors into the Fairfield Sentry and the euro-based Fairfield Sigma funds, both run by the Fairfield Greenwich Group — and, in turn, into Mr. Madoff's hands.

The arrangement worked like this: Investors put up cash to buy the notes from the bank. In return, the bank promised to pay them up to three times the future earnings of the Fairfield funds. When the notes matured in five years, assuming the funds did well, these investors would get more than if they had invested in the funds directly. The bank collected just under 2 percent in fees, investors said.

Some wonder if JPMorgan saw trouble brewing and got its London unit, above, out of two hedge funds before the storm.

And because the bank had to hedge its entire risk, it put up to three times the face amount of the notes into the Fairfield funds. Thus, Fairfield Greenwich got more cash to manage than it otherwise would have, increasing its own fee income. To reward note-holders for making that possible, Fairfield paid them a so-called rebate of a fifth to a third of a percentage point a year, according to documentation of those transactions.

The first sign of trouble came in early October, when Fairfield Greenwich notified investors that it would no longer pay them rebates.

The reason, according to the Italian asset manager, was that JPMorgan Chase had “suddenly cashed out” of the Fairfield funds. “The official explanation was that there had been a strategic decision to get out of all hedge funds,” the asset manager said. “The Fairfield official was quite upset.”

Several other European money managers said they were told the same thing.

A spokesman for Fairfield Greenwich declined to comment on the bank’s actions last fall, citing restrictions imposed by the beleaguered firm’s lawyers.

Given the turbulent times, the Italian asset manager said he thought the bank urgently needed to raise cash. That seemed the only way to explain why the bank would pull out of a fund that was up 5 percent when other major market indexes were down 30 percent, he added.

A source close to JPMorgan Chase, however, recalled bank officials saying that the bank’s “due-diligence people had too many doubts” about the performance of the underlying funds.

“They felt the consistency of its performance wasn’t any longer credible” given the downturn in the overall market, the source said. He added: “Just three months before that, I remember that they were ready to issue more notes.”

Some investors now note that Mr. Madoff maintained several accounts with JPMorgan Chase, and wonder if the parent bank saw trouble brewing in those accounts and got its London affiliate out of Fairfield before the storm hit.

The Italian asset manager's colleague, the firm's chief institutional adviser, said, "Since I heard about Madoff's arrest, I have been wondering if it was just a tremendous stroke of luck — or if there was something JPMorgan in New York knew that led London to cash out." Told on Tuesday about the bank's explanation for its move, he added, "Now that I know why they say they got out, my doubts increase."

Did the bank use its access to the Madoff checking accounts to detect trouble before his arrest? "Absolutely not," Ms. Lemkau said.

In any case, banking authorities say there is nothing wrong with a bank looking into a customer's checking account to get information for its other lines of business.

"It is routine for the bank to look into your checking account if you apply for a loan — so why couldn't they look into your account if someone else applies for a loan whose risks are tied up with you?" said Stuart I. Greenbaum, a banking specialist who is the retired dean of the Olin Business School at Washington University in St. Louis.

He added, "Still, I suspect that's worth a lawsuit somewhere."

One of the key tests in court would be whether investors could show that they were harmed by anything the bank did or failed to do last fall, or whether any other course of action would have simply made things worse, said Charles Mooney Jr., a law professor at the University of Pennsylvania. "If I were the bank's lawyer, those are the questions I'd ask — and the answers are far from clear," he said.

Investors say the bank should have done a better job of investigating the Fairfield funds before it issued the notes. Another European investment manager, who also declined to be identified because of potential litigation, says he decided to purchase the notes for his clients partly on the strength of the bank's reputation.

He said that when he saw JPMorgan Chase "put its brand name" on the Fairfield notes, "I thought that there was no more reason to remain cautious." He added, "For me, the JPMorgan notes were the final imprimatur of Sentry's financial soundness."

What has upset him and other investors interviewed about their stake in the notes is that they did not know that JPMorgan Chase had already exited from Fairfield, almost unscathed, without notifying them.

"We looked at the prospectus and concluded that they had no obligation to do that," the Italian asset manager said. "But I certainly expected it, after such an unusual move."

After JPMorgan started pulling out of Fairfield, with credit markets in disarray everywhere, the quoted price of the notes fell by about 12 cents on the dollar, a discount that discouraged some investors from selling because the price seemed at such odds with the Fairfield Sentry fund's continued good performance.

An executive with a Swiss financial advisory firm said that he had placed an order to redeem some notes at the end of October. But when he found out how low the quotes were, he said, “I immediately placed a stop to the withdrawal — a decision that, after Madoff’s arrest, I haven’t stopped regretting.”

His regrets seem to be justified. Some buyers of the notes face the loss of their entire investment.

In a letter dated Dec. 31, 2008, Timothy R. Hailes, a managing director and associate general counsel for the bank in London, notified investors that Mr. Madoff had been arrested and that his firm was being liquidated by regulators. These events activated provisions in the terms of the notes that allowed the bank to substitute some other asset for the Fairfield funds, which “may have a considerable impact on the value and the amount payable” to investors, according to those contracts.

Investors said that the bank had not provided any further information about their potential losses, even when asked for updates. “As of today, I still do not know if JPMorgan attributes any value to those notes,” said one European money manager.

About two-thirds of the Fairfield-linked notes the bank issued were guaranteed against principal loss, according to the bank. But the bank said the owners of the remaining notes, like all the investors cited here, had probably lost their entire stake. That would mean a loss the bank puts at about $30 million but that investors say could be much larger.

“We believe the notes that are not guaranteed are now valued at zero,” said Ms. Lemkau, although investors “could reach some recovery through bankruptcy proceedings.” In any case, she added, “The risks were fully explained to clients in the purchase agreements.”

If the bank had withdrawn almost $250 million directly from Mr. Madoff’s firm, Bernard L. Madoff Investment Securities, the bank would be subject to federal bankruptcy rules that give the court-appointed trustee leeway to recover money paid out over the previous year and use it to repay creditors. It is less likely that a similar withdrawal from Fairfield Greenwich would be within the trustee’s reach, but the question is certain to be posed in litigation, several lawyers said.

“I would consider it a probable development,” said the source close to JPMorgan Chase. “Especially with a redemption so close in time to Madoff’s arrest.”